

INFOCUS

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FEEDING THE DRAGON
The modernisation of China's
food industry

FOREWORD

We often hear about the population and income growth in China, and the opportunities this presents for Australia's food and agricultural businesses. With a population of more than 1.34 billion¹ and growing, China's demand for food imports from Australia over the past decade has generated significant opportunities for exporters. Australia is uniquely positioned to capture a significant share of the Chinese premium food and beverage sector. China's food and beverage sector is estimated to be the largest in the world, having recently surpassed the US.² This market is already valuable for Australian exporters. Australia's agricultural exports reached \$4.7 billion with a further \$2 billion in food alone³. Understanding the 'mega trends' in the modernisation of China's food industry is important. These include: rising disposable incomes; urbanisation; brand exposure; consumer affluence; food safety concerns; health consciousness; demand for convenience; improved infrastructure; and development of the retail industry. China – and the broader Asian region – is a crucial part of Australia's medium term economic story. Exporters will need a thorough understanding of the end consumer – who is buying Australian food? Where is Australian food consumed? What are China's consumers looking for? How are the products sold?

The ANZ Economics team have undertaken a comprehensive analysis around the end consumer and the channels to market. This follows the release of ANZ's insights Report, 'Greener Pastures: The Global Soft Commodity Opportunity for Australia and New Zealand' in October 2012 that identified the wide-ranging opportunities and challenges for Australian agriculture in responding to the Asian growth story.

What we do know is that the underlying quality of Australian food and agricultural products underpins our target market. Australia's opportunity is in accessing the growing number of affluent urban households. This requires dedicated focus, research and hard work to deliberately target the distribution networks that will deliver to our targeted segments. Such a target market will comprise incomes that have reached a level such that overall consumption intake has stabilised. This group spends up to five times more on products, such as dairy, seafood, and meat compared to those in the lowest income brackets. Much of the spending reflects higher per-unit spending in the search for quality due to food safety concerns, but there is an increasing presence of processed and packaged products in their shopping baskets. The best distribution channels to access these consumers are through hypermarkets, specialty supermarkets, online, high-end hotels and restaurants, and fast-food restaurants. Direct access is traditionally difficult to achieve, although a clearly visible focus from the Chinese on supply-chain control and/or significant influence will create tremendous opportunity for progressive producers and processors in high quality productive origin countries such as Australia.

To fully maximise opportunities in the sector, Australia will need to identify markets within China that offer facets that are complimentary to the basket of goods we can provide, such as refrigeration and distribution functionality. The opportunities are significant. More broadly than China, the Asia Pacific region is at the heart of future world growth. ANZ continues to grow our presence in Asia and leveraging our strong foundations in Australia and New Zealand to become a super regional bank across the Asia Pacific region with Agriculture a key strategic specialisation within ANZ. We hope you enjoy reading the following analysis provided by our ANZ Economics Team. We look forward to discussing the content with you – whether you're selling directly or indirectly to domestic markets or through to China, the trends in China's food manufacturing industry make an interesting read.

Mark Bennett

Head of Agribusiness, Regional Business Banking - Australia

¹ World Bank 2011

² According to IGD retail analysis and the International Monetary Fund. This is also corroborated by United States Department of Agriculture (USDA) and Euromonitor data.

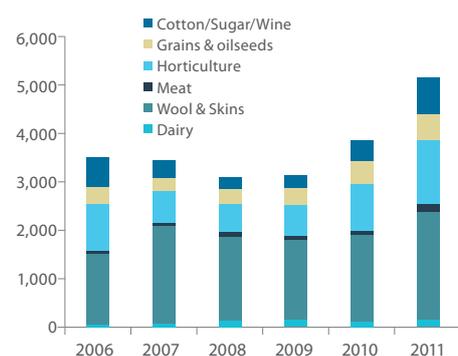
³ Department of Foreign Affairs and Trade, Australia's exports to China 2001 – 2011

CHINA'S FOOD INDUSTRY TODAY

China is often referred to as not just one market but a multiplicity of markets, or each of the 23 provinces effectively being a country in its own right. Certainly each of its provinces now have economic outputs similar to many Western economies. With Europe struggling and likely to do so for some time we are currently witnessing a more rapid change in our end export destinations for packaged and fresh food than could have been imagined a decade ago. The change has always seemed inevitable, but the pace of change is staggering.

China is our largest agricultural export destination accounting for 17.1 per cent of our exports in that sector in 2011.⁴

Figure 1: Australia's annual agricultural exports to China



Source: ABARES; ABS

So, while we sharpen our knives in anticipation of the riches awaiting us from China (and the wider Asian region) there's still a sense we have a long way to go to understand the enormous number of new customers and how to keep their bellies full. **China is different to our more traditional Western export destinations** due to:

1. **The vast scale** of the marketplace and the pressure this places on distribution channels. China is the third largest country by total land area behind Russia and Canada, with a land area encompassing 9.5 million km².
2. **Multi-layered bureaucracy and fast-changing regulation** that causes complexity and business uncertainty, especially for food safety standards.
3. **A fragmented cool chain** outside tier one cities that still supports 'wet markets' as the major means of trade.
4. **Culture**, which affects consumer trends, tastes and business practices.
5. The **time and cost** required to become truly established.
6. A different attitude to the **enforcement of contracts** and other legal niceties.

Indeed there is often contradictory information on many aspects of the fresh and packaged food supply chain and consumer trends in China. This reflects our limited understanding, the factors listed above, and other large structural shifts occurring rapidly within the Chinese economy. For farmers, processors and marketers, understanding the preferences of our new customers and the channels they use to source their food is crucial. **Given the scale of the Chinese market, each industry will need to target specific food categories and the corresponding consumer channel that offers the highest margins and least risk. Trying to achieve this will prove challenging at times; therefore an intimate knowledge of the chosen marketplace and trends will be required.** Here we set the ball rolling with a broad overview of the Chinese food industry and some of the trends and changes taking place.



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⁴ Department of Foreign Affairs and Trade, Agriculture and the WTO

DOMESTIC FOOD PRODUCTION

China is the largest consumer of food and beverages in the world, recently surpassing the US according to several independent research firms⁵.

