Understanding the Dragon – China’s Changing Dairy Market
Typical North China Breakfast
baozi

Typical Central/East China Breakfast
ci fan tuan

Typical South China Breakfast
mantou
congee
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Introduction – Orrani Consulting
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KEY MESSAGES
Key Messages

• China remains *the* strong international market prospect for dairy trade & investment
• Those who get involved most closely may get fingers burnt but will benefit most over time
• Crisis & market shake-up increases opportunities for engagement with local industry
INTRODUCTION
– ORRANI CONSULTING
Orrani Consulting – Background

- International dairy sector strategic consulting/research
- Established 1993, independent 2003
- Based UK (Bath) & US (VA)
- Global multidisciplinary network of sector specialists (marketing, policy, economics, technology, nutrition)
- Objective – to provide customers with specialist, independent, confidential resource for exploring issues, developing/refining strategies & plans
- Background, testimonials – [www.orrani.com](http://www.orrani.com)
- China dairy project experience since 1990
Dairy Products China News

- Hard market to track (language, scale, complexity, cost)
- Objective – to provide regular update on events behind the headlines in the Chinese market
- Partnership with CCM International
- Newsletter customers are leading dairy:
  - Processors, exporters, traders, export organisations, suppliers, investors
  - Based mainly China, US, Europe, Oceania
Trade Situation/Trends
China’s Key Dairy Imports, 2005-2008

Tonnes

2005 2006 2007 2008

187,497 184,548 66,576 211,371

61,649 67,449 51,212 55,649

44,487 28,635 23,781 43,939

0 50,000 100,000 150,000 200,000 250,000

SM P
WMP
Whey Powder
Lactose
China’s Key Dairy Suppliers, 2008

New Zealand - 19%
France - 14%
Australia - 11%
Netherlands - 6%
Germany - 3%
Finland - 2%
Others - 6%
US - 37%
NZ Exports to China

- Fonterra – record quarter of exports to China
- Plus strong SMP sales to China, ex-NZ & ex-US

![NZ Exports of WMP (FCMP) to China, 2008](chart.png)
China’s Key Dairy Powder Imports – Early 2009

<table>
<thead>
<tr>
<th></th>
<th>Tonnes</th>
<th>% +/- (vs 2008)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jan</td>
<td>Feb</td>
</tr>
<tr>
<td>SMP</td>
<td>3,631</td>
<td>3,946</td>
</tr>
<tr>
<td>WMP (FCMP)</td>
<td>18,741</td>
<td>15,048</td>
</tr>
<tr>
<td>Whey powder</td>
<td>18,697</td>
<td>19,394</td>
</tr>
<tr>
<td>Lactose</td>
<td>3,200</td>
<td>5,501</td>
</tr>
</tbody>
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Market Challenges
Melamine Crisis

• Timeline:
  - Melamine in Sanlu infant formula, no action! – March 2008
  - Scandal breaks at Sanlu – 2 August 2008
  - Fonterra involves NZ government – 5 September 2008
  - Sanlu production halted – 12 September 2008
  - Sanlu bankruptcy application accepted – 25 December 2008
  - State compensation plan operational – 1 January 2009
  - Convictions of key Sanlu personnel – 22 January 2009 (upheld 26 March 2009)
  - Sanlu bankruptcy approved – 12 February 2009
  - Sanyuan acquires most Sanlu assets – 4 March 2009
  - Further Sanlu assets auctioned off – 7, 9 & 13 April 2009
Other Food Crises

• Some examples from recent years:
  ✓ Eggs: 2006 – Sudan red carcinogenic dye
  ✓ 2007: SFDA head executed; melamine in pet food scandal

• 2009....so far:
  ✓ Infant formulae: Wei Chuan, Danone Dumex, Wyeth
  ✓ Mengniu: safety of OMP in drinking milk questioned
  ✓ Goat milk powder: 8 “foreign” brands revealed as “local”

• Not all allegations proven, many very questionable – but damage done
Market Shock – Economic Crisis

• Problems abound:
  ✓ 2009 GDP growth likely closer to 6% than 12-13%
  ✓ March exports down 25.7%
  ✓ Imports down, trade surplus almost disappeared, rising unemployment

• Hunt on for “green shoots” of recovery
  ✓ Economy less directly affected by financial crisis than many
  ✓ Industrial output in March +8.3% (first growth in 6 months)
  ✓ Credit expansion underway (record bank loans in March)
  ✓ China: no. 2 in world economy in 2009, no. 1 in 2020’s?

