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Towards a Branded Food Economy in China

Industry Speaks

Damien McLoughlin [a], Steve Bourne [b], Mary Shelman [c], Frank Bradley [d] and Aidan Connolly[Φ e]

[a] *Professor of Marketing, UCD Michael Smurfit Graduate Business School, University College Dublin, Blackrock, Co Dublin, Ireland*

[b] *Vice-President, Asia Pacific, Alltech, 3031 Catnip Hill Pike, Nicholasville, Lexington, Kentucky, 40356, USA*

[c] *Director, Agribusiness Program and President of IFAMA, Harvard Business School, Morgan T74, Boston, Massachusetts, 02163, USA*

[d] *Emeritus Professor, Michael Smurfit Graduate Business School, University College Dublin, Blackrock, Co Dublin, Ireland*

[e] *Vice President Corporate Accounts, Alltech, Summerhill Road, Sarney, Dunboyne, Meath, Ireland*

Abstract

The Chinese economy has achieved extraordinary levels of economic growth and prosperity over the past 30 years. This has evolved into a desire for greater quantities, quality and variety of food products both from its newly enriched citizens and political leaders. These changes have affected the rest of the world, most notably in the demand for the commodity products needed to feed an expanding agricultural industry and its citizens. This paper discusses the six forces which are currently shaping the food industry: an expanding middle class; concerns for food security, safety and quality; the integration and consolidation of industry supply chains; the simultaneous complexity and simplicity of Chinese culture. These forces will shape food production and consumption; the emergence of a Chinese consumer market, the emergence of food retailing and a we conclude a branded food economy.

Keywords: branded food, china, demographics, food safety, supply chains

[Φ]Corresponding author: Email: aconnolly@alltech.com

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Introduction

China is currently in the throes of a breathtaking economic growth phase that is transforming China and the world. China has a population of 1.3 billion but has only 7% of the world's arable farmland. Harsh climate, rough terrain and a growing water shortage (China only has 25% of the world's average per capita water supply) each present limiting factors, although China is the world's largest agricultural producer. In 2009/10 it was the global leader in many categories such as cotton, rice, pork, apples and dairy/dry whole milk powder.

Through an export oriented economic growth strategy China has seen significant growth in its economic prosperity over the past 30 years. In 1980, per capita GDP (on a purchasing power parity basis) was US$250, this rose to US$7,500 in 2010 and is expected to rise to US$17,400 by 2025.

This growth in income has already led to an increase in food consumption and a switch from grains to protein in particular. Meat consumption in China has doubled over the past 20 years, with per capita consumption of 26kg in 1990, 55kg in 2011 and estimated growth of up to 85kg per person in 2030.

Pork is the favorite meat and over half of the world's pork is produced and consumed in China. Poultry consumption is also rising, particularly as pork prices have risen by more than 50% over the past year. China produces 4.7bn broilers annually and firms are moving towards integrated production. While Chinese diets traditionally do not include dairy products, dairy consumption is also growing–especially for infant formula and other products for children. Chinese consumers are also dining on Western style fast food (KFC is opening a new restaurant every 13 hours) and buying convenience products.

Agriculture is a top priority for government as it contributes 10.9% of GDP in China and employs 39.5% of the labor force, although this is gradually leaking to other parts of the economy. There has been a consistent migration of population from rural areas to cities over the past decades, with 15-20 million people moving each year. In 2011, China had 160 cities with population in excess of 1m people, Europe had only 25. By 2025, 65 new cities will have populations of more than 1m and 24 new megacities will be home to more than 5 million people. This movement is re-shaping China's demand for food and presenting new challenges for the location of farms and the availability of farm workers with the absence of a cold chain becoming an increasing problem.

China faces serious issues as it strives to keep feeding its ever-hungrier population. Farms are small–less than 1 acre on average – which requires food processors to deal with a myriad of suppliers of varying capabilities. Meat and milk production is also fragmented: about 60% of Chinese hog operations have fewer than 50 pigs and many dairy farmers milk only four or five cows. This leads to problems with productivity, disease (especially when animals are raised in close proximity to cities), and food safety–sometimes leading to very serious consequences.

By 2020, China will be the world's largest economy. While today it is largely self-sufficient in food, China is an important and growing importer of several commodities. It buys over 50% of

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all globally traded soybean and in 2010 passed Russia to become the world's largest importer of dairy products. During 2011, China surprised the global market by importing increasing quantities of corn and pork. However, even with strong government efforts to keep prices in check, food inflation is running at over 11%.