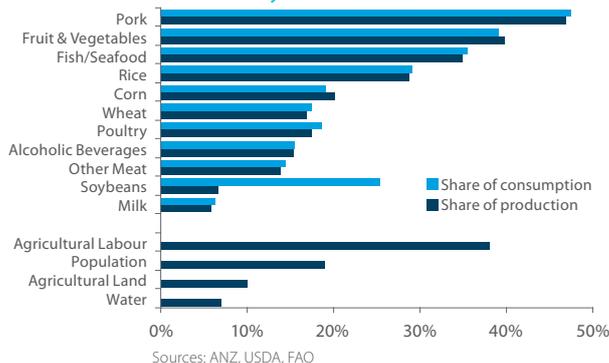


China's ability to meet its food needs has exceeded most analysts' expectations.

China is also one of the largest producers and is self-sufficient in a number of basic strategic crops and food sources, providing food security and ensuring social stability.

Since adopting market-based reforms more than 30 years ago, China's ability to meet its food needs has exceeded most analysts' expectations. The enormous increases across the board in staple grains, as well as livestock, aquaculture, fruit and vegetable production suggests it was producing well below its potential prior to introducing market-based reforms. However, **productivity growth has slowed sharply in recent years**, for several reasons including pollution (water, soil) and urban encroachment. This has led to higher food inflation and an increase in imports of a number of soft commodities, and an opportunity for Australia.

Figure 2: China's estimated share of global production and consumption for key commodities



While China has come a long way, it still retains many of the institutional vestiges of 30-odd years ago. Nearly all produce is bought and sold at market prices, but collective land ownership, ambiguous water rights, and weak legal and financial systems confound market-driven resource adjustments, farm consolidations,

and agricultural investment. In the absence of well-functioning market-supporting institutions, Chinese economic planners gravitate toward a range of interventionist policies in each industry to resolve market failures.

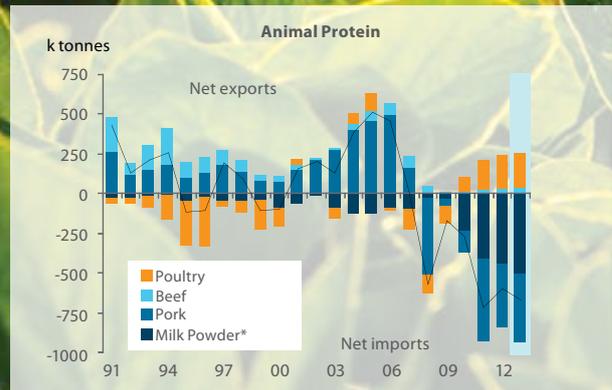
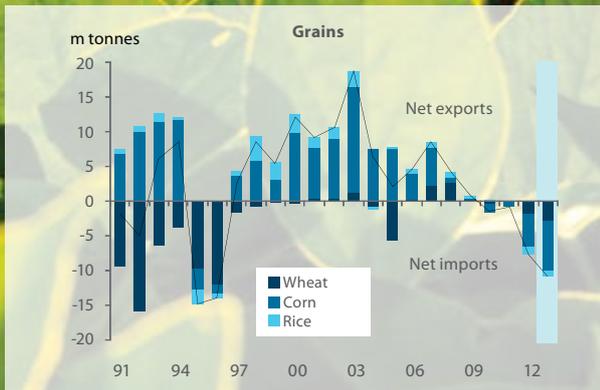
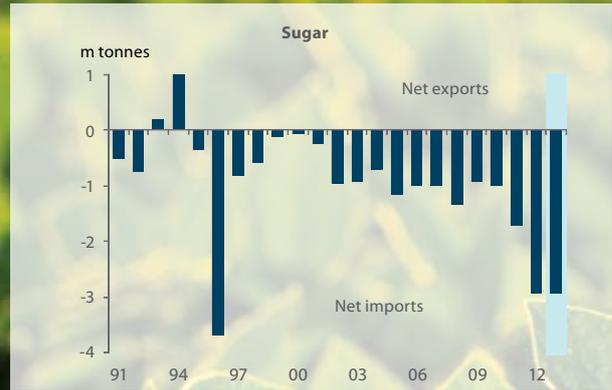
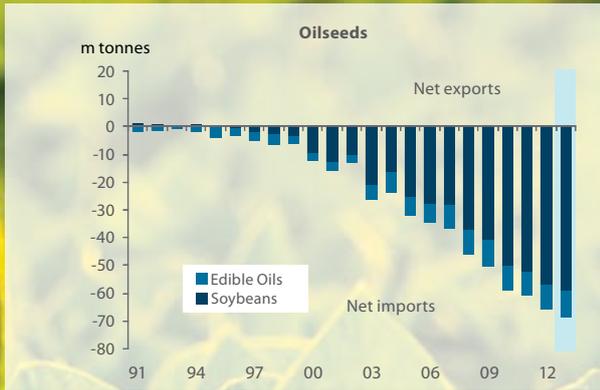
With just 7 percent of the world's fresh water, and 10 percent of the agricultural land, but nearly 20 percent of the world's population there are some tough decisions to be made and stiff challenges to navigate in order to maintain self-sufficiency and reinvigorate productivity growth.

China has a large labour pool, changing urban diets, limited capital investment in agriculture so far, and scarce water and land resources. Given this, China is likely to maintain its self-sufficiency in horticultural production, which is generally labour intensive, but less capital and resource intensive. For livestock and grain production, self-sufficiency will be more difficult to maintain as these sectors are usually relatively land-intensive and not produced as efficiently in China relative to other more land and water-abundant countries. To this end, it is clear that the Central Government will be required to prioritise the growth of certain crops over others. We expect that wheat, sugar and corn will be maintained as key commodities.

⁵ According to IGD retail analysis and the International Monetary Fund. This is also corroborated by USDA and Euromonitor data.

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Figure 3: China shifting to a net importer in recent years



Sources: ANZ, USDA

*Milk Powder = Whole & Skim Milk Powder

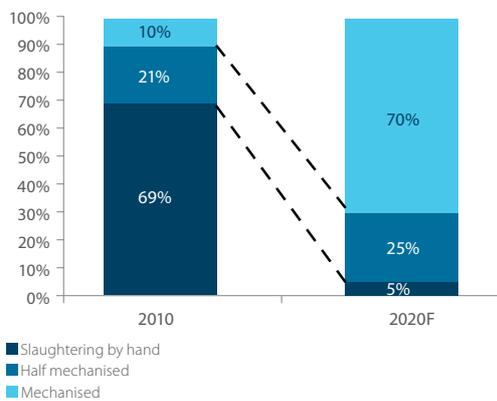
FOOD MANUFACTURING



Produce is typically purchased directly from farmers, often just after harvest and on the roadside.

