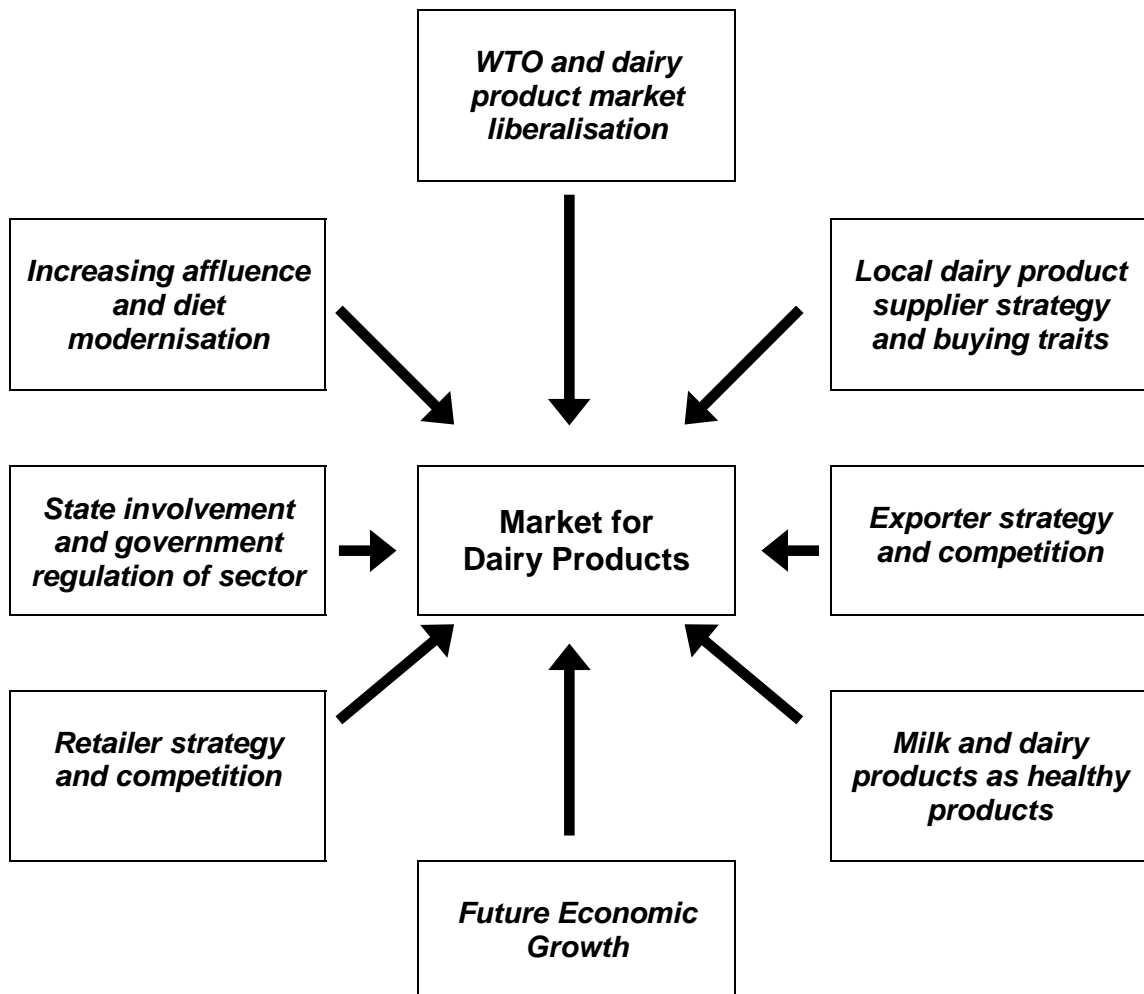


The Market for Imported Dairy Products in China - 2004 to 2009

*An Analysis of Future Strategic Opportunities
and Directions for Dairy Product Exporters*



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China today and tomorrow

China (Population: 1.26 billion) looks set to report yet another impressive economic growth rate in 2003. Current full year estimates GDP growth range for 2003 will be reported at about 9.1%. Economic growth in China is now stimulated by a combination of three forces:

- Foreign direct investment into China. This continues unabated because investors continue to be mesmerised by China's potential to become the largest consumer market in the world.
- Exports, which continue to be strong despite slow world economic conditions over the past 2 years as a result of China's status as a low cost base for export oriented manufacturers.
- Domestic consumption, which is being stimulated by favourable government policies and underpinned by increasing affluence, especially in the key urban areas. This has become increasingly important to the Chinese economy over the past 3 years.

Looking forward, China's economy is expected to continue growing at a high rate for at least the next 2 years. Available forecasts suggest that its economy should be able to grow at between 7% and 8.5% in 2004 and between 7% and 8% in 2005.

These forecasts are very positive for both new and increased existing demand from China's consumers and the industries that supply them, including the dairy processing industry and other industries that use dairy ingredients/inputs in their products. Additionally, as in the other rapidly growing Asian economies in the 1980s and 1990s, such growth will also be positive for development of markets for imported finished dairy products.

