OPPORTUNITIES IN THE FOOD INDUSTRY

MARKET INFORMATION

June 2016
Business Sweden, China
THE CHINESE FOOD INDUSTRY SHOWS PROSPECTS FOR CONTINUOUS GROWTH AND DEVELOPMENT

KEY TRENDS

AGRICULTURE
- One of the largest producers in the world in several categories
- Strive for self-sufficiency in several crops and foods
- Increasingly import dependent
- Strong investment activity

INDUSTRY AND MARKET
- Food market and imports keep growing despite economic slow-down
- Foreign companies dominating in terms of brand recognition and technology
- Quality and safety standards in industry are lagging behind

CONSUMERS
- Growing middle-class driving growth
- Food safety still high public concern
- High trust in foreign brands
- General health and quality trends
- Post -85, -95, -00s and their families are becoming important factors for food companies
THE WORLD’S LARGEST FOOD MARKET CONTINES TO GROW, DESPITE GENERAL ECONOMIC SLOWDOWN

FOOD CONSUMPTION OUTPERFORMS GDP GROWTH

<table>
<thead>
<tr>
<th>Year</th>
<th>Food Consumption (CNY BN)</th>
<th>GDP Growth %</th>
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<tbody>
<tr>
<td>2012</td>
<td>4.5</td>
<td>9.1</td>
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<td>2013</td>
<td>5.1</td>
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<td>2015I</td>
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CAGR +9.1%

IMPORTS NEEDED TO MEET DOMESTIC DEMAND

- China has become the world’s largest food importer
- The world’s largest middle-class demands quality and has a strong bias towards foreign brands
- Chinese consumers are becoming more health aware
- Numerous food scandals have severely damaged trust for domestic food production

SOURCE: NATIONAL BUREAU OF STATISTICS, 2015, BUSINESS MONITOR, EU SME CENTER
BUYERS OF IMPORTED FOOD ARE TRADITIONALLY FOUND IN THE RICHER COASTAL REGIONS

A LARGE CONTINENT, NOT A SINGLE MARKET

- Many provinces have the equivalent GDP levels of industrialized countries
- Each province is like its own market with unique prerequisites
  - Costal provinces, Tier-1 and high Tier-2 cities have strong purchasing power
  - Markets are more mature and becoming highly competitive
- Market grows and middle-class expansion continues further west

*GDP PER PROVINCE IS BASED ON 2014 DATA, COUNTRY GDP DATA IN PPP TERMS IS BASED ON 2014 DATA RELEASED 2014 BY IMF
**1 INTERNATIONAL DOLLAR $ NOMINALLY CONVERTS TO 6.40 CNY ACCORDING TO THE AVERAGE 2014 EXCHANGE RATE, AND TO 3.7603 BY PURCHASING POWER PARITY (ALTHOUGH PRICES VARY FROM REGION TO REGION WITHIN CHINA)

SOURCE: THE ECONOMIST INTELLIGENCE UNIT, 2015, NATIONAL BUREAU OF STATISTICS OF CHINA, CBBC
CHINA IS TODAY THE HOME OF THE WORLD’S LARGEST MIDDLE CLASS, WHICH CONTINUES TO GROW

MIDDLE-CLASS AS SHARE OF TOTAL POPULATION

CHARACTERISTICS OF THE MIDDLE-CLASS

- **31%** Live in tier 1 cities Shanghai, Beijing, Guangzhou and Shenzhen
- **79%** Have a college education or higher
- **80%** Are aged between 18-45 years

**no1** The world’s largest middle class since 2015

FOOD SAFETY IS A MAJOR PUBLIC CONCERN…

- Food safety issues make conscious consumers turn away from domestic brands

- Pushing preference for imported food
  - Food from foreign brands is considered safe and nutritious
  - Imported food is regarded as a premium product, generally distributed at a higher price
  - With increasing affordability among the growing middle-class, the demand for imported food is growing

CONSUMER PREFERENCES

- Willing to pay premium for the best product: 62%
- Trust foreign brands: 52%

DOMESTIC COMPANIES CAN NOT MEET DEMAND NEITHER IN TERMS OF SUPPLY OR PREFERENCES

SOURCE: PEW RESEARCH CENTER 2015 GLOBAL ATTITUDES SURVEY
ONLY MIDDLE CLASS AND AFFLUENT CONSUMERS CAN AFFORD PRICE PREMIUMS FOR IMPORTED PRODUCTS