In China, produce is typically purchased directly from farmers, often just after harvest and on the roadside, by hundreds of thousands of private traders who cruise villages and the surrounding countryside in small trucks. Many farmers prefer this sales channel, which saves them time and transportation costs. Cash payments are then assured. Traders then sell their load to larger traders, or deliver it to wholesale markets, where it is typically aggregated onto larger trucks for transport to distant manufacturing facilities closer to end markets.

Figure 4: The changing trend of swine slaughtering



Sources: ANZ, USDA, China Commerce Department

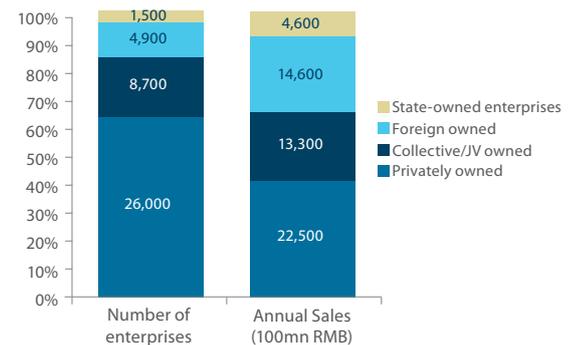
Livestock products, particularly pork raised by farm households, are also marketed by multiple small traders, but there is also a growing contingent of large-scale farms and sophisticated agribusinesses. Small traders and brokers visit villages to buy pigs on behalf of local slaughterhouses that market most of their pork in local wet markets through a shrinking group of small vendors. The USDA has estimated that there are currently 21,000 designated slaughter houses, where 70 percent of the pigs are slaughtered by hand. Due to changing regulation, food safety pressures, disease issues and industry consolidation the number of slaughterhouses is expected to shrink to 3,000 by 2020, with 70 percent of pigs processed by mechanised methods instead of manually.

State-owned enterprises no longer monopolise the wholesale (processing/marketing/distribution) part of the supply chain.

Many state-owned enterprises have been reborn as agribusiness companies, or semi-official "industry associations". Growth potential and lucrative margins have lured domestic and foreign investment. **This has resulted in a diversified**

ownership structure of the manufacturing industry and competition. Low entry barriers have enabled a large number of private participants with relatively small amounts of capital to enter.

Figure 5: Ownership structure of food and beverage manufacturing industry in 2011



Sources: ANZ, Chinese National Statistics

Private enterprises in 2011 now constitute 63 percent of the number of manufacturing enterprises, but only 41 percent of annual sales. The popularity of private small-sized manufacturers in the industry is likely to constrain further development.

Figure 6: Food Processing and Manufacturing Enterprises

Industry Total	2001	2011	% Change
Number of Firms	18,250	41,140	225%
Av. Sales Revenue (RMBm)	39	75	193%
Food Processing			
Number of Firms	10,380	25,600	247%
Av. Sales Revenue (RMBm)	37	74	200%
Food Manufacturing			
Number of Firms	4,560	9,150	201%
Av. Sales Revenue (RMBm)	33	82	247%
Beverage Manufacturing			
Number of Firms	3,300	6,370	193%
Av. Sales Revenue (RMBm)	52	69	33%

Sources: ANZ, China Statistical Yearbooks

Whilst the number of food processing and manufacturing firms in China has been rising, so too has the number of food imports into China from Australia increased over the past decade. The growth figures of trade into China are significant. At the same time, this again underscores the opportunity for cooperation between Australian and Chinese entities.

For strategically important (generally regulated) food products such as grains, there is a mix of enterprises involved, from small private traders and agribusinesses, to state-owned companies. State companies compete directly with private traders for supply, but have preferential access to government-owned storage facilities and are charged with purchasing certain food products under recently established government price support programs. Such strategically important food products include frozen pork, sugar, soybeans, rice, wheat, and corn. State companies buy inventories of these products should prices be deemed too low, or sell inventories should prices be deemed too high, thereby influencing the spot market price. Imports of regulated commodities such as wheat and sugar are restricted to entities that hold an import quota. E.g. COFCO holds approximately 70 percent of the import quota for wheat and sugar.

Development of the food manufacturing industry is uneven between coastal and inland regions.

A substantial portion of manufactured food is produced and consumed in coastal areas. This is due to urbanisation and higher consumer purchasing power in these regions. In inland areas, where there is less urbanisation and comparatively lower levels of disposable income, high-valued processed foods are consumed mainly in big cities. A rule of thumb is that the majority of food is produced in the north (above Shanghai) and consumed in the south.

The traditional production and processing of domestic food products is extremely flexible and low cost, but these efficiencies come at the expense of providing strong incentives for producers, traders, manufacturers and others in the supply chain to achieve quality or safety.

Benefits to farmers from providing food safety assurances are limited because their products are aggregated with others. Companies that institute costly measures to ensure food safety cannot recoup these costs, because counterfeiting and mislabelling are so widespread that consumers lack sufficient confidence in private assurances to pay a high enough premium for them. Companies producing unsafe products have traditionally had little risk of being caught and, if they are, they're typically shut down, but not fined or liable for damages.

The government has now taken a leading role in addressing food safety issues with limited success so far. However, with no clear hierarchy between government and provincial agencies and no single organisation responsible for all food safety regulations, keeping track of the various standards is confusing to producers and consumers alike.

Nevertheless, while standards have improved, monitoring and enforcement remains problematic for similar reasons. Such dynamics are symptomatic of the journey many countries face when they evolve from developing to developed and central planning goes head to head with market forces.



Figure 7: Australia's exports to China by level of processing (A\$ million)

	% GROWTH				
	2001	2006	2011	2010 to 2011	10 year trend
Primary products	5,890	17,252	65,532	21.3	29.7
Unprocessed	4,476	14,073	62,849	24.8	32.9
Food & live animals	520	493	975	38.8	2.7
Live animals, chiefly for food	8	15	121	3.8	14.6
Seafood, fresh, chilled, dried, smoked, salted	27	33	120	96.5	10.0
Vegetables, fruit & nuts, fresh, chilled, or provisionally preserved	5	14	12	-7.7	17.6
Cereal grains	385	428	598	23.3	2.6
Unprocessed food nes	95	3	124	363.8	-1.2
Processed	1,414	3,179	2,684	-27.1	10.2
Food	360	446	985	8.3	11.2
Meat & meat preparations	62	57	225	40.5	12.7
Seafood, frozen or processed	37	43	12	3.2	-16.6
Dairy products	64	65	129	-5.9	8.2
Vegetables, fruit & nuts preparations	4	2	3	8.2	-6.2
Cereal preparations	0	3	4	87.3	19.3
Animal & vegetable oils, fats & waxes	85	114	212	12.6	11.3
Sugars, honey, cocoa & confectionery	93	74	16	-62.8	-18.2
Preparations of food, beverages & tobacco nes	15	88	384	5.4	42.1

Source: DFAT- Australia's exports to China 2001 – 2011

IMPORTED FOOD



Customs procedures have become more transparent as standard protocols for individual products evolve.