The potential for agriculture and the food industry in China is great. The Chinese governments, as well as the indigenous and global food industries, have recognized this, as have partners outside the industry such as international banks, who have begun to provide loans to farmers for investment.[1i] Each of these parties sees the challenges, but above all the opportunities, in the modernization of the Chinese agricultural production. China must make important choices about the future of its food industry. These choices will shape the development of the industry. The question is how will this industry evolve?

The authors suggest the next significant development in the Chinese food industry will be the emergence of a branded food economy.

Six forces are identified that individually, but particularly when combined, help to understand why the future of food in China will be branded. Ambition for a branded future was confirmed by a number of speakers at the Alltech Presidents Club, including senior leaders of COFCO, Bright Foods and Liuhe. This end point will be important for the momentum that it will introduce into the food supply chain. This was highlighted by one speaker at the Alltech Presidents Club who noted that the emergence of a branded food economy in China would impact upon every business as its effects rippled through supply chains, improving margins at the front end and tightening them in the middle.

The remainder of this paper is divided into two parts; the first highlights the six forces, each individually important, but which, as they converge, will drive the emergence of a branded food industry. The second is a reflection on the forces of uncertainty in the Chinese food economy that might impact on the imagined future.

Forces Leading the Chinese Food Industry Towards Brands

The presentations and discussions of the Alltech Presidents Club revealed six forces driving the Chinese food industry towards a branded model:

- Expanding middle class
- Food security, safety and quality
- Integration and consolidation of industry supply chains
- Simultaneous complexity and simplicity
- Emergence of a Chinese consumer market
- Emergence of a retail economy

Each of these forces is detailed below.

[1] 'HSBC Sows Seeds in Chinese Countryside', *The Financial Times*, 5th September 2011.

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Expanding Middle Class

The principle driver of a branded economy in food will be the emergence of a middle class, those with an income sufficiently large that they have discretion over what they spend their income on. The McKinsey Global Institute estimates that by 2025 up to 75% of the Chinese population will be middle class[2]. This will include groups of lower and upper middle class consumers with incomes of up to 25,000 RMB and 100,000 RMB respectively. These new groups will be younger than other global middle class cohorts and will see their income as sufficient to save for both old age and ill-health and consume new types of higher quality food. Much of this growth will be located in 400 mid-size cities in China and other parts of the South and East of the world. By 2025, more of the world's middle class will be in the developing world than in the developed world. This will be a huge new growth market that is not currently on the radar of many organizations.

A speaker at the Alltech Presidents Club identified three groups in the Chinese population: survivors, builders and boomers. The 'survivors' are the fast growing 60+ age group who lived through hard times of famine and austerity in China's past. However, their economic power and good health make this group an important target for food companies. Their children are the 'builders', the brand conscious, tough negotiating investors in the modern Chinese economy. The next population cohorts are the 'boomers' who will be the first generation to offer a private alternative to public investment as a driver of economic growth. This group is important as they are in the midst of a love affair with brands in many other categories. For example, many of the world's luxury goods such as Burberry and Prada are thriving on the basis of Asian and particularly Chinese demand. This cohort is educated on the value of brands as a symbol of status and a guarantee of quality. It is imperative to monitor, understand and participate in the emergence of this middle class.

Food Security, Safety and Quality

China faces the challenge of balancing food security with the need for food safety. The latter has become a particular challenge following the rapid expansion of domestic food consumption. While China is able to feed itself, it relies heavily on imported food inputs; it imported, for example, 78% of its soybean requirements in 2010. An important challenge in coming years will be the need to balance its raw materials imports, particularly for animal feed, against the price for food in China. A further challenge to food security is access to suitable land in the face of rapid urbanization, the availability of water and the competition for labor with better-paid industrial work.

China's opportunity is to improve the safety and quality of the food that it produces. Attempts to develop national systems of food standards have been described as 'sluggish' due to the absence of a food safety culture. One speaker spoke of food safety being the number one issue for the Chinese government. Another explained that safe food was not a luxury for the Chinese people, but a necessity. However, there is a demonstrated willingness on the part of the Chinese government and firms to engage in meaningful learning with international partners, with the Jilin

[2] The Value of China's emerging middle class
https://www.mckinseyquarterly.com/The_value_of_Chinas_emerging_middle_class_1798

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Food Zone an excellent example of this. A cooperation between the governments of Singapore and China, along with the city government of Jilin and Singapore's SATS, aims to share China's access to natural resources and Singapore's expertise in safe food production to improve the quality and safety of food in China.