DEMOGRAPHICS (% OF WORKING POPULATION)
- Wealthy: 0.2%
- Middle-class: 19.0%
- Migrant workers: 30.6%
- Rural workers: 50.2%

AVERAGE ANNUAL INCOME (USD)
- Wealthy: 500,000 USD
- Middle class: 11,733 USD
- Migrant workers: 5,858 USD
- Rural workers: 2,000 USD

PRICE STRUCTURE OF FOOD PRODUCTS
- Imported high-end
- Domestic premium
- Locally produced
- Domestic brand

SOURCE: GOLDMAN SACHS, CHINESE NATIONAL BUREAU OF STATISTICS
BUSINESS SWEDEN ANALYSIS
REOCCURRING FOOD SCANDALS ARE SHAPING THE FOOD INDUSTRY IN CHINA

PRODUCTION CONSTRAINTS
- Development of domestic production has been neglected for past decades
  - Have not developed in line with other industries
  - Hampered by inefficacies in production, much more labour dependent than foreign counterparts
  - Still highly fragmented, but under transformation
  - Sustainability challenges from decades of poor natural resource management put great constraints on production capacity

FOOD SCANDALS
- A number of food scandals have damaged trust for domestic food production and local brands
  - Milk melanin scandal
  - Decades-old rotting meat
  - Dumping of dead pigs

CONSUMER TRUST
- The trust for domestic food production has reduced significantly during recent years
  - Strong bias for imported brands
  - Imported brands means retailers can charge a price premium
  - Leading domestic players are investing a lot in developing their own premium
INTERNATIONAL INVESTMENTS ARE USED AS SHORTCUTS TO TECHNOLOGY AND BRAND UPGRADES
OVERVIEW OF SELECTED NOTABLE DEALS AND INVESTMENTS 2013-2016

FOREIGN DIRECT INVESTMENT

- International companies investing for market entry and expansion

CHINESE OVERSEAS INVESTMENTS

- Chinese companies are investing overseas for strong brands, technology and intellectual know-how to bring back to the Chinese market

**FDI 2013-2016, Bn USD**

- Inbev - "Greenfield" 2.57
- Cheiljedang - Meihua 0.8
- Inbev - Ginsber 0.622
- Fonterra - Beingmate 0.556
- Coca-Cola - Culiangwang 0.4
- Heinz - Foodstar 0.165

**OFDI 2012-2016, Bn USD**

- ChemChina - Syngenta AG 43
- Shunghui - Smithfield Foods 7
- Shanghui - Campofrio Food 4.6
- COFCO - Noble Agri 4
- Bright Food - Weetabix 1.9
- Bright Food - Tnuva 1
- Shangdong Ruyi - Cubbie 0.3

ALMOST 20% OF GLOBAL CHINESE M&A’S IN 2014 WERE IN THE FOOD OR AGRICULTURE SECTORS
OVERSEAS PRODUCTION AND SALES STRATEGY AIMED TO BUILD CONSUMER TRUST
THE YASHILI INFANT FORMULA CASE

OVERSEAS SALES AND PRODUCTION
- CN Yashili moves to sell its infant formula in NZ
- Production takes place in Yashili's plant in NZ, a USD 220 mn investment

THE “COUNTRY OF ORIGIN” EFFECT
- Chinese parents tend to trust imported formula brands more if
  - Also sold in country of manufacture
  - Produced solely for export

NZ Retail price 24 NZD
CN Retail price 61 NZD

CHINESE PRODUCERS STILL STRUGGLE TO REGAIN TRUST AFTER 2008 MILK SCANDAL

SOURCE: NZ HERALD
DOMESTIC CONSOLIDATION

- The acquisition of intermediaries and suppliers further up the chain of production demonstrates the desire of firms to consolidate absolute control of the entire process
- Increased cost of compliance with new regulations and general cost of production are also pushing smaller players out of business
- Trend is shifting towards fewer and larger players

LARGER PLAYERS GO FOR VERTICAL INTEGRATION

THE FOOD INDUSTRY IS SLOWLY SHIFTING TOWARDS FEWER AND LARGER PLAYERS

SOURCE: BUSINESS SWEDEN ANALYSIS
GOVERNMENT ENDORSED INVESTMENTS AIM TO UPGRADE THE CHINESE FOOD INDUSTRY

GOVERNMENT PUSH

STRATEGIC ACQUISITIONS TO BUILD GLOBAL COMPETITIVENESS

1. FOOD SECURITY
   - Companies are encouraged to extend their value chain overseas and to strengthen positions in international commodities trading
     - The ultimate goal is control both supply and pricing