Less than a decade ago, most of the imported products flowing into mainland China first made a detour through Hong Kong. With economic and policy liberalisation, along with infrastructure improvements, increasing quantities of imported food is being delivered directly into Shanghai, Dalian, Tianjin, Qingdao and other ports, all of which have modern docks, warehouses, and container-handling facilities. In addition, customs procedures have become more transparent as standard protocols for individual products evolve. Combined with improved motorways and cold chain infrastructure, this has sped up delivery times, reduced costs and improved shelf life.

However, outside major metropolitan areas, cold chain distribution is still unreliable. China did not start establishing national cold chain standards until 2010 – a major hurdle for its development.

It is estimated that only around 15 percent of food, meat and vegetables in China are transported via the cold chain, compared with 90 percent in more developed countries⁶.

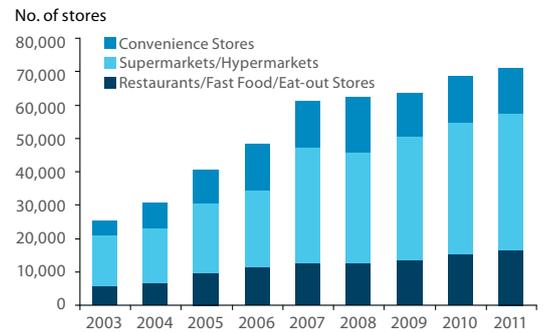
The ongoing development of China's cold chain logistics will effectively reduce food wastage during transportation and improve food safety. Moreover, it will increase the availability of some food products. This is likely to influence consumption patterns, especially in inland cities, where consumers will have better access to the likes of seafood that requires refrigeration.

⁶ Euromonitor estimate from country report on China.
⁷ Maine international trade centre estimate.

Air transportation for imported food is also popular, despite improvements in overland infrastructure. Air shipments are estimated to make up around 10 percent of China's imports by volume and more than twice that in value.⁷ Many still report airborne imports face fewer customs and quarantine difficulties compared to imports by sea, despite recent improvements in port processes.

The Hong Kong 'gray channel' is still a primary route for products destined for certain regions. According to Maine International, most northern distributors have eliminated reliance on the gray channel. This was historically cheaper than official channels, as imported goods were often shipped from Hong Kong outside of official channels to evade tariffs. However, WTO tariff reductions have diminished the advantages of under-invoicing, and the central government has, and continues to, crack down on customs tariff and tax avoidance. In addition, with improved infrastructure the extra transportation costs via Hong Kong often eats into the other perceived savings.

Figure 8: Structure of China's food distribution network



Sources: ANZ, China Statistical Yearbooks



FOOD RETAILING

According to Euromonitor, the grocery retail sector in China was worth US\$504.4 billion in 2011. Euromonitor forecasts this will grow to a value of US\$707.2 billion by 2016, a compound annual growth rate of 7 percent. There are a number of different formats in China for food retailing.⁸

Hypermarkets

Hypermarkets (a combined supermarket and department store) have a reputation for offering high-quality products that appeal to affluent urban Chinese who are concerned with food safety issues. They generally offer more imported products than domestic supermarkets. International hypermarket retailers in China are more receptive to introducing imported products as they are more familiar with them. Hypermarkets usually have a small group of preferred distributors they deal with, and exporters looking to get their products onto the shelves in hypermarkets should focus on these select few distributors. **Foreign retailers have performed far more strongly in the hypermarket channel than any other retail channel.** Major hypermarket players are Carrefour, Wal-Mart, Metro, Lotus, Auchan, and Tesco.

Supermarkets

This channel is quite fragmented as there are large numbers of small regional chains or independent supermarkets, especially in many second and third-tier cities. Imported food is less prominent in Chinese supermarkets. Products that do well in this sector tend to be commodity products already widely available, such as fresh fruit and frozen vegetables. Supermarkets seldom import directly, or even buy directly from an importer. Instead they usually rely on wholesale markets and local manufacturers or distributors. The best possibilities for exporters are in the smaller, privately held chains, which are more likely to see the value of high-margin imports and tend to have better integrated distribution systems. Major supermarket players are Lianhua, Wellcome, ParknShop, China Resources Vanguard and Suguo.

Specialty Supermarket Stores and Boutique Stores

These types of stores are often located near high-end department stores and fashionable business centres. They generally have a high proportion of imported food products – ranging from 10 to 80 percent of their product range. Specialty supermarkets are not only present in first-tier cities, but also some second-tier ones. Major specialty supermarket players are City Shop Supermarket (Shanghai), City-Super, CRV Ole, BHG (Beijing Hualian Supermarket), Hisense Plaza in Qingdao, and Jin Bou Da in Zhengzhou.

Convenience Stores

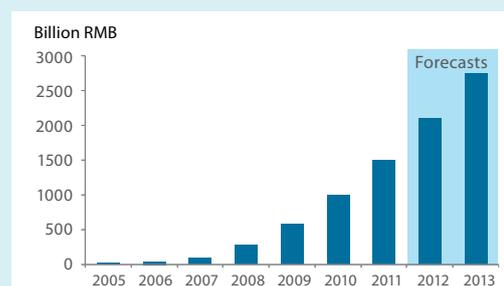
This is the least developed channel, but has lots of potential for growth. State-owned domestic retailers have tended to dominate this channel. The leading players are Quik, Kedi, and Alldays, which are all owned by local groups. International convenience

retailers such as 7-Eleven, Family Mart (Japan Ito Yokado), Sincere (Hong Kong), C-Store (Taiwan), and Lawson's (Sino-Japan JV) are all developing strongly though. **There is relatively low import penetration, as imported products are less familiar to convenience store managers than they are to their counterparts in hypermarkets.** Another cause for the low import penetration is that convenience stores require small package sizes, typically single-serve products.