The Integration and Consolidation of Industry Supply Chains

The integration of industry supply chains will be an important dynamic in the future as they will contribute to the safety and productivity needed to support a branded food economy. The desire to produce safe food is driving the integration of industry supply chains. For example, leading Chinese feed firm Wellhope and its European joint venture partners De Heus, have been active in creating an integrated chain with the objective of resolving the issues of safety and quality through creating a farm to fork integrated chain in which control and authority, and thus responsibility, for safety can be readily observed[3].

The opportunity of integration is not just open to Chinese firms. Nestlé is one Western firm that has been making such investments in the dairy industry in China[4]. Recognizing the need to improve the efficiency and profitability of farming in China they have worked to provide advice on feed and build relationships directly with feed suppliers for those wishing to supply them with milk. They also provide bank~~s~~ loans, agronomic advice and advice on sourcing the right equipment.

Chinese food firms are also under pressure to invest in improving the productivity of the industry in order to maximize the country's ability to meet food security goals, reduce input price volatility and produce safer food.

In ten years, it is likely that there will be 1,000 significant food firms operating in China, down from 20,000 ten years ago and 12,000 today. This consolidation of the Chinese industry and the resulting drive for efficiencies will leave the largest of these firms looking for new ways to create and capture value, with branded goods and the lure of higher margins an easy choice. This approach was signaled by Liuhe as an important future growth strategy. The best way to get a return for these investments is to brand their products, incorporating the safety message as part of their promise to consumers, and secure a premium from consumers.

Simultaneous Simplicity and Complexity

China will continue to offer simultaneous simplicity and complexity. The apparent simplicity arises around the strength of Chinese culture and its apparent uniformity. For example, during the Alltech Presidents Club, the role of culture was highlighted in the case of Wellhope and Liuhe. In the former, the success of the firm was founded on the five Confucian principles of benevolence, justice, courtesy, wisdom and honesty. The Liuhe case highlighted the importance of their values of kindness, hard work, study and harmony in how they dealt with internal and external stakeholders. The complexity begins to arise when an attempt is made to try and under-

[3] 'Wellhope – A Feed Fairytale in Northern China', Pig Progress, Vol. 27, No. 6, 2011.
[4] 'A Market for Local Sourcing', The Financial Times, 4th April 2011.

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stand in a specific, rather than an anecdotal, way the role that culture plays in decision-making and action. This is a particular challenge for companies and managers from outside China.

One of the consequences of the apparent uniformity of Chinese culture is the assumption that all Chinese people are the same. However, simple demographics such as income, geography and education lead to the presence of significant market segments. For example, large segments exist in food for children, as a gift for rural dwellers and food as a gift or conspicuous consumption. While health is a major concern for Chinese people, there is also a traditional view in China that they eat for taste first and life second.

A number of forces will drive the further splintering of the consumer market in China. One is population mobility as the move from the countryside to cities continues as improved rail, road and air infrastructure allows for easier movement between cities and regions. Second is the very strong role that TV and movies play in diffusing culture in China. A third force is the role of conspicuous consumption and gift giving amongst the Chinese population. The opportunity is to target one of these segments and participate in its development over the medium term.

Emergence of a Chinese Consumer Market

The current size of the consumer market in China is great and its economic potential greater. For example, the soft drinks market is expected to double in size to $86bn by 2015[5]. This makes the market attractive for both Chinese and international firms. Chinese firms have made good use of their local knowledge to develop products that Chinese customers want (for example, peanut flavored milk drinks), but international firms cannot let a historic opportunity of this size pass by and are responding with their own locally adapted products.

However, the Chinese consumer has a strong commitment to domestic brands, such that no consumer goods category is led by a Western brand although there are many such competitors in the market. The innovation and competitive battle between Chinese and international firms for this market will be intense but will also yield products which are unique and valuable to Chinese and international consumers.

A key trend for Chinese consumers is the need for novelty, with the average life cycle for a consumer product in China being about three years[6]. For suppliers to these companies there will be a constant need for proactive engagement with consumer focused innovation. Such innovation may have global resonance and be in areas such as health and sustainability but will have to be tailored to the needs of the Chinese consumer. The experience of firms beyond China, and their supply chains, in meeting the needs of demanding customers in areas such as health and sustainability leave them well placed to actively participate in this growth.

