July 2, 2013

US & EU Food
China: Freedom of Choice (But Watch How You Price?)

What’s New: A report published today in the People’s Daily confirmed that the Chinese National Development and Reform Committee (NDRC) is investigating milk formula pricing practices and is holding related discussions with key foreign manufacturers (e.g., Mead, Danone, Nestle). Given the limited detail available thus far, we would not be surprised by modest weakness in the impacted companies until the scope of the investigation is clarified. However, we would caution against assuming any negative financial impact at this stage, and would also note that pricing scrutiny/intervention on the part of the Chinese government is by no means a new dynamic.

Greater scrutiny on domestic & foreign producers: Broadly speaking, it appears clear that the government is placing greater scrutiny on both domestic (to restore consumer confidence and increase competitiveness) and foreign manufacturers (to ensure compliant pricing practices). One company thus far, the local ultra-premium manufacturer Biostime, has confirmed that it is being investigated for an alleged violation of Article 14 of the country’s Anti-Monopoly law (for “managing the market sales prices at which… distributors and retail sales organization sell” their products). At this stage, it is obviously unclear whether the government’s intent is in any way to limit pricing going forward or simply ensure compliance in distributor agreements, but – as noted above – we believe the government has already exerted some pressure on pricing in recent years (for instance, urging MJN and others in 2011 to limit price increase despite significant dairy inflation).

Thoughts on the potential impact: To be clear, details are very limited thus far, so our interpretation here is based largely on our understanding of market dynamics. Our thoughts are as follows:

(i) Unclear which manufacturers could be most impacted: It remains unclear whether language in the distributor agreements of Mead, Danone or others...
Includes specific minimum prices. Our understanding is that:

(i) the companies have suggested price points for each individual SKU, but beyond this the exact mechanics of distributor agreement are not known, and

(ii) that for the vast majority of Food & Beverage categories in China, retailers/distributors have the ‘final say’ in terms of determining the selling price.

(ii) Foreign manufacturers offer an extremely wide range of products and price points, and – in our view – the Chinese consumer has, over a sustained period of time, chosen to gravitate toward premium price points. In the case of Danone, the company offers a wide range of products (from Dumex on the mainstream premium end to Karicare on the ultra-premium end), while Mead’s products are typically concentrated at what we would consider slightly above-average premium price points. Nestle’s products also cover a broad range of price points.

(iii) Foreign manufacturers have been careful to link price increases in recent years to inflation, in our view. As mentioned above, in some cases such as 2011, we believe companies such as MJN delayed passing through inflationary dairy prices at least in part to accommodate the government’s interests in limiting pricing inflation in the category. We also understand that the European players have not taken any price increases year to date in 2013.

(iv) We believe high price points have aided the rapid share gains of ultra-premium manufacturers (generally at price points above the larger foreign manufacturers), given Chinese consumers’ broad association of higher price with higher quality. In our view, any government action on this issue could potentially be focused on selected brands/manufacturers (perhaps at the higher end of the price spectrum) rather than be a broad-ranging industry action.

(v) Limited framework for benchmarking government penalties: Our understanding is that, in recent investigations involving spirits companies, the government imposed fines roughly equivalent to 1% of sales. If this were to be the case, we would see a limited financial impact (e.g., perhaps 1% of EPS or less for MJN, and immaterial for Nestle and Danone, for whom we estimate total Chinese infant formula sales are ~4% and ~5% of group sales respectively), although longer-term concerns around limited pricing power would likely linger.
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(as of June 30, 2013)

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## Industry Coverage: Food

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* Historical prices are not split adjusted.