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CHINESE CITRUS IMPORTS

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THE GROWING IMPORTANCE OF CHINA – THE SUNKIST EXPERIENCE

Thank you very much. I'm delighted to have the opportunity to participate in this program today with such knowledgeable co-panelists.

Sunkist Growers, as you may know, is a 112-year-old marketing cooperative, owned by our 6,000 citrus farmers in California and Arizona, who grow about 65% of the citrus produced in western United States. Despite popular assumption, we do not have operations in Florida. During much of our history, Sunkist has been extensively engaged in the development of export markets for our growers' fruit. Today, exports constitute about 30 percent of our fresh fruit sales and yield nearly 45 percent of fresh fruit revenue paid to our growers.

China has been and continues to be an important export market for us. We worked closely with our good friends at FAS and APHIS for nearly a decade to gain market access for US citrus into China – finally succeeding in early 2000. But even before that, Sunkist oranges were found in wet markets and food stores all over China – having entered via the grey market from Hong Kong. Before WWII and the 1949 takeover, China had been Sunkist's biggest export market.

Today China is indeed a market opportunity, still evolving, yet to be fully realized, and it is, longer term, also a competitive threat.

Let's talk first about the OPPORTUNITY. For exporters, China market looms as the "big enchilada" or more appropriately the "big won ton". Enjoying stable growth with GDP in the 9, 9.5, and 10 percent range in each of the last three years, China today ranks 5th on global stage. Living standards continue to rise, more and more of the population continues to migrate into the "middle class" (today pegged at 19% of the population and projected to grow to 40% by 2020) with increasing levels of disposable income – all this particularly prevalent in the urban areas of eastern China – a market population of over 300 million consumers.

According to recent surveys about 42% of consumers are influenced by and lean towards western brands when purchasing. Consumers express their loyalty to retailers who offer large scale and highly recognized brands. China is evolving into acceptance of modern retailing - supermarkets, hypermarkets, department stores, and shopping centers as primary channels for consumption. But PRICE AND QUALITY are still the biggest determining factors for consumers when making a purchase.

Shanghai, Beijing and Guangzhou are China's three major commercial cities and major markets for imported foods. Because the living standard in these three cities is relatively higher than the rest of the country, imported foods have a larger market share as a result. Dalian, Qingdao, Tianjin in northern China, Hangzhou in eastern China and Chongqing and Chengdu in western China are potential markets of the future.

Shanghai is a national economic trade center and serves as the distribution gateway to smaller cities nearby, many well over a million in population. Guangzhou and Hong Kong continue their roles as the trade windows to southern China. With Beijing and Tianjin to the north and larger, growing markets. Retail trade in China is expected to maintain an 8-10% growth rate, following two years with growth rates in excess of 13%.

450 of the world's top 500 companies have invested in China and 70% of the world's top 50 retailers are in China – Carrefour, Trust-Mart, Wal-Mart, Vanguard, Metro, Hy-Mall, Lotus, Shanghai Hualian, Suguo Supermarket, NGS, Wu-Mart, and others. Official statistics show 302 foreign retailers with 3,903 outlets approved for business in China.

Sunkist in the China market –

Sunkist trademark is widely recognized by Chinese consumers – brand awareness is well over 90%. Our fruit with the Sunkist brand on it has been in the China marketplace for decades. We enjoy the highest sales volume of any imported citrus sold in China. Today, we enjoy a 98% market share in our category in Hong Kong and a 91% share in China. This is in large part due to our brand. To have value, a brand must stand for something in the consumers' mind… Research indicates Sunkist is identified by consumers' with high quality fruit. (Unfortunately, this favorable reputation is also being capitalized on by counterfeiters in China using our brand on local products of questionable quality.)

Our market strategy – Sunkist is in the China market for the long term not there to grab the quick buck and get out. Like other markets, we seek to cultivate it… slowly and steadily,

building relationships with our Chinese importers and customers.

We face various challenges in the China market –

The customer base of buyers is fragmented. Direct buyers/importers in the PRC tend to be smaller operations with financial, cash-flow limits.

While I previously described how the big retailers – Wal-Mart, Carrefour et al. are aggressively moving into China, so far, they continue to buy <u>indirectly</u> via importers and wholesalers rather than <u>directly</u> from suppliers like Sunkist. This seems to derive from the restrictive import licensing system operating in China and factors like receiver servicing and trying to limit risk.

As I said PRICING has to be competitive. Despite being a farmer-owned cooperative, to be successful Sunkist must be focused on the market and the consumers in that market – to be <u>customer driven</u> – not production driven, the historic role of a producer owned marketing cooperative. If our customers, meaning the Chinese importer in this case, can't make a profit, we're dead regardless of consumer desires.

We need to provide efficient and thoughtful SERVICE before and after sales, presenting a good business environment to our Chinese business partners.

MARKET INTELLIGENCE - we need to have a comprehensive market perspective – up-to-date intelligence providing a clear picture and understanding of the marketplace, enabling Sunkist to detect and adapt to market trends and changes.

COMMUNICATION - Ongoing good communication with local traders, importers, distributors and retailers with the aim of cultivating loyalty to Sunkist.

We see traditional demand patterns still in play in China – Hong Kong traders are very savvy. They buy the range of run sizes in the packing manifest and parse out the loads to various targeted markets in China. In contrast, importers in the PRC don't want size variations in fruit shipped - From the US shippers' perspective this limits development of the direct shipment market in China.