Online Sales

Online shopping is growing rapidly in China, especially in first-tier cities. Euromonitor estimates that online food and beverage sales are set to make a staggering jump from US\$485.6 million in 2011 to US\$3.1 billion in 2016. This is corroborated by iResearch projections that online transaction volumes are experiencing exponential growth; albeit one company Taobao reportedly has a 75 percent market share at the moment. Outside Taobao, importers usually run online food and beverage businesses. **As there are fewer intermediaries in the supply chain, consumers can buy the imported products at lower cost, and importers save the expense of having their products listed on a retail shelf** (i.e. shelf space payments to supermarket and additional government taxes). Importers can also communicate with consumers and deliver product information more efficiently.

Figure 9: Online transaction volumes in China



Sources: ANZ,iResearch

Traditional Markets

These markets exist throughout China, although they are no longer the dominant retail food source in the larger cities they are still important for certain food categories. **Traditional markets fall into three general categories: wet markets, variety stores (xiaomaibu), and fruit stands.** Wet markets specialise mainly in fresh vegetables, meat, poultry and seafood (mostly sold live), eggs, tofu and (to a lesser extent) fruit and staple foods.

⁸ Main descriptions from:

1. New Zealand Trade and Enterprise Food & Beverage Market Profile for China published in January 2012.
2. Maine International Trade Center: China & Hong Kong Food Opportunities for Maine published in March 2012.



FOODSERVICE

According to Euromonitor, the Chinese foodservice sector was worth \$367 billion in 2011, and is expected to grow to \$495 billion by 2015.

This represents compound growth of 7.8 percent for the period 2011-2015. Dining out has become more and more popular across China, particularly in big cities. City dwellers, especially young people, frequently consume fast food or convenience food for breakfast or lunch, due to the quickening pace of life. A faster pace of life, higher living standards, increasing disposable incomes, as well as the faster development of the restaurant sector have made dining in a restaurant an affordable social event for gatherings with family, friends and business contacts.

Full-service restaurants dominate the foodservice landscape, with a market share of around 72 percent, followed by fast food restaurants at around 25 percent. However, the Chinese foodservice sector is extremely fragmented. Western-style restaurants account for only 1 percent of the market, and tend to be concentrated in the coastal cities. Fast-food

restaurants account for approximately 23 percent of this market. The main players are: Yum! Foods (KFC, Pizza Hut), McDonalds, and Dicos (a Texas fast-food chain).

Foodservice is a key player in introducing imported foods. High-end restaurants and hotels are less constrained by price considerations and more interested in presenting unique dishes and products.

If successful, their efforts are likely to be copied by other restaurants, bringing them closer to mainstream middle-class consumers. It is important to note that while the sector as a whole has great potential, many parts are not strong candidates for imported foods. Catering operations that run cafeterias and provide box lunches, as well as small family-owned restaurants, account for a large proportion of the industry, but are price-sensitive.

MARKET SHARES FOR FOOD DISTRIBUTION

Euromonitor and official statistics show supermarkets/hypermarkets are now dominating the retail landscape, with a market share of around 50 percent.



For a labour intensive market, increased labour costs creates significant implications.

Other research by AC Nielsen and McDonald's shows wet markets are still very important for fresh produce, especially seafood, meat, fruit and vegetables. However, these traditional wet markets are losing market share in those categories to organised retail (supermarkets, hypermarkets etc). This is due to more consumers being concerned about hygiene and food safety, changing consumption patterns to more packaged and processed foods, and government tax structures making it more and more difficult for wet markets to operate.

McDonald's recently presented a breakdown of their estimates of market shares for each food distribution channel of the main meat types at the Red Meat sector conference. It showed the organised retail share in 2010 for poultry, beef, seafood and mutton as less than 8 percent. Pork, the preferred meat in China, was a little higher at 17 percent. The foodservice sector, specifically

the hotel/restaurant/catering trade, had a higher market share at 12-20 percent. For McDonald's business, which is classified as a quick service (fast-food) restaurant, their market share is only 1-3 percent. **The most interesting aspect of the presentation was the projected change in market shares between 2010 and 2020.** They have projected the hotel/restaurant/catering share of sales will stay about the same, and there will be slight growth in the share of sales for quick service restaurants in the poultry and beef segments reflecting the majority of the offerings on internationals' menus. The dramatic change is wet markets losing nearly half, or more, of their current market share to organised retail due to the trends mentioned above, as well as continued expansion and consolidation in organised retail across the country.

Figure 10: Channel most often used to purchase different products

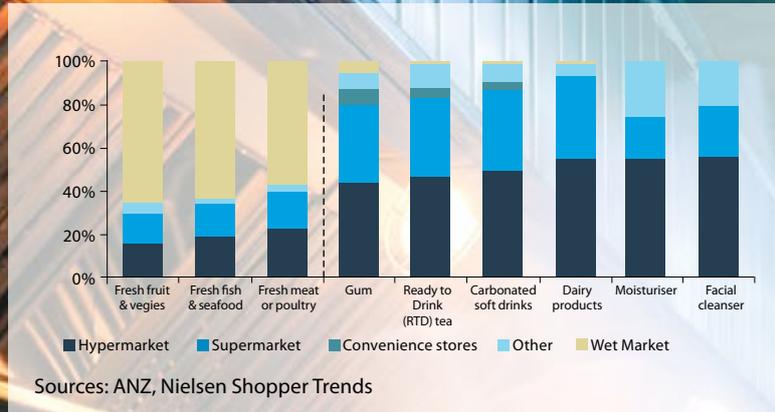
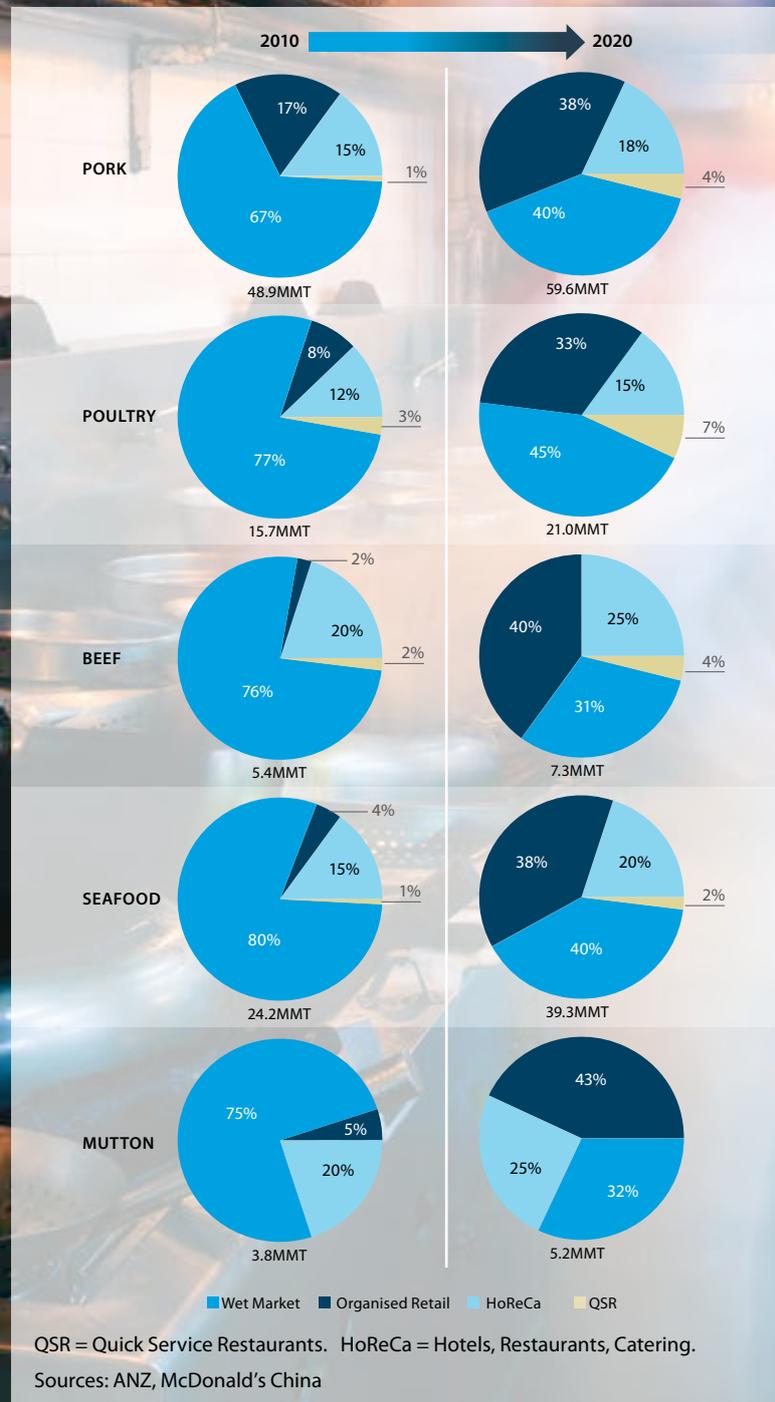