China's dairy product supply yesterday and today

China is currently producing just over 10 million tonnes of liquid milk per annum. This is supplemented by imports of dairy products, which have become increasingly important for Chinese dairy ingredient users since the early 1990s (see Table below).

| Dairy Product Consumption Mix in 1991 and 2002 (Liquid Milk Equivalent Data) | | | | |
|---|-------------------|----------|-------------------|----------|
| | 1991 | | 2002 | |
| | LME Tonnes | % | LME Tonnes | % |
| Local liquid milk production | 4,500,000 | 93 | 10,840,000 | 84 |
| Imported dairy products | 350,000 | 7 | 2,114,000 | 16 |
| Total usage in China * | 4,850,000 | 100 | 12,954,000 | 100 |

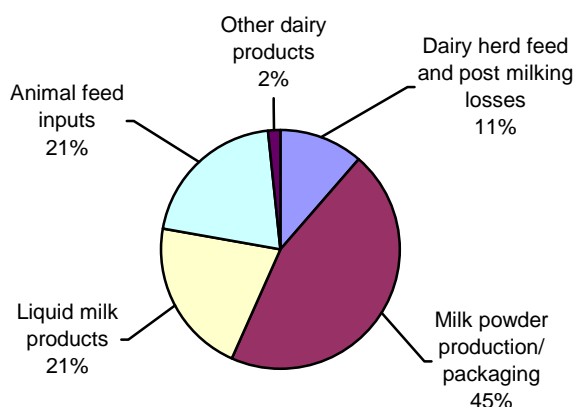
*: Includes products that are eventually exported, e.g. 139,000 LME tonnes in 2000.
 Source: Ministry of Agriculture, PRC (Converted at standard LME factors)

The Market for Imported Dairy Products in China - 2004 to 2009
An Analysis of Future Strategic Opportunities and Directions for Dairy Product Exporters

Shortfalls in a range of locally produced dairy products and the inability of China's dairy farming industry to develop at a pace similar to the growing demand for its products have seen imports take larger and larger shares of China's dairy product consumption over the past 10 years.

Today, the three largest areas of demand within the dairy product market occur in milk powder, liquid milk and animal feed production (see Chart below).

Utilisation of China's Dairy Product Supply in 2000 - 9.7 million LME tonnes *



*: LME = Liquid milk equivalent.

Source: Chinese Government (All data converted at standard LME factors)

The scenario highlighted in the Chart above has developed from a number of factors, including investment and quality control constraints in the dairy farming, processing and supply chain, pent-up demand from the animal industry for feedstuffs, and local dairy industry strategy towards development of the milk powder and liquid product markets.

What about future demand and demand criteria?

The value of China's of dairy product imports increased by close to 26% in the first 10 months of 2003, when compared to the corresponding period in 2002. The value of imports in the first 10 months of 2003 amounted to US\$ 374.7 million, up from US\$ 298.2 million in the same period in 2002.

China ranked as the world's fastest growing market for imported dairy products in the 12-month period from November 2002 to October 2003.

While growth was undoubtedly stimulated by more favourable import duties introduced after China joined the WTO in late 2001, a review of the trends in growth of specific market segments suggests that past trends are not wholly indicative of where future demand may be going. Examples of recent trends include:

- Declining imports of some finished products, e.g. infant formula and yoghurt.
- Much slower growth than in previous years for some animal feed inputs, e.g. whey powder.

- Explosive growth was seen in some segments in:
 - Finished dairy products, e.g. butter; and
 - Dairy ingredients, e.g. whey protein concentrates.

While growth in demand for imported dairy products appears to have some sense of surety over the next 5 years, because of WTO liberalisation and favourable consumer market traits, demand growth may not be as broad-based as might be assumed by outsiders, i.e. dairy product exporters. Additionally, there is evidence in China that the market has already begun to shift away from its commodity orientation to a more sophisticated market in which the key players have strong demands on service from their suppliers.

While it will be possible in the short to medium term to achieve some success by *"throwing products at the market"*, the conditions now developing in China will mean that commodity-oriented traders will ultimately be left to *"fight it out amongst themselves for the scraps in the market"*. Only well-organised exporters with a strong China-oriented business strategy will be able to participate consistently in the high volume and higher margin markets that will exist tomorrow.

This study focuses on the demand-side scenarios and basis of competition that are now developing in China's market with the objective of providing our clients with an analysis of future strategic opportunities and directions for dairy product exporters in the period from 2004 to 2009.

Who is the study written for?

Arising from enquiries received from clients in the dairy industry, this study has been specifically researched and written for Managing Directors, Marketing Directors, Export Managers and/or Business Development Managers of:

- Dairy processing and exporting companies with products already in the China market that need further information about the market structure, basis of competition and future prospects.
- Dairy processing and exporting companies with an interest in entering the China market at some stage in the future.

The report will also be useful to government officials that are involved in the promotion of their country's exports to China and policy aspects of the dairy product trade.

What does the report provide?

The report provides essential information on:

- Dairy product market size and structure today.
- Recent market development trends for imported dairy products.

- The regulatory environment and other government policies affecting the dairy product markets.
- The basis of competition of competition in the market, including identification of the key competitors, their market shares and inherent strengths and weaknesses.
- Buyer preferences and purchasing criteria.
- The distribution channels for imported dairy ingredients.
- The forces for change that will impact on the market and supply chain in future
- The barriers to market entry and expansion by dairy product exporters.
- An analysis of areas of opportunity and threat for dairy product exporters in tomorrow's market.
- Likely future trends and best prospects for imported dairy products over the period from 2004 to 2009.
- Contact details for dairy processors businesses, dairy ingredient users and importers operating in China.