• Premier Wen Jiabao: 2009 “most difficult year of past 30”
Market Response
Market Response
– Sector Trends: Pasteurized Milk

• Fresh milk led until mid 1990s
• UHT dominant 2002-2008
• Increasing trend to pasteurized milk
  ✓ Most pasteurized processors avoided melamine scandal
  ✓ Is UHT recombined from melamine-contaminated milk powder?
  ✓ Recommended as fresher, with higher nutrient content
• New pasteurized milk quality association to support this trend (greater regulation, coordinated promotion)
Market Response
– Sector Trends: Alternative Milks

• Soy milk boom
  ✓ Vitasoy Q4 sales +100% vs Q3, capacity expansion underway
  ✓ Blue Sword building new plant in Sichuan
  ✓ New players: edible oil co. Yihai acquires/expands Chenxingdao brand
  ✓ High potential – low per capita consumption vs HK, SE Asia

• Goat milk
  ✓ Niche, but consumption levels have doubled
  ✓ Some capacity expansions but insufficient supply a constraint
  ✓ Powder scandal – one step forward but two back?
  ✓ High potential – low per capita consumption vs HK, SE Asia

• Buffalo milk production growth
Market Response
Sector Trends: Infant Formulae

- Growth likely based on combination of:
  - Increased requirement due to changing lifestyles & expectations
  - Still low per capita – room to grow
  - Little Emperor syndrome
  - Stronger standards
  - Increased competition based on quality
  - Demographics
- During the course of this presentation…. 

340 babies will be born in the USA
1,540 babies will be born in China
Market Response
– Sector Trends: Infant Formulae

• Beneficiaries?
  ✓ Local producers taking up Sanlu share, especially in the 2nd/3rd tier cities
  ✓ Existing key players
    ✓ Mead Johnson, Danone Dumex, Nestlé
    ✓ Abbott – new plant operational in Guangzhou
    ✓ Yashili
    ✓ Synutra
    ✓ American Dairy
  ✓ Smaller but growing local manufacturers
    ✓ Beingmate – new plant in Hangzhou (2010)
  ✓ New entrants such as New Hope
Market Response
– Government Action

• Melamine test guideline introduced – December 2008
  ✓ Problem – test costs ranged between US$60-150 per sample
  ✓ Issued by AQSIQ & NDRC
  ✓ Standardizes charges (around US$87 per sample)
  ✓ Places responsibility for charges with processors (processors may not charge the MCCs, nor may the MCCs charge the farmers)
  ✓ Local government subsidies to help processors meet these costs

• New loan policies for dairy industry – March 2009
  ✓ Interest subsidies
  ✓ Payback period extended, 3 to 6 months
Market Response  
– Government Action

• **New Food Safety Law**
  - 1st draft late 2007, accelerated after melamine crisis
  - Passed 28 February, effective 1 June
  - Establishes Cabinet-level food safety commission
  - Increased severity of punishment for infringements
  - Systems to ensure & standardize product recall & compensation

• Potentially most important step yet in the trend over last 5 years for increasing regulation & factory shutdowns
Market Response
– Local Government Action

• 1st guide milk prices introduced....
  ✓ Shijiazhuang (in Hebei province, former HQ of Sanlu’s)
  ✓ Guangdong
  .... but not mandatory

• 1st standard issued (Sichuan province) for milk collection centres
  ✓ Approvals required for centre owners/management
  ✓ Scale, service radius, logistics
  ✓ Milk quality testing
  ✓ Transparent dealings with producers & processors
Market Response
– Local Government Action

• Heilongjiang – major WB bank project underway
• But developments at low level also
• Example – Guiyang City, Guizhou province
  ✓ Guizhou – minor milk producing province
  ✓ Local demand & processing capacity outgrown local supply
  ✓ Milk imported from Sichuan, some shutdowns
  ✓ Dairy expansion programme funded by
    ✓ City government (41%)
    ✓ 2 leading local processors (49%)
  ✓ Importing cattle from other provinces
  ✓ 20,000 head planned by 2010
Market Response – Industry Action

• For several years
  ✓ Industry dominated by 3 majors: Yili & Mengniu followed by Guangming Bright

• Now majors challenged (financially, market positions)
  ✓ Yili & Mengniu (much less Guangming Bright)
    ✓ Badly hit by the melamine crisis (& recent OMP issue on Mengniu’s drinking milk)
    ✓ Core strengths outside key growth sectors (pasteurized milk, infant formulae)
    ✓ Currently restructuring
    ✓ Big cut in Yili adspend on CCTV primetime for 2009 (but much higher spend from others eg Sanyuan, Firmus, Synutra)
  ✓ Smaller players seizing opportunity to grow
Market Response – Industry Action

- Sanyuan Foods’ acquisition of Sanlu
  - Sanlu: strong powder business but a surprising choice for Fonterra
  - Sanyuan: long-troubled business, strongest northern & eastern seaboard; broader product mix
  - Creates China’s no. 4 dairy business
  - Sanyuan favoured bidder (limited entanglement in melamine affair)
  - Major challenge for Sanyuan Foods – make or break?
    - 2008 sales US$170 million vs Sanlu US$1.47 billion (pre-scandal)
    - 5,000 employees vs Sanlu 8,000
    - Overcapacity or not enough milk?
Market Response – Industry Action