2. SAFETY & PRODUCTIVITY
   - Food safety concerns motivate investors to acquire premium agricultural assets, including dairy farms, animal husbandry pastures and food processing plants and advanced technologies
     - “Borrow foreign chickens to lay golden eggs in our yards”

3. PREMIUM BRANDS
   - Domestic food companies acquire well-known Western food brands and bring products back to the domestic market
     - Grasp ready-to-grow & well-established brands within short-term period
CHINA HAS ALSO REACHED A POSITION AS THE LARGEST PRODUCER IN SEVERAL CATEGORIES

CHINA’S SHARE OF WORLD FOOD PRODUCTION

- Seafood
- Pork
- Eggs
- Fruits & Vegetables
- Rice
- Wheat
- Corn
- Chicken
- Beef
- Soybean
- Milk

AGRICULTURE IS OF GREAT POLITICAL IMPORTANCE

- Agriculture has traditionally been the backbone of China’s economy and development
- Currently launching the largest reform since 1980s:
  - Tighten up regulations to improve food safety
  - Increase consolidation and shift towards more large scale farming
  - Amend property legislations to improve operation and property rights
  - Raise the technological level to increase productivity and over-all standards
  - Strive for self-sufficiency in main crops

SOURCE: GIANNINI FOUNDATION OF AGRICULTURAL ECONOMICS, FAO
CHINA’S SUSTAINABILITY CHALLENGES PUT GREAT CONSTRAINTS ON ITS AGRICULTURAL OUTPUT

CHALLENGES TO CHINA’S AGRICULTURAL SECTOR

- China holds 20% of the world’s population
- With a strong urbanization movement and changing diets

- China has only about 10% of world’s arable land
  - 40% is degraded
  - 20% is polluted

- China has 6% of global water resources
  - 80% of groundwater in the major river basins are unsafe for human contact
  - China’s largest lakes have big dead zones caused by fertilizer run-off

CONSTRAINTS IN ARABLE LAND

CHINA NEEDS TO FIND WAYS TO ACHIEVE INCREASED PRODUCTION AND QUALITY FROM DIMINISHING RESOURCES

SOURCE: FOOD SECURITY PORTAL, CHINA DAILY, THE WORLD BANK
HEAVY BOOSTING OF HARVESTS IS JEOPARDISING BOTH ARABLE LAND AND FOOD SAFETY

VAST USE OF FERTILISER AND PESTICIDES

LATE ACTIONS TO TACKLE ISSUES OF OVERUSE

- China today consumes one third of world’s total consumption of both nitrogen fertilisers and pesticides
- Fertilisers and pesticides have been strongly advocated by the government to boost agricultural production
- Issues of overuse are now becoming evident and actions are being taken

PESTICIDE AND FERTILISER USE KEEPS GROWING WHILE YIELDS HAVE PLATEAUED SINCE THE 1990S

SOURCE: FAOSTAT, CHINA DAILY, CHINA NATIONAL BUREAU OF STATISTICS
THE AGRICULTURAL SECTOR IS CHINA’S SINGLE LARGEST USER OF WATER

**WATER USE**

- Municipal (13%)
- Industry (24%)
- Agriculture (61%)

100% = 590 bn m³

**TOP 4 FARM PROVINCES ARE IN THE DRIEST AREAS**

- Shandong 12%
- Hebei 10%
- Henan 6%
- Jiangsu 4%

100% = total agriculture output
DISCREPANCY BETWEEN CHINA’S ARABLE LAND AND WATER RESOURCES CAUSES FURTHER STRAIN
34% OF SOWN LAND LOCATED IN WATER SCARCE AREAS

FURTHER POLICIES REQUIRED FOR WATER ALLOCATION TO AGRICULTURE

SOURCE: CHINA WATER RISK (BASED ON CHINA STATISTICAL YEAR BOOK, AVERAGE BY PROVINCE 2003-2012, HSCB GLOBAL RESEARCH)
FOOD SAFETY AND SUSTAINABILITY ISSUES ARE SHAPING THE INDUSTRY AND DRIVE DEMAND

KEY TAKE-AWAYS

KEY ISSUES

FOOD SAFETY AND SUPPLY

SECTOR

AGRICULTURE

Modernisation of agriculture

Severe production limitations

FOOD INDUSTRY

Investments in brands and safety

Consolidation for control

Building domestic premium

CONSUMERS

Increasing awareness

Willingness to pay

KEY TRENDS
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