Being specifically written for the busy export or international business development director, the report is not just a catalogue of statistics and fact, as are many reports that now emanate from China. Our *Asia-Dairy Series* of reports provide a practical analysis of the market, distribution channels, usage trends and forecasts.

Stanton, Emms & Sia has been preparing reports for clients about Asia's dairy markets since 1991 and has been undertaking research and consulting projects for clients in China since 1993. This report has been researched and written by senior consultants based in Asia with many years specialising in advising food and beverage companies about market development in Asia, including China.

What products are by covered in the report?

The following imported dairy products are covered by this study:

- Finished dairy products:
 - Liquid milk.
 - Dairy cream.
 - Sweetened condensed and evaporated milks.
 - Yoghurt.
 - Butter.
 - Processed cheese.
 - Natural and specialty cheese.
 - Ice cream.
 - Milk powder and infant formula.

- Dairy ingredients:
 - Skim milk powder.
 - Whole milk powder.
 - Milk powders, sweetened.
 - Buttermilk powder.
 - Whey.
 - Whey protein concentrates.
 - Anhydrous milk fat.
 - Cheese, powdered and grated.
 - Lactose and lactose.
 - Casein and caseinates.

Why do you need this report?

This report will help you:

- To gain first-hand and up-to-date knowledge and insight of China's market for imported dairy products.
- To understand the buying traits, criteria and preferences of dairy product importers in China.
- To understand who your competitors are and the basis of competition in your target markets.
- To appreciate the risks and problems associated with the China dairy market.
- To assess the prospects for imported dairy products.
- To develop your future business and marketing plans for the China market.

How to order this report

This report was published on 18th January 2004 and is available at a cost of US\$ 980.

To order the study, simply complete the order form on the following page and fax/mail it to us at the following fax number/address. On receipt of your order, a copy of the report will be sent to you securely wrapped and by courier.

Should you have any queries about the report, please do not hesitate to contact either Mr Anthony L. Emms or Ms Cindy Sia at the telephone/fax number listed below.

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1. Introduction

1.1 Scope of study and this report

This report has been prepared to provide senior management of dairy processors, exporters and marketing organisations with up-to-date insight into the future opportunities that exist for development in The People's Republic of China's market for imported dairy products over the period to 2009.

The study considers the following imported dairy products:

- Liquid milk.
- Ice cream.
- Yoghurt.
- Retail packed milk powders, including infant formula.
- Butter.
- Cheese in all forms.
- Dairy cream.
- Condensed and evaporated milks.
- Dairy ingredients, including:
 - Skim milk powder.
 - Whole milk powder.
 - Sweetened milk powders.
 - Buttermilk.
 - Whey and whey products.
 - Dairy fats and oils
 - Lactose.
 - Casein and caseinates.

The study is highly focused on dairy products and considers and analyses the following matters for each market segment:

- Market size and structure.
- Market growth patterns.
- The nature and source of supply.
- The performance of imported dairy products.
- The identity of major users and consumers.
- Sales and distribution channels.
- The forces for change on the market and industry.
- Future strategic directions for the market, and opportunities and best prospects for exporters.

It also provides insight into:

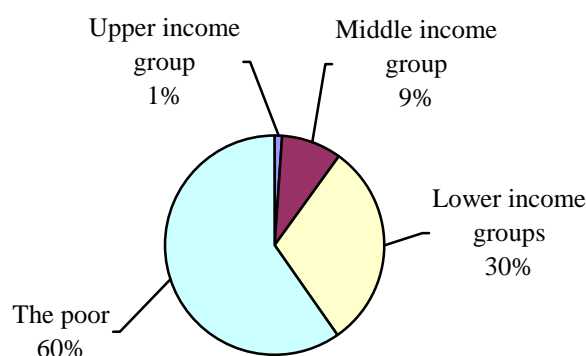
- China's development as a consumer market; and
- The regulatory environment that exists for imported dairy products in China.

The official foreign exchange rate used to translated RMB/Yuan (local currency data) quoted in this report is RMB 8.28: US\$ 1.00.

1.4.2 Review of consumer market size today

Discussions with government officials and a range of different trade sources indicate that between 80 and 120 million persons are involved in the market for branded food products, although only 10 to 15 million persons would be full participants in this market (see Chart below).

The Structure of China's Consumer Market Today - 1.28 Billion Persons



Source: Government and trade respondents (estimates)

Some key points to note when interpreting the above information:

- China's upper and middle income groups are well dispersed around China's key cities, although the key targets for marketing products to them are Shanghai, Beijing and the major urban areas of Guangdong Province, e.g. Guangzhou and Shenzhen cities.
- Conservative estimates by trade sources indicate that only about 10 million persons would rank as "super rich". They also comment that:
 - These persons earn more than RMB 200,000 (US\$ 24,200) per annum and can afford to live in a lifestyle similar to the wealthier persons in developed countries.
 - This group of persons mainly comprise businessmen, top level management with foreign-invested enterprises and financial institutions, professionals such as lawyers, real estate developers, pioneers in the high-tech industries and some well known singers, actors, fashion models and sport's personalities.
- Obtaining an accurate estimate of the numbers of persons in the middle income group is difficult, but it would appear that they now number somewhere between 60 and 100 million persons. This group includes many younger single adults who generally have about RMB 2,000 in discretionary income to spend on products other than necessities. Trade sources comment that these persons are generally indulgent and are, importantly, a growing market for branded products.