- Other recent investments/reports:
  - Nestlé: new Beijing R&D centre (October 2008), 2 key plant expansion plans
  - Uni-President (Taiwan): raised stake in Wondersun (lead dairy in Heilongjiang)
  - Want Want Group (Taiwan): opens new WMP/FCMP plant in Ningxia
  - Guangming Bright: sees opportunity to catch up with Yili & Mengniu
  - Yakult: budgets 19% sales growth 2009 (new capacity Guangzhou, Shanghai)
  - Wahaha: budgets 50% dairy beverage sales growth in 2009
Market Response
– Securing the Milk Supply Chain

• Increasingly widespread recognitions
  ✓ Product mix needs improving & diversifying
  ✓ Too much focus downstream, not enough upstream
  ✓ Need for increased supply

• Increasingly strong focus on supply chain issues
  ✓ Growing acceptance of third party inspection
  ✓ Greater investment in production alongside processing

• Existing processes, extra impetus from melamine crisis
Market Response – Mengniu

• Organics
  ✓ Launched Aoya farm in Hohhot, IMAR – 2005; 10,000 cows
  ✓ Currently building up Saibei Mengiu organic production at 3 farms in Hebei
    ✓ 1st farm started mid 2006, operational from May 2007
    ✓ 2nd & 3rd farms due completion 2010
    ✓ <14,000 cows, plan for 50,000 head

• Markets Deluxe organic milk
• Competing with
  ✓ Yili’s Classic & smaller brands (Fucheng, Yuanzhen, Hemeida, Green Yard)
Market Response – Mengniu

- Starts operations at Hongya farm, Sichuan
  - At Meishan, near Chengdu (pop. 10-11 million)
  - Claimed largest dairy farm in SW China – 68 hectares
  - Commencement delayed by earthquake!
  - Initial shipment 1,500 Holsteins December 2008
  - Remainder 1\textsuperscript{st} half 2009, target 10,000 head
  - Total local milk production 120,000 t/yr
    (Mengniu local plants’ capacity 180,000 t/yr)

- Other new farms include:
  - Wuhan, Hubei; Hefei, Anhui province
  - Total 7 modern farms, 20+ small farms
Market Response – Yili

• Investments in supply chain – US$73 million by 2010
  ✓ Concentration – sourcing from fewer producers
  ✓ Accelerating production of farms
  ✓ Creating DFPCs to achieve lower costs & greater flexibility

• Investments in quality control
  ✓ Melamine test equipment
  ✓ Third party inspection

• Increased transparency of operations
  ✓ Website windows into plants
  ✓ Plant visits
Conclusions & Future Prospects
World GDP & Milk Consumption
1950 - 2001

The diagram above shows the correlation between World GDP (in US$ million) and Milk Consumption (in Million tons) from 1950 to 2001. The GDP and Milk Consumption data are represented by blue and red columns, respectively. The blue columns denote GDP growth, while the red columns indicate Milk Consumption growth. The graph illustrates a clear upward trend in both GDP and Milk Consumption during this period, with GDP increasing at a faster rate than Milk Consumption.
The Upper Quartile In China

...is greater than the total population of the USA
Conclusions

• China’s economic prospects strong medium/long term
  ✓ Only political revolution can derail the country’s ongoing emergence as an economic superpower

• Hard to overestimate the pace of change in China
  ✓ China of the 1980s vs China today – an amazingly different place
  ✓ From....
    ✓ Total government control to government steered market economy
    ✓ Meat consumption >x4 since 1980
    ✓ Famine with 30 million deaths to rising obesity .... in < 50 years!

• Recent shocks experienced by the Chinese dairy industry will strengthen it, not kill it off
Conclusions

• Food industry regulation not wholly convincing yet – but significant steps in right direction
• Supply chain restructure/industrialization of dairy farming
  ✓ At variance with Government key driver for dairy development (rural poverty alleviation, political stability)?
  ✓ Impact on milk price?
• International dairy industry needs direct involvement to fully exploit market opportunity
  ✓ Crisis & shake-up increases opportunities for engagement with local industry
Future Prospects

• Strong import demand
  ✓ 2009 growth will depend on melamine recovery – will WMP demand remain?
  ✓ Medium/long term growth assured (economy permitting)

• Local industry
  ✓ Reassertion of position by key players under challenge
  ✓ Growth of some 2nd tier & smaller players
  ✓ Increasingly diverse product offer
  ✓ Greater recognition of ingredients with health/nutrition proposition

• Increased foreign investment
Future Prospects

• Caution: water scarcity a huge challenge
  ✓ Per capita water requirement for food more than trebled since 1960’s
  ✓ Per capita water availability far below global standards
  ✓ Of 650 cities, >400 considered “water short”, 300 are “acutely water short”
  ✓ Water scarcity concentrated northern China – as is dairying

• Impact on dairy production...
• ....even on trade policy, should government move towards mitigating water scarcity by encouraging import of water-intensive foods
Victory belongs to the most persevering
Napoleon Bonaparte

Opportunities multiply as they are seized
Sun Tzu
THANK-YOU