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# China's dairy sector

## Catching up with demand growth?

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Author Lillian Lou
Email: lillian.lou@rabobank.com

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Contact address for this publication
Rabobank International
F&A Research and Advisory
Telephone + 31 30 216 1178
Website www.rabobank.com/far

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# Foreword

With its rapid growth, a huge population and a low level of consumption bringing substantial business opportunities, China's dairy market attracts increasing attention from companies across the world. This study, published at the IDF World Dairy Summit 2006 in Shanghai, aims to give an overview of the complicated Chinese dairy market which is in the process of fast evolution. The study addresses the Chinese dairy value chain and presents an in-depth analysis on each part of the chain from raw milk production, collection, processing to distribution, end consumer market and international trade.

This study has been published in line with Rabobank's long-term commitment to the international food and agribusiness. It is one of a series of publications undertaken by the global department of Food & Agribusiness Research and Advisory.

# Executive summary

As the second biggest dairy market in Asia, China's appetite for dairy products remains eager. Growth in the dairy industry is maintaining momentum, underpinned by a variety of drivers including strong demand for liquid milk, improved availability to consumers provided by fast-expanding modern retail chains, and increasing brand awareness thanks to aggressive advertising campaigns by dairy processors. The enormous growth potential has attracted an influx of new entrants, resulting in stiff competition and price wars being waged in recent years amongst producers in the liquid milk market. Declining margins coupled with the ambitions of the leading players to expand market share have also led to industry consolidation.

Demand for dairy products in China has more than doubled during the past five years to reach over 25 million tonnes in 2005 of liquid milk equivalent (LME) in 2005. UHT milk remains the biggest segment and is starting to penetrate rural areas. Consumption upgrading in developed cities will boost demand for higher-end products such as yoghurt and cheese. However, consistency of quality is a major concern for Chinese consumers.

Although growth in the production of raw milk started to outpace that of the demand in 2004-05, China remains in a net milk deficit position with milk production of 24 million tonnes. The shortfalls in raw milk supply started to reduce when herd size increased dramatically from the turn of this century and raw milk production grew faster than anticipated. Rabobank expects the gap between raw milk supply and demand to persist in the short term due to robust demand for higher-value added products like yoghurt and more consumption of liquid milk in rural areas. But production would be able to gradually catch up as the growth momentum of production remains strong and the supply deficit accounts for a small portion of the demand.

Industry chain remains long and complicated

The process of consolidation in the industry in recent years is still ongoing. China's dairy value chain continues to be long and complicated due to the unevenly distributed sources of raw milk supply nation-wide. For instance, with the strong growth of leading dairy processors in recent years, a duopoly in raw milk sourcing is forming in certain regions like the northern province of Inner Mongolia where the two leading dairy companies Mengniu and Yili are based. In contrast, severe competition for raw milk is taking place in most of the other regions where no player is able to command dominance.

Domestic companies lead the industry

Most dairy processors tend to source raw milk through third-party milk collection stations in villages (as back-door farming is still commonly practised in China). In order to secure a consistent and reliable source of raw milk from these dispersed milk collection stations, close cooperation with government is needed at all levels, from provincial to village due to the existence of regional protection. Understanding Chinese cultural and business environments and practices is also a prerequisite for dairy processors. This represents an entry barrier for foreign players seeking to establish an effective and large scale raw material sourcing system independently in China, giving rise to a dairy industry that is still dominated by domestic companies.

Brand is important for milk

China's dairy industry started its boom in the late 1990s when liquid milk (excluding yoghurt) quickly replaced milk powder as the major component of a dairy diet, accounting for 45% of total dairy consumption. Total retail market value was estimated at approximately USD 10 billion in 2005 with a compound annual growth rate (CAGR) exceeding 20% in the past five years. Unlike western countries where liquid milk has become a commodity product, the liquid milk industry in China is still in its growth phase. Consumers have also proven to be highly brand-conscious, perhaps as a result of high-budget 'brand-promise' marketing campaigns employed by leading dairy companies. Furthermore, industry leaders' aggressive expansion, the high cost involved in setting up stable raw milk sourcing systems and a lack of scale have slowed the penetration speed of private labelling in the liquid milk sector; this contrasts with the fast expansion of organised retail chains in urban cities.

UHT milk is prevailing

UHT milk has been the major growth driver for China's dairy industry in recent years, accounting for over half of the growth in volume terms. Mengniu and Yili brought UHT milk into the market in late 1990's and their aggressive promotions triggered the explosive growth in demand for this product. The fact that China lacks cold-chain distribution channels coupled with the long distances between major milk production regions and consumption markets makes UHT milk a good fit for the current Chinese market. Also, UHT milk's lower price, longer shelf life and more convenient storage helped shift consumer interest from pasteurised milk in urban areas and provided more potential for boosting the demand in rural areas.

Global dairy players are returning

The opportunities presented by a fast-growing Chinese dairy market have prompted global companies to re-think their strategies for penetrating the China market despite earlier cases of unsuccessful market-entry. These companies have departed from the greenfield approach attempted earlier by most of the dairy giants. Instead, market entry through cooperation with local partners has been the preferred route for the foreign players as they can then take advantage of their local partner's existing distribution channels and market presence. Unsurprisingly, China's regional and even leading national dairy companies have become major mergers and acquisitions (M&A) or joint venture targets.

Import trends have shifted to higher-end products

China remains a net importer of dairy products. However, its import structure has gradually shifted from importing raw material to importing more value-added processed products. This has been driven by the narrowing of price differences between imported milk powder and domestic procurement of raw milk. Due to the government's new regulations on labelling reconstituted milk, and the increasing demand for higher-end products, imports will be increasingly driven by high value-added products. This will include formula milk powder products: cheese and dairy ingredients which local producers lack the capability or necessary economies of scale to produce.

Consolidation is the theme in the next few years

As the world's fastest growing dairy market, China is still hungry for dairy products. While demand for liquid milk is becoming saturated in some tier 1-2 cities where the per capita consumption is getting close to the level of developed Asian countries, consumption is in growth phase in the smaller cities and rural areas where the population represents over 60% of the country's total. Fast capacity expansion and competition for market share resulted in a price war in urban liquid milk markets and caused margin squeezes for most of the dairy players. Many small and regional players were forced out of the market. Further penetration into rural markets became a meaningful way to excel from the competition. Acquiring existing local processors is a cost-efficient strategy for big dairy processors to establish a presence in out-of-home markets due to less organised retail channels and scattered consumer markets in the less-developed areas. Rabobank expects the industry's consolidation to continue on the back of industry leaders' recovering profitability and the strong cash flow position upon gaining dominant market share.