Figure 11: China's estimated structure of food distribution



FOOD EXPENDITURE AND CONSUMPTION PATTERNS

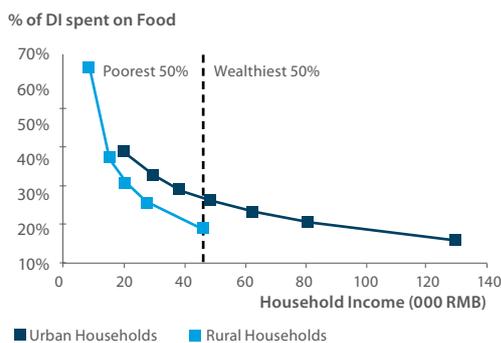
Until the 1980s the average Chinese household devoted more than 50 percent of their income to food, reflecting its importance in Chinese culture and their historic vulnerability to food insecurity.

Food’s share of spending remains the single largest item for both urban and rural households, but has shrunk as a proportion of budgets.

Disposable income spent on food currently averages around 35 percent for rural households and 28 percent for urban households.

This remains high compared with Australia’s average of 17 percent (ABS) and 9 percent for the US, which is the lowest in the world.

Figure 12: Food expenditure patterns by income level



Sources: ANZ, Chinese National Statistics

However, there is a wide range, depending on the income levels of different households.

The wealthiest 20 percent of urban households, which account for 10 percent of all Chinese households, spend less than 22 percent of their disposable income on food. At the other end of the spectrum the poorest 10 percent of urban households (accounting for 5 percent of all Chinese households) spend more than 40 percent of their disposable income on food, and 66 percent for their rural counterparts.

Interestingly, higher-earning rural households tend to spend a lower proportion of their disposable income on food when compared to urban households with a comparable income level. A different dietary mix and access to lower-cost food would seem to explain the majority of the difference. The proportion spent has also been calculated against net income for rural households and disposable for urban households, which could also provide a slight difference.

Urban Consumption Patterns

For all households the mix of food consumed, the price paid and where it is sourced, continue to change rapidly, adding to increased market sophistication. A number of mega trends can be attributed with influencing these changes.

Such trends include:



Over the last six years urban per capita incomes have grown by 13 percent per annum, while food expenditure has grown at a slower rate of 10 percent per annum. Rural per capita incomes have grown by 12.5 percent per annum and household food expenditure by 9.5 percent over the same period.

Much of the increased food spending by urban consumers has reflected higher per-unit spending commonly attributed to a preference for quality. The average amount spent per kilogram on food purchased for the wealthiest 20 percent of urban households is now up to RMB20 per kilogram (US\$2.95 per kg). This is nearly double the poorest 20 percent of urban households at RMB11 per kilogram (US\$1.60 per kg). The average overall growth in per unit expenditure for all income deciles has been 11 percent over the last six years, which was slightly more than total expenditure increased over the same period.

Urban household incomes for the wealthiest 30 percent (20 percent of total households) have now reached a level such that overall food consumption intake has stabilised and will not increase further with a rise in income.

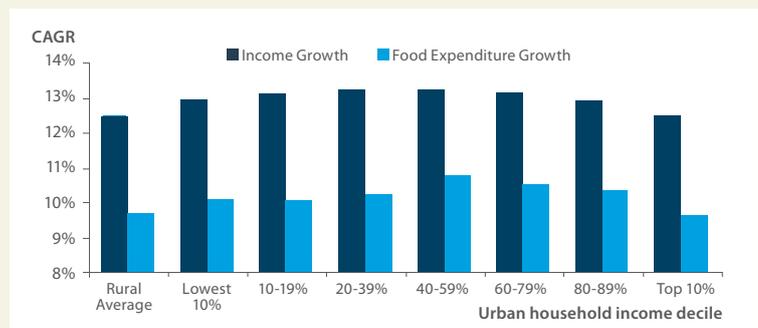
In addition, the apparent linear relationship between total food consumption and the log of income suggests that demand elasticity declines as income rises up to RMB11,000.⁹ This shows that for the other 80 percent of urban households the relationship between total food consumption and income weakens as incomes rise. In other words, the increase in total consumption in response to a 1 percent rise in income is much greater for low-income households, than it is for mid-to-high income households.