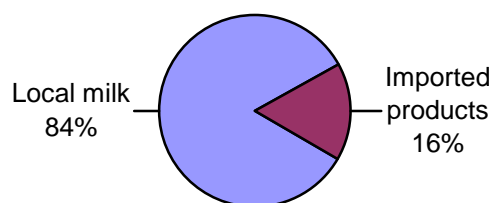
2. Dairy product supply in overview

2.1 Dairy product supply today

The Chinese market and food processing industry consumed more than 12.95 million LME (liquid milk equivalent) tonnes of dairy products in 2002 (see Chart below), up from around 4.85 million LME tonnes in 1991. This equates to an overall increase in consumption of more than 10% per annum over the period between 1991 and 2002.

Over this period per-capita consumption of milk and dairy products increased to 10.2 kilograms in 2002, up from 4.21 kilograms in 1991.

Total Milk Consumption Profile - 12.95 Million LME Tonnes (Consumer Market and Industrial Usage)



Source: Ministry of Agriculture, PRC (Converted at standard LME factors)

Local dairy products continue to dominate supplies today, as they have in the past, although there has been a gradual change in the local-import mix since 1991 (See Table below).

| Dairy Product Consumption Mix in 1991 and 2002 | | | | |
|--|------------|-----|------------|-----|
| | 1991 | | 2002 | |
| | LME Tonnes | % | LME Tonnes | % |
| Local liquid milk production | 4,500,000 | 93 | 10,840,000 | 84 |
| Imported dairy products | 350,000 | 7 | 2,114,000 | 16 |
| Total consumption | 4,850,000 | 100 | 12,954,000 | 100 |

Source: Ministry of Agriculture, PRC (Converted at standard LME factors)

While the government has implemented policies designed to boost production of local raw milk, most trade sources believe that dairy product imports will grow in future. Over the next 5 years, imports could rise to between 20% and 25% of China's dairy product consumption.

3. Dairy product consumption in China in overview

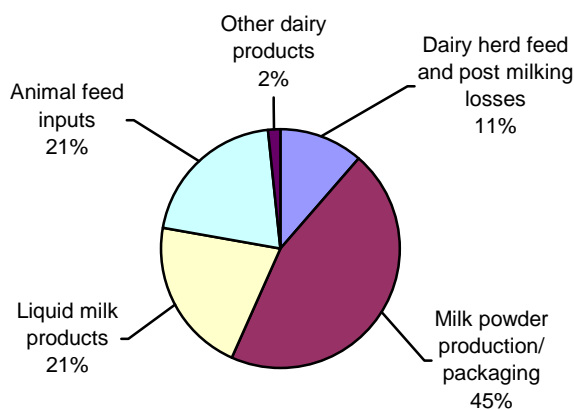
According to recently released official data, China is currently consuming/using between 13 and 14 million LME (liquid milk equivalent) tonnes of dairy products per annum, up from about 7 million LME tonnes in 1996 (see Table below).

| China's Consumption / Usage of Dairy Products - 1996 to 2002 in LME Tonnes * | | | | | | | |
|--|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | 000' LME Tonnes | 000' LME Tonnes | 000' LME Tonnes | 000' LME Tonnes | 000' LME Tonnes | 000' LME Tonnes | 000' LME Tonnes |
| Total | 7,072 | 6,890 | 7,430 | 8,319 | 9,877 | 11,806 | 12,954 |
| Per capita | 5.8 Kg | 5.5 Kg | 6.0 Kg | 6.7 Kg | 7.8 Kg | 9.3 Kg | 10.2 Kg |
| % year to year change | - | (2.5 %) | + 7.3 % | + 11.9 % | + 18.7 % | + 19.5 % | + 9.7 % |

Source: Ministry of Agriculture, National Bureau of Statistics, and Customs Department of PRC Government

The Chart below provides an overview of China's consumption/usage profile of milk and dairy products based on the last detailed survey conducted by the government.

Utilisation of China's Dairy Product Supply in 2000 - 9.7 million LME tonnes *



*: LME = Liquid milk equivalent.

Source: Chinese Government (Excludes exports and all data is converted at standard LME factors)

Discussions with officials at the Ministry of Agriculture (MOA) revealed that:

- While there has not been a dramatic change in China's consumption/usage profile for dairy products between 2000 and 2003, the trends between these years indicate that:

4.2.3 Demand traits for milk powder

In recent consumer surveys amongst the middle and higher income groups in Beijing, Shanghai and Guangzhou cities, it was found that awareness of milk powder was universally high at between 70% and 80% of 1,000 consumers in each city. Purchasing of the product was, however, much lower at 36% in Guangzhou, 33% in Beijing and 27% in Shanghai.

Trade sources comment that:

- The low purchasing level highlighted in Shanghai city survey may have arisen because this city is developing a vibrant market for liquid milk and drinking yoghurt in preference to milk powders.
- Milk powder is popular amongst families that have developed the milk drinking habit and can afford to buy it.
- Price is a very important factor and milk powders are considered better value-for-money than more expensive liquid milks.
- Additionally, although a relatively high percentage of urban households own refrigerators, powdered milk is still considered more convenient to store than liquid milk that has to be chilled, irrespective of whether it is short life pasteurised or long life UHT or sterilised milk.

