



Revisit the Dragons' den

A pulse check on China's FMCG market



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Introduction

2018 has been a volatile year in China.

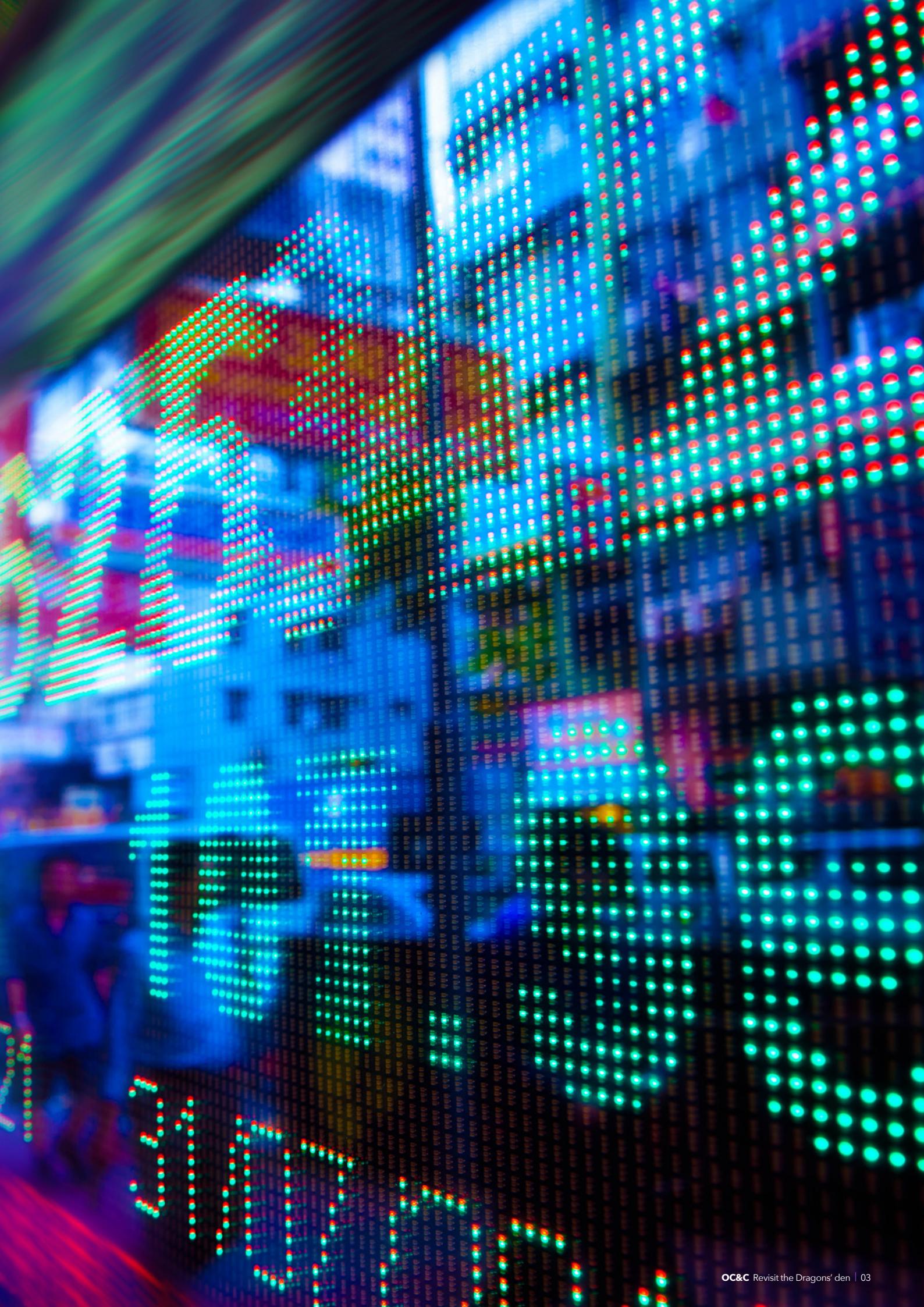
Following heightened economic and geopolitical uncertainties from the trade war and corresponding RMB depreciation, concerns over the strength of domestic demand and China's FMCG market outlook are rising as momentum in both private consumption and investment has weakened. After decades of rapid double digit growth, China's FMCG market has reached a new era of stabilized single-digit growth coupled with consumption upgrade and retail digitalization in recent years.

To better understand the outlook and attractiveness of China's FMCG market in today's uncertain world, we revisited the top 20 domestic leaders (the China 20 by sales) and assessed their performance against their global rivals, as identified in our Global 50 2018 report. This report seeks to bring clarity to China's FMCG market outlook with new perspectives on existing market performance and to uncover success factors to best seize market opportunities to win in this new era.