In its trade negotiations, our government has worked hard to improve market access into China. But as they have been successful in getting the Chinese government to bring down tariffs on imported fresh citrus – from 40% in 2000 to 11% today, the actual cost to the consumer which ultimately defines the attractiveness of our product in the marketplace hasn't improved. The VAT and other taxes and fees burden the cost structure of these imports. It is becoming more and more expensive and difficult to get an import license. Shanghai New Long March (which is government connected) is often used as an agent by fruit importers. That firm with its import license charges those other fruit importers upwards of $900 US per container load of fruit. These are the hidden costs that can temper optimism in that market.

Financing for importers is difficult in China. That in turn limits the field with whom you can do business … because in the end you want to be sure you're going to get paid. Cash flow can be a real challenge for importers.

Now let's talk very briefly about <u>China as a competitive threat</u> –

As a result of market forces and government programs, China's citrus production plantings have expanded rapidly over the past few years. Today with over 1.7 million hectares, now accounts for over 20% of the world's total citrus production acreage. China is the third biggest producer of citrus with just under 15 million metric tons, nearly as much as the US.

The Chinese government has been promoting citrus production, investing in large-scale projects in the poorer regions in the south and along the Yangtze River Basin in what is called the Three Gorges.

National, Provincial and Local governments have been promoting development of the citrus processing (juice) industry and modernizing the already successful citrus canning industry. China is already the biggest producer and exporter of canned mandarins, producing 320,000 MT in 2005, 90% of which was exported.

The Chinese government see excellent medium to long-term export opportunities for fresh citrus into the expanding domestic consumer market and into nearby export markets, particularly as China's FTA with ASEAN countries takes effect and those trading partners lower the tariffs on imports of Chinese citrus to zero. While final implementation will not occur until 2010, several countries including China have already lowered import duties on citrus to zero as part of the FTA's Early Harvest program.

Researchers and government officials at many levels are encouraging a shift from Tangerine to orange production in the Yangtze River belt, Jiangxi and south western China in order to supply the orange juice processing industry they're working to create.

All this official effort to build up the citrus industry in China does get our attention.

However, in the near term, I don't believe there's need to panic about China coming onto the world market in a big way with respect to fresh oranges. Domestic demand in China is growing as fast as domestic production, perhaps faster when taking into account the as yet inefficient orange juice processing industry. While still below the world average, Chinese per capita consumption is rising – a trend likely to continue as incomes rise, the distribution system improves and citrus becomes more widely available to more remote locations.

We will no doubt see increasing amounts of China's higher quality oranges being exported because of the higher price such fruit can command in export markets like Hong Kong. But the proportion of China's oranges that meet such high standards upon deliver is still very low.

Higher quality domestic oranges from China do present increased competition within the China market for imports. In addition to high shipping costs, imported product is still subject to an 11% duty and a 13% VAT as well as all those hidden costs I referred to earlier. Improved quality, lower cost Chinese origin citrus is having a greater impact on non-brand imported citrus than on our Sunkist brand product. Importers are not about to pay a premium price for an imported generic orange over a lower cost generic domestically produced Chinese orange. As a result, we see a migration of our US competitors with their non-brand citrus to Korea or other markets rather than trying to compete with us and with domestic Chinese citrus in the PRC.
The Challenges facing the Chinese citrus industry are significant –

Extremely low yields: only 9.9 ton/hectare… only 27% of the US yield on similar acreage.

Average farm size – extremely small – orchards ranging from 1/8 acre to 1.5 acres, limiting efficiency

Major disease issues like citrus canker and citrus greening (huanglongbing) in nearly all provinces

Relatively short harvest season - 75% of the fruit is harvested in November and December

Serious shortage of disease-free seedlings and cultivars

Soil quality and climatic conditions limit prospects for expansion of production acreage in the future which means China's production increases will have to come from increased yields on existing acreage.

Similarly China's ability to export is constrained by the same factors as restrict its ability to market domestically:

Lack of climate controlled storage and transport
Lack of modern packing facilities
Poor post-harvest handling and infrastructure
Inconsistent quality
Lack of brand identification
Poor marketing

But a commitment of resources, acquisition of modernizing and technological skills in a few years will result in China becoming a major producer and major competitor first in the Asian region and eventually globally. For Sunkist and our

growers, we just need to be in the right position when that happens.

Let me close by sharing with you something imparted to me by one of our Chinese business partners - <u>12 Rules to remember for success in China</u>:

1. **EVERYTHING IS POSSIBLE**

2. **NOTHING IS EASY**

3. **WESTERN BUSINESS LOGIC DOES NOT APPLY**

4. **IT IS A FUN PROJECT IF THERE IS NO DEADLINE**

5. **YOU MUST PERSIST – THINGS WILL COME YOUR WAY EVENTUALLY**

6. **PATIENCE IS THE ESSENCE OF SUCCESS**

7. **"YOU DON'T KNOW CHINA" – IT MEANS THEY DISAGREE**

8. **"WE NEED TO STUDY IT FURTHER" – ALSO MEANS THEY DISAGREE**

9. **"NEW REGULATION" – MEANS THEY HAVE FOUND A NEW WAY TO AVOID DOING SOMETHING**

10. **"BASICALLY NO PROBLEM" – MEANS YOU HAVE A BIG PROBLEM**

11. **WHEN YOU ARE OPTIMISTIC, THINK ABOUT RULE #2 – NOTHING IS EASY**

12. WHEN YOU ARE DISCOURAGED, THINK ABOUT RULE #1 – EVERYTHING IS POSSIBLE

Thank you for your time and attention today.