Product quality is very important to housewives who buy milk powder for their families. This is especially the case in the infant formula market where mothers:

- Are very concerned about the overall quality of the product that they buy for their infants.
- Have major concerns over fake products. Counterfeit products are a major problem in some of China's food and drink market segments, especially those where sales growth has been rapid and the counterfeiters want to profit from such demand growth.
- Tend to look to "*big and well known brands*" to ensure (guarantee) that they purchase a high quality and authentic healthy and nutritious product for their children. This is one reason why foreign or international brands are now performing well in this market.

Foreign brands have already developed dominance in the infant formula market because of the above mentioned concerns of mothers. The Marketing Manager with a milk powder supplier operating in China commented:

- *"Every time we perform a survey on preferences for milk powder brands, we find that the majority of consumers prefer to buy internationally branded infant formulas rather than locally branded products.*

Our understanding now is that international brands, even those on China-made formulas, provide mothers with a perception that product quality is guaranteed and that their babies will be safe when consuming such products. There have been many scandals in the food market involving local brands so mothers are very concerned about quality and tend to rely on international or foreign brands for their babies' nutrition.

- Ice cream is one product where there are now significant concerns over sanitation and hygiene amongst the lower end producers.
- Just over 50% of China's ice cream plants can comply with its food safety standards in 2002.

Interestingly, the Ministry also reported that there are about 60 foreign-invested ice cream companies operating in China today. This situation appears to have arisen from the high levels of interest in producing certain products after the China published data in the mid-1990s that showed the demand for some products, notably beer and ice cream, were growing at spectacularly high rates.

The majority of better quality manufacturers operate in the major cities, especially Shanghai, Beijing and some of the urban areas in Guangdong Province, just north of Hong Kong. The main businesses operating in the industry today are reported to be Unilever (Wall's), Meiyile, Nestlé, Sanlu Dairy Group and Inner Mongolia Yili.

The key business and marketing strategies employed by the major suppliers include:

- The strategic placement of "branded" freezers in retailers across the target urban areas.

The most important distribution channels for ice cream are street kiosks, known as *Xiaomaibu*, and convenience stores. Trade sources comment that the Meiyile brand probably has the best distribution coverage on a nation-wide basis today.

- Pricing the products at a unit price that is acceptable to the different target markets that exist in China today.

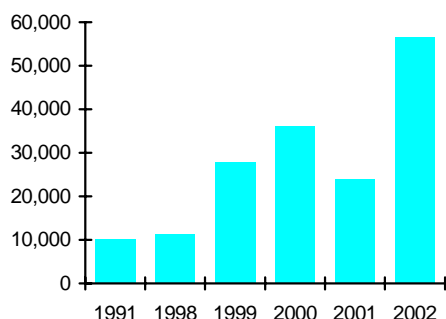
Currently, ice creams have to be sold at a unit price of less than RMB 2.00 (US\$ 0.24) in provincial cities. In more affluent cities, such as Shanghai and Beijing, a range of products with unit prices of between RMB 2.00 (US\$ 0.24) and RMB 5.00 (US\$ 0.60) are acceptable to local consumers.

- Periodic promotional activities in retail channels.
- High profile advertising, mainly by the key brandowners, especially Nestlé and Unilever that have been trying to build their markets and market share across China. Some state-owned businesses, e.g. Inner Mongolia Yili, are also developing their brands via some high profile advertising.
- Focusing on products that have a sweetness, flavour and texture that is well liked by local consumers. Over the past 5 years, the foreign manufacturers operating China have generally shifted from their original "western oriented" product portfolio to one that includes products that are more acceptable to the Chinese consumer.

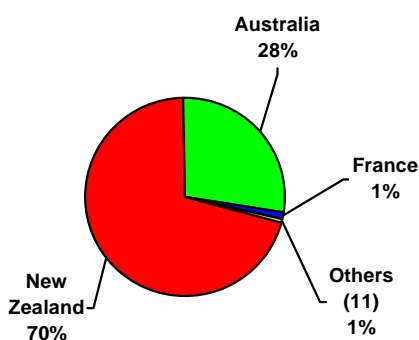
Research, development and periodic release of new flavours and product concepts into the market. This activity has also involved upgrading the portfolio of products and packaging in the market so that the Chinese brands are able to compete more effectively with internationally branded products that are also manufactured in China.

5.3.5 Whole milk powder

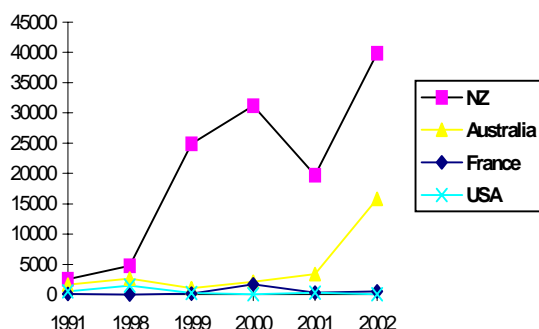
**Total Imports
(In Tonnes)**



**Key Supply Countries in 2002
(56,561 tonnes)**



**Import Trends by Key Supply Country
(Imports in Tonnes)**



Source: National Bureau of Statistics, PRC

- Whole milk powder (WMP) imports increased to 56,561 tonnes valued at US\$ 82 million (CIF value) in 2002, up from 10,099 tonnes valued at US\$ 17.4 million in 1991.
- According to trade sources, WMP currently has a preference amongst milk powder users and some major users have access to imported WMP via duty free channels, albeit that import duties are now reducing as a result of China's WTO commitments.
- New Zealand is currently the most successful and consistent player in the market, in which it has been the 'market maker' for imported WMP. Its market share has grown to 70% in 2000, up from 25% in 1991. Trade sources comment that:

 - New Zealand is the most price competitive supplier in the market (see Table on following page).
 - New Zealand has already developed strong business relationships with importers and users in China's key urban area markets.
- Up to 20 different countries supplied WMP to China over the past 5 years. Currently, other exporters in Australia, the EU and the USA are having problems competing with New Zealand because of its competitive pricing, product quality and other "first mover" advantages, e.g. service to users, it has developed since the mid 1990s. Trade sources comment that the EU currently has some regulatory barriers as a result of China's rules over food health certificates.
- The key drivers in this market are competitive price (landed cost) and a strong business relationship with Chinese importers and users.

| Purchasing criteria | Large State Owned Enterprises | Small and Medium Sized State Owned | Foreign-Invested Businesses |
|---|--|---|---|
| Location of supplier of imported ingredients and additives. | <ul style="list-style-type: none"> ▪ Direct from overseas supplier (For strategically important products). ▪ Direct from importer. ▪ From local distributor (minor products). | <ul style="list-style-type: none"> ▪ Mainly from localised distributor. ▪ In some cases, direct from the importer, e.g. in the main port cities in Eastern China. | <ul style="list-style-type: none"> ▪ Direct from importer (Major products). ▪ From local distributor (minor products). ▪ Direct from overseas supplier, if transaction has received official approval. |

The following comments were received from trade respondents with food ingredient suppliers in discussions about dairy ingredient purchasing criteria in China:

- *"The market for dairy ingredients in China is generally sensitive to price. Most food manufacturers that are attempting to develop a mass market for their products have the opinion that their end products must have a low unit price, say no more than RMB 1.00 per retail pack. For this reason, manufacturers involved in this type of business want the best quality ingredient at the lowest possible price.*

Products that are higher priced than the 'predetermined' retail price threshold for the market segment have to be sold into the very small higher income group markets that only exist in cities, such as Shanghai. These niches are not very attractive to most state-owned manufacturers because of competition with the international brands".

- *"Demand on product characteristics and quality varies widely from buyer to buyer and company to company. Today, no one really buys a high quality product and pays for it. It seems that most food manufacturers demand higher quality ingredients that they don't have to pay any additional cost for. In many cases, they are now able to obtain such a deal because over-capacity in some ingredient industries has led to price competition between local suppliers, most of which are state-owned businesses".*
- *"Many food manufacturers here do not hold large inventories of their ingredients. Because they focus on cash flow, they tend to order on a just-in-time basis, i.e. when they have the cash and when they need to produce. Also, while we attempt to plan a supply/demand scenario, our customers don't plan their purchases. I think this makes things very complicated for ingredient suppliers, especially those that don't have the inventory when they receive an order. Under these circumstances, the buyer will always go elsewhere for their supplies".*
- *"Over the past 5 years, demands for some form of service has been rising from buyers in the state-owned food manufacturing sector. Aside from various incentives which the distributor may have to pay to the buyer (sometimes referred to as 'listing fees'), the supplier may also get demands for free samples, technical support or, even, product development, which could involve new formulations or more depending on the buyer".*

7. Distribution of finished dairy products

7.1 China's food retailing industry today

China's food retailing industry is highly fragmented today. No single entity holds more than 1% of total sales. According to the National Bureau of Statistics:

- The total sales of the food retailing industry in 2002 amounted to RMB 1.8 trillion (US\$ 215 billion).
- Supermarket sales amounted to about 42% of the food retailing industry in 2002. There are more than 180,000 supermarkets operating in China, although not all of these would comply with the definition of a supermarket normally used in the Developed West.
- The largest food retailing business known as Shanghai Lianhua Supermarket, which operates over 1,900 outlets in China, had a market share of just 0.8% based on the annual sales it reported in 2002.
- The second largest businesses, Hualian Supermarket, operates about 1,100 stores and had a share of about 0.7% of total industry sales in 2001.

Trade sources comment that the largest foreign retailers operating in China today are Carrefour and Walmart, which operate 40 and 30 outlets respectively. Carrefour's sales in China were estimated by local analysts at about RMB 13 billion (US\$ 1.6 billion) in 2002.

Follow-up discussions with importers highlighted that the supermarket sector, which includes hypermarket style operations, is the most dynamic area of the food retailing industry. The sector has seen double digit growth for more than 5 years and has become very popular with the middle to upper income group shoppers in all of China's urban areas.

As a result, supermarkets and hypermarkets are the main channel for imported products that are targeting sale through retail channels. While this is the case, several importers warned that the supermarket and hypermarket channels are not open to most imports, despite China's recent WTO commitments.

This situation arises because businesses that want to obtain a licence to operate a retail store in China often have to sign an agreement with the respective local government under which they commit to selling mostly local products and only limited quantities of imports.

Local trade sources comment that these agreements can affect both local and foreign investors in the food retailing sector. As an example, in some parts of China, Carrefour was required to formally commit to carrying between 95% and 98% of China-made products before it was permitted to open new hypermarkets.

At the time of writing, no one is sure what will happen to these agreements, which appear to run counter to WTO policy, in future. Most commentators believe that they will be quite difficult to remove as most do not come under the purview of central government but are an entrenched part of the localised protectionism that prevails in some parts of China. As discussed in the regulatory section of this report, this is one area of WTO non-compliance that foreign governments and exporters will have to monitor closely over the next 5 years.