[5] 'China Sets Pace in Brand Innovation', *The Financial Times*, 2011
[6] 'China Sets Pace in Brand Innovation', The Financial Times, 2011.

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Influence of Retailers

Consumers face the challenge that many products sold as brands in China are not authentic. As a result, Chinese consumers often trust retailers above brands as a reliable retailer guarantees the authenticity of a brand. As a consumer brand culture develops in China this will reverse, although this will likely take a generation. Retailers can be expected to take advantage of power and leverage the emergence of brands that meet consumer needs for variety, safety and quality, but also provide the best margins for retailers. In short, an international retail model looks likely to prevail. While no national channel currently exists, one speaker did identify the likelihood of government support for one or two national, or supra regional, retail champions as a likely option in the near future. Such a development would assist in a national brand roll out and encourage food producers to engage in branding.

Many international retailers, such as Walmart, are already present and growing fast in China[7]. The presence of such retailers provides branding expertise to Chinese food producers either directly through the desire of retailers to stock local brands, or indirectly through demonstrating 'how it is done' via driving brand development in other categories and stocking international brands. The latter are likely to be partners of retailers in other countries and will take advantage of retailer presence in China to enter the market, helping further to create a branded food economy.

The Future

There were three uncertainties raised during the Alltech Presidents Club that will interact with the previous six forces to ultimately decide the future of the Chinese food industry.

How will China access and use the resources it needs to develop the next stage of its food industry?

Most brands in China are relatively small and have a regional focus. While the firms which own them can be large in sales terms, they lack expertise in technology of food safety, agricultural productivity and branding. There are a variety of ways in which this expertise could be secured such as international partnerships, internal development or acquisition. The latter appears to be gaining currency in the Chinese food industry. One good example of this is provided by Bright Foods, who recently acquired 75% of the Australian company Manassen Foods in one of the largest ever acquisitions by a Chinese food company. The company had previously attempted to acquire the French yogurt maker Yoplait, US vitamin retailer GNC, and the UK snack manufacturer, United Biscuits. The common theme across the successful and unsuccessful acquisition targets is the access they would provide for Bright to international distribution channels, production technology and strong brands in developed markets. While there is no problem in securing capital for such acquisitions, there is a challenge in integrating knowledge acquired, a challenge faced by every firm post acquisition.

[7] 'Walmart in US Sales Struggle', The Financial Times, 18th May 2011.

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Will China allow its food industry to develop to international models or will it seek another way?

With industry integration and consolidation under way, the Chinese food industry looks to be heading in the same direction as the international food industry with larger farms and concentrated processing. However, the commitment of the government to social harmony and the existing desire of the Chinese people to eat fresh rather than processed food may mean that another path is chosen.

How will western influence shape food consumption in China?

As the Chinese food industry develops, it will not do so with a blank slate, rather it will progress in interaction with international participants operating in the industry. It is a source of uncertainty to consider how these Western influences will be allowed to shape and direct the development of the industry in China and whether the mistakes made elsewhere will be repeated or repaired in China.

Conclusion

This paper reviewed discussions which occurred during the 4th Annual Alltech Presidents Club conference. Six prevailing forces were identified which we conclude will accelerate the development of strong local branded food products. While three scenarios also emerged which may make the path less certain, the end point is clear. The implications for the food and feed industries are that the provision of technologies, products and processes that facilitate the ability of Chinese national and international companies to develop these brands, must be the goal of any supplier to these businesses. In addition to offering cutting edge technology, traceability, cost-effectiveness and consistency, such companies should also consider offering softer, knowledge based, services such as the transfer of branding building skills. Our conclusion is that while the Chinese industry might be ten years behind Western companies in building a branded food industry, it is unlikely to take ten years to catch up.

About the Alltech President's Club

The Alltech Presidents Club is an annual meeting of food and agribusiness industry leaders hosted by the founder and President of Alltech, Dr. Pearse Lyons. This invitation only event is intended to be a club of presidents and a forum for open exchange and debate on leadership issues. It expressly focuses on identifying opportunities for business growth. The 4th Alltech Presidents Club in 2011 took place in Beijing and Shanghai, China, and was attended by 105 Presidents.

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