Much of the increased food spending by urban consumers has reflected higher per-unit spending commonly attributed to a preference for quality.

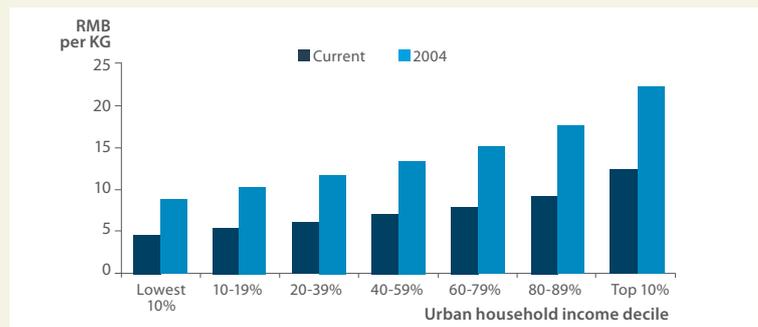
⁹ Mathematically the chart shows the change in the absolute quantity purchased against the log of income. If the slope of the line is greater than zero and constant, then the elasticity declines as quantity of food consumed and income increase.

Figure 13: Annual growth rate for incomes and household food expenditure by income class over the last six years



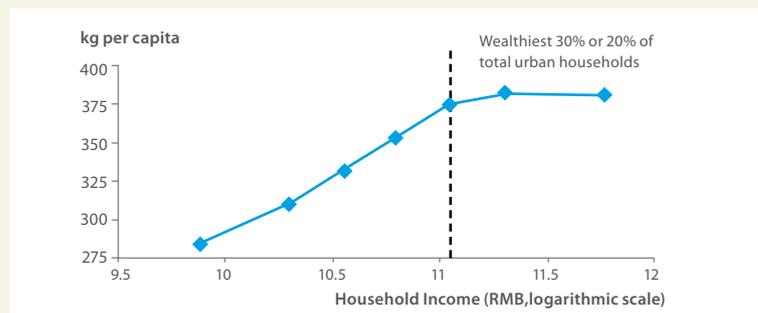
Sources: ANZ China National Household Survey

Figure 14: Urban household food expenditure patterns by income class



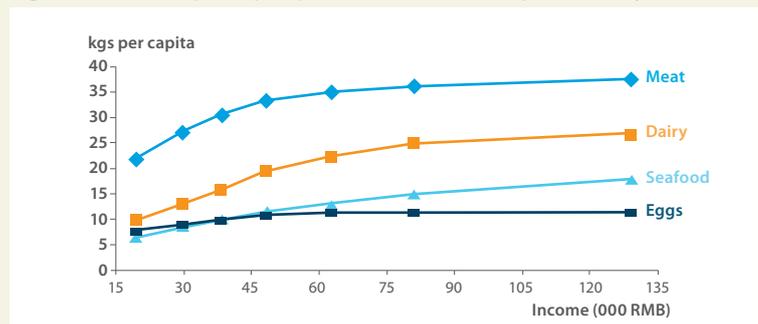
Sources: ANZ China National Household Survey

Figure 15: Annual per capita consumption of food by level of income



Sources: ANZ China National Household Survey

Figure 16: Annual per capita purchases of livestock products, by income level



Sources: ANZ China National Household Survey

FOOD EXPENDITURE AND CONSUMPTION PATTERNS

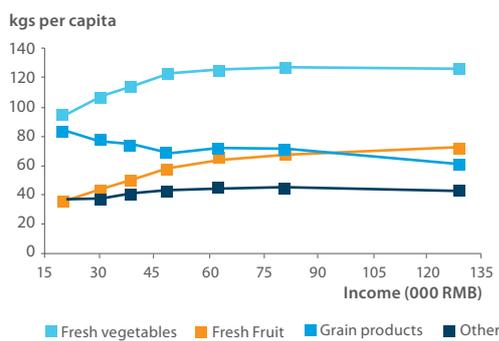
The national household survey shows that as incomes rise, urban households change the structure of their diets.



Consumption of traditional (stable) foods such as grains, starches and vegetable oils tends to fall or remain stagnant as income increases.

For low-income households, pork and eggs are usually the dominant sources of animal protein, but **purchases of seafood, dairy and poultry rise more quickly as income increases. There is also a rise in fresh fruit and vegetable consumption as income increases.** However, the rise in consumption for these products appears to plateau earlier than for the likes of seafood, dairy and poultry. **In contrast, the consumption of traditional (stable) foods such as grains, starches and vegetable oils tends to fall or remain stagnant as income increases.** These trends suggest wealthier consumers prefer a diet rich in protein and vitamins, but low in carbohydrates.

Figure 17: Annual per capita purchases of other products, by income level



Sources: ANZ, China Statistical Yearbooks

Households in China’s wealthiest deciles spend as much as five times more on dairy and seafood products than those in the lowest income deciles. Meat, egg and grain expenditure is nearly double also, reflecting these products being relatively more homogeneous than dairy and seafood, and there being fewer food safety issues. The overall difference between the wealthiest and poorest households’ expenditure reflects both higher expenditure per kilogram on food, and total food consumption levels. **Households spend the highest amount per kilogram on seafood and meat.** For wealthier households, the difference in the value paid per kilogram generally reflects the purchasing of processed products, better cuts of meat, branded or packaged products, and more costly products (e.g. shrimp/crayfish versus fish for seafood).

From an Australian exporter perspective, the target should be accessing the growing number of affluent urban households. Both per unit expenditure and consumption levels of our main exports are higher in these households. The high-end restaurant channel also offers opportunities to access those in the higher income brackets. Accessing this market segment will be assisted through the recognition by Chinese consumers of Australia’s produce as being not only high quality, but most importantly, as being from a reliably safe source.



HOT SPOTS FOR AUSTRALIAN EXPORTS

With China being such a vast marketplace, the question is where can we find the wealthiest households that might be willing to spend big on Australian food and beverage products?

Of course, targeting the wealthy is only one component: to be successful, Australia will need to identify markets that offer facets that are complimentary to the basket of goods we can provide such as refrigeration and distribution functionality. We note the following key indicators:

1. **Population density:** concentration of possible customers and the prevalence of food retail and foodservice providers utilising imported products.
2. **Urbanisation ratio** (i.e. resident living in urban municipality of province): purchasing power, the prevalence of food retail and foodservice providers utilising imported products, concentration of customers, and more westernised consumer preferences.
3. **Income per capita:** purchasing power.
4. **Food expenditure per capita:** purchasing power of Australian orientated exports and higher expenditure per kilogram of food purchased.
5. **Proportion of food expenditure on Australian orientated exports:** specifically meat, dairy, seafood and dining out.
6. **Refrigerators per 100 households:** ability to store Australian orientated exports, which usually require some form of refrigeration if bought via retailers.
7. **Fixed investment per square kilometre:** infrastructure intensity and cool chain development, as well as the likely prevalence of food retail and foodservice providers utilising imported products.