These biscuit companies and the small businesses operating European style bakeries in key cities represent the main targets for imported dairy ingredients in China's baked product industry. Trade sources comment that the main ingredients demanded by these businesses are full cream milk powder, skim milk powder, butter and, to a lesser extent, mild flavoured cheeses.

8.3.4 Other human foods using dairy ingredients

Other human foods that are manufactured in China which contain some dairy ingredients include:

- Sugar confectionery.

This is a major industry that produced close to 650,000 tonnes of product in 2002 (see Table below). Sugar confectionery is the largest segment in the China's confectionery market.

| China's Consumption of Sugar Confectionery - 1997 to 2001 | | | | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| 1997 Tonnes | 1998 Tonnes | 1999 Tonnes | 2000 Tonnes | 2001 Tonnes |
| 531,580 | 540,258 | 576,274 | 610,621 | 645,473 |
| Source: China National Food Industry Association | | | | |

According to the China National Food Industry Association, China has more than 1,200 confectionery manufacturers today and a very large number of different sugar-based products, including:

- ❑ Toffee.
- ❑ Hard boiled sweets.
- ❑ Soft chewy candies
- ❑ Lollies
- ❑ Mints
- ❑ Jelly and gummy candies, etc.

While most of the products being produced by this industry do not appear to include dairy ingredients, China's leading sugar confectionery retailed under the "White Rabbit" brand is a hard chewy creamy milk-based candy that is wrapped in rice paper. This brand is produced by Guan Sheng Yuan Food Group and is very reported to be very popular and to have controlled about 30% of China's sugar confectionery market in 2002.

China's sugar confectionery industry mainly operates out of Guangdong province, which produces about 50% of national output, Shanghai (12%) and Beijing (10%).

Apart from the above mentioned Guan Sheng Yuan Food Group, the major players in the sugar confectionery industry include:

10. Assessment of future prospects for imported dairy products

10.1 China's long term economic vision

The Chinese government's long term vision for the economy revolves around quadrupling the gross domestic product of the year 2000 by 2020. It envisages that China will be the world's third largest economy with a GDP per capita of about US\$ 3,000 by 2020.

In order to achieve this economic status, China will need economic growth of just over 7% per annum over the period to 2020. The government foresees being able to stimulate this level of growth through a range of policies aimed at:

- Stimulating sustainable economic growth in a low inflation environment;
- Maintaining a favourable balance of payments;
- Reducing unemployment and creating new jobs; and
- Restructuring the economy around the private sector and better managed / more accountable and transparent state-owned businesses.

This vision recognised that China currently has a number of major challenges that need to be dealt with over the period to 2020, including:

- The state-owned enterprises, many of which are insolvent and anachronisms in the new economic circumstances that have developed over the past 10 to 15 years.
- Unemployment as a result of the gradual collapse of state-owned enterprises.
- The need to create new jobs for new entrants to the work force.
- Reforming the social security system that has been inherited from the "command economy era".
- State involvement in various industries and markets, which still distorts the market mechanism.
- A poorly managed banking sector that is undermined by large numbers of non-performing loans.
- Growing income disparities between urban and rural areas and rich and poor families.
- A weak commercial law system relative to that of the developed world, combined with a lack of transparency in enforcing policies and regulations
- Corruption.

Economists who monitor the situation in China comment that the vision makes no mention of the potential for social unrest that could arise if the Chinese government are unable to deliver new jobs and real wages to its population in future.

- For canned sweetened condensed and evaporated milks:

The trade currently has two opposing views about the future of the market for canned condensed and evaporated milks:

- One that sees increasing affluence as providing opportunities to develop a larger market as in other parts of Asia, e.g. Indonesia or Malaysia.
- Another that sees no significant opportunities because of the current market focus on milk powders and liquid milk in which there is a developing trend towards consuming less sweetened dairy products.

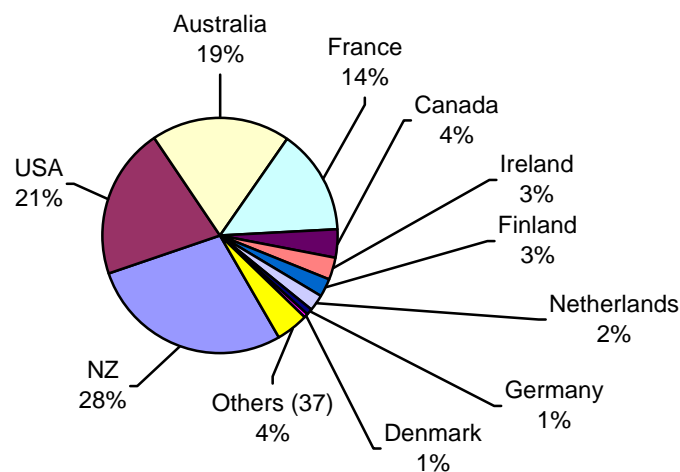
Currently, the market is experiencing slow growth in consumption of between 3% to 5% per annum and has been in this state of growth for more than 5 years.

10.4 Review of competition in the market for imported dairy products

10.4.1 Overview of trends in imports from key countries

China imported 291,991 delivered weight tonnes of dairy products valued at US\$ 366.4 millions in 2002. Close to 50 different supply countries were involved in this trade. The leading supply countries involved were New Zealand, USA, Australia, France and Canada (see Chart below).

China's Dairy Product Imports By Supply Country in 2002 - 291,991 Tonnes



Source: National Bureau of Statistics, PRC

The key supply countries can be divided into 3 groups:

- The dynamic supply countries, which include New Zealand, USA, Australia and France (see Chart below).
- The second-line supply countries, which include Canada, Ireland, Finland, the Netherlands and Germany (see Chart below).

| Product | Market Size for Imports Today | Opportunities | Challenges | Barriers to Market Development | Potential Opportunity Takers |
|---|--|---|---|--|--|
| <p>10.7.2 Processed cheese in all forms</p> | <p>477 tonnes valued at US\$ 1.3 million (CIF value) in 2002, up from 50 tonnes valued at US\$ 0.2 million in 1996.</p> <p>Since 1996, imports of processed cheese have seen very high rates of growth from near zerobase.</p> | <p>Trade sources forecast that processed cheese imports should grow at more than 10% per annum and, possibly, higher over the next 5 years.</p> <p>This growth will be fueled by:</p> <ul style="list-style-type: none"> ▪ Better market access and lower import duties under the new WTO compliant trade regime. ▪ Supply push from key exporters, e.g. Kraft and New Zealand Milk, supported by advertising and promotional activities in retailers and food service channels. ▪ An emphasis in marketing messages on the health and nutrition aspects of consuming cheese, especially by children. ▪ Demand pull from international fast food outlets, e.g. McDonald's, and other outlets that utilise sliced cheese or cheese spreads. ▪ Increasing disposable incomes amongst China's younger generations that can afford to "exotic" imports, eat sandwiches and also use fast food outlets. | <ul style="list-style-type: none"> ▪ Cheese has not developed any strategic fit in the Chinese diet. As a result, its market is a very small niche. ▪ It will not be possible to develop a long-term market for cheese in China without some form of investment in advertising and promotion at this point in time/over the next 5 years. ▪ The cost of developing a market for processed cheese is inherently high because of the immature state of demand for such products. | <ul style="list-style-type: none"> ▪ The price of imported products in a market, which is still low income relative to the Developed West. ▪ Taste and, possibly the smell for stronger smelling products. ▪ Lack of understanding on how to use processed cheese. ▪ For new entrants, the existing brands owned by businesses such as Kraft and New Zealand Milk are already developing their presence in the market and brand awareness in the key cities. | <p>Opportunities exist mainly for cheese specialists that operate as brand managers and can:</p> <ul style="list-style-type: none"> ▪ Take a long term view of market opportunities; and ▪ Invest in market development in China. <p>Other cheese exporters have the opportunity to develop contract manufacturing business with key Chinese businesses that want to add cheese products to their own product / brand portfolio.</p> <p>Commodity exports of processed cheese will be problematic under current market conditions unless they are tied to a purchasing agreement with a major food service operator or input supplier.</p> |

Stanton, Emms & Sia - Capability Statement

Stanton, Emms & Sia (SES) is a specialist food and beverage market research and consultancy business. The firm is based in Singapore with research and consultancy resources in all South East Asian countries as well as in Australia, New Zealand, Hong Kong, India, Japan, South Korea and China (Shanghai, Beijing and Guangzhou).

SES focuses on the international industry and markets for food and beverages in our region. We offer our clients a full "food chain" consultancy service ranging from analysis of farm input usage to the strategic planning of business strategies in the international agricultural, food and drinks sector. Our experience covers the complete spectrum of food types from commodity to highly value added, generic to branded, fresh to processed.

SES maintains an on-going research programme, analysing and assessing key markets and underlying food, beverage and agribusiness issues that affect the Asia Pacific region now and in the future. Much of our work for clients is forward looking and interpretative. Our management team has been monitoring the region's food, beverage and agrifood markets since the late 1980s.

We actively produce a number of multi-client studies each year as part of this research work. As a result, we regularly interview food manufacturers and processors, food importers and wholesalers as well as key decision-makers in some of the main retail groups. SES' advantage is that our research consultants actually know and understand how the local food industry actually operates and thinks.

Past multi-client studies have included:

- *"Beyond the Asian Economic Crisis: Marketing Processed Foods Under New Scenarios in the Developing East Asia's Food Supply Chain"*.
- Our *Asian Dairy Series* of reports, which includes forward looking opportunity identification studies on the markets in Indonesia, Malaysia, Singapore, South Korea, Philippines, Thailand and Vietnam.
- *"Beer in Developing East Asia and China: Strategic Directions & Opportunities for Brewers"*.

The real value delivered to our clients is in the interpretation of what the research is telling us. The lack of skilled synthesis, analysis and interpretation is often the aspect which undercuts good market research performed by our competitors who operate without having a tangible presence in our region. Having researchers who are based in the country and aware of the trends and tone of the market is therefore invaluable. We believe our team has this proven track record.

We undertake assignments for a wide range of clients, drawn from both the public and private sectors. Our client base includes the following types of entities:

- Offices of multinational companies located in Asia, Australia, Europe and North America.
- Large national companies from Australia, UK, USA, South Africa, Japan and the Philippines.
- Smaller companies based in countries such as Australia, Malaysia and Singapore.
- Governments, government organisations and embassies of European and North American countries and Australia located in Asia and their home countries.
- Other entities, including co-operatives and societies, operating in Australia, Netherlands, Denmark, the USA and France.
- Food and agricultural research organisations located in Australia and the UK.