OBSERVATIONS

From James Campbell, ANZ Head of Agribusiness, China

- Historically textiles (cotton and wool) have dominated Australian agricultural exports to China. However, an emphasis on food safety, elevated middle class incomes, and rising protein demand in China has uniquely positioned Australia to capture a significant share of the Chinese premium food and beverage sector.
- The opportunities are certainly grounds for optimism however are not an automatic 'golden ticket' to financial success. Competition from other productive economies including South America, US, Africa, and New Zealand is significant and must eliminate any grounds for complacency. Combined with the ever-present risks of doing business in China, we consider that **understanding the supply chain is more important than ever**, to accurately target the right market and end-consumer. We are seeing a growing trend for control and/or significant influence over supply chains in the interest of meeting established consumer demand for safe, reliable, and increasingly traceable products.
- It is well understood that China **perceives Australia as a clean, safe, reliable food producer** in close geographical proximity, coupled with a stable political and legal environment. Lesser known is their view of Australian farmers and graziers as being collectively one of the most efficient globally, driven by low government subsidies that in turn promote high levels of innovation.
- **Management and know-how is being increasingly sought after** as development in areas such as genetics, animal husbandry, and value-added products gather pace. This is an export that is not immediately considered, however our observation is that this is being sought and will grow in significance as China advances further, especially in the industrial livestock industries (dairy and beef).
- **Understanding how to access the best distribution channels to consumers is changing.** Traditionally, mainland agents have operated as conduits between exporters and distributors/end-users. The still highly fragmented nature of distribution is expected to underpin this to remain a key means of channelling product over the medium term. That said, the increasing focus of the Chinese on control/ significant influence over the supply chain by entering both upstream (production) and downstream (distribution) partnerships will begin to alter the traditional agency arrangements with direct trade likely to become more prevalent. This trend is a direct response to growing perceptions of more scarce resource constraints and greater consumer demand for traceable, reliable, and safe products.
- Recent examples of transactions that evidence this include Bright Foods' acquisition of Manassen (Australia), Weetabix (UK), and Synlait (New Zealand), COFCO acquisition of Tully Sugar, Yili acquisition of Oceania Dairy Limited (NZ) and Yashili announcing a NZD200m construction of an infant formula plant (NZ).
- **This is not limited to food**, as seen with Shandong RuYi, one of the largest fully integrated textile producers, processors, and retailers in the world, acquiring Cubbie Station, the world's largest cotton producing aggregation in a joint venture arrangement with Australia's largest wool procurer, Lempriere Group.
- Our view is that the increasing supply chain focus is not only limited to large enterprises such as those noted above. **Opportunities exist for progressive primary and secondary production/processing entities to explore means of co-operation on an individual and collective basis**, particularly beyond traditional trading relationships. To a degree outcomes are dependant on scale, though this will differ across the classes of commodities and products being contemplated. Allocating attention to this will give rise to a high potential for positive results including access to end-to-end supply chain returns as opposed to being limited to one section of the supply chain such as farm-gate or first stage processing.
- Given the disparity of the many fragmented distribution networks in China it is our experience that a large Australian exporter does not necessarily trade with an entity of similar scale and risk profile in China. To this end, ANZ's in-country specialists, not just across Asia but globally, continue to explore means by which we can leverage being on both sides of trade flows by directing risk appetite to establish end-to-end trade solutions in the interest of both exporter and importer.
- When evaluating potential supply chain partnerships, we draw on what we identify as the primary drivers of Chinese investment: (i) Procurement; (ii) Growth; (iii) Technology (including expertise); (iv) Expanding distribution network; and (v) Lifestyle. Our observations from Australian entities who have successfully entered supply chain partnerships is that their evaluation of potential partners is premised on a comprehensive evaluation of their own core business, overlaying this with the investment drivers, and determining the quantum of capital and resources which will be directed to the 'China strategy'. An assessment of the scalability of the venture post investment is also important. Our experience has been that the Chinese regularly seek additional investment soon after the initial investment occurs.



CONCLUSION

Feeding the Dragon – The modernisation of China's food industry

China – and the broader Asian region – is a critical part of Australia's medium-term economic story. The region's economic structure is changing. Such changes play to Australia's economic strengths.

From paddock to plate, China's food industry continues to modernise and consolidate at a rapid pace, driven by a number of mega trends. They are not flashes in the pan and will continue to evolve and develop over time.

The level of modernisation and increased market sophistication now offers increased opportunities for imports of the types of food and beverages that Australia produces.

However, cracking what is now the world's biggest food and beverage market is not a task for the faint-hearted or uncommitted.

Beyond this analysis, **the next step for businesses requires an even deeper dive, to gain an intimate knowledge of a chosen market based around a specific proposition.**

Lessons from those who have gone before have shown **essential elements for success include:**

- **strong business relationships** built up over time and based on mutual trust;
- **an intimate knowledge of a targeted market segment;**
- **cultural understanding of tastes and business practices;**
- **local staff or collaborators;**
- **some scale** as everything is super-sized compared with Australia, and therefore collaboration will often be required within a sector; and
- **patience,** with a long-term view because of the time and cost of becoming truly established.



From paddock to plate, China's food industry continues to modernise and consolidate at a rapid pace, driven by a number of mega trends.

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Please contact your ANZ point of contact with any questions about this publication including for further information on the above disclosures of interest.

CONTRIBUTORS

Cameron Bagrie
Chief Economist

Telephone: +64 4 802 2212
E-mail: cameron.bagrie@anz.com

Con Williams
Rural Economist

Telephone: +64 4 802 2361
E-mail: con.williams@anz.com

David Croy
Head of Market Research – NZ

Telephone: +64 4 576 1022
E-mail: dc@anz.com

Glen Thompson
Senior Insights Manager

Telephone: +64 9 2526878
E-mail: glen.thompson@anz.com

James Campbell
Head of Agribusiness- China

Telephone: +8621 616 96181
E-mail: James.campbell4@anz.com

Tamara Keys
Associate – Agribusiness Research

Telephone: +61 3 8655 1253
E-mail: Tamara.keys@anz.com