IN SUMMARY, WE BELIEVE:

- The overall China FMCG market still remains more attractive than developed markets in terms of growth.
- The market dynamic is, however, becoming more challenging for FMCG players to win, with winners taking a disproportionate share of the growth.
- To succeed, four winning factors are demonstrated by top performing Chinese FMCG companies who have exhibited an ability to register both high growth and solid profits.





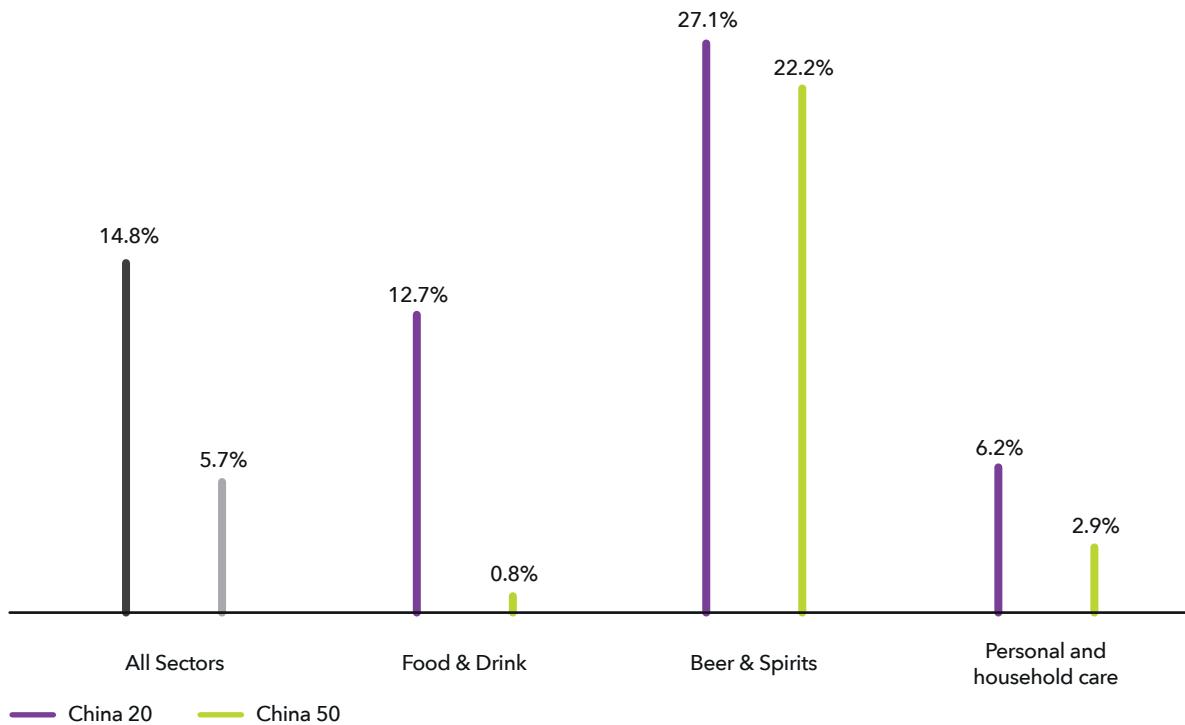
China's FMCG market still remains a solid growth market

While many people professed concerns over the slowdown of China retail sales in 2018, China's FMCG market has indeed slowed down progressively from double-digit growth to single-digit growth of 6% - 8% in recent years. The stabilized rate is not surprising given that China is now the second largest FMCG market in the world. Even so, the growth in China has still remained stronger than developed markets in major economies which all recorded little or no growth.

The China 20 companies, or the Chinese Dragons, registered an average growth of 15% compared to their Global 50 rivals 6% in 2017. While performance varied significantly by sector, the attractiveness of the Chinese market was particularly apparent in the Food and Drink sector with the Chinese Dragons outgrowing the Global 50 by a large margin of 12 percentage points. In the first half of 2018, the top 10 Chinese Dragons continued to demonstrate solid growth compared to last year, with 60% of them achieving accelerated year-on-year growth.

We expect this relatively stronger growth to continue with a number of favorable tailwinds. One of the key growth drivers is the continual rise of the middle class that is spending more on premium and healthier products. The rising disposable household income has also improved the consumption power of consumers in lower tier cities, where the penetration of large brands has yet to be saturated.

GROCERY REVENUE GROWTH OF CHINA 20 VS GLOBAL 50, BY SECTOR





But market challenges are also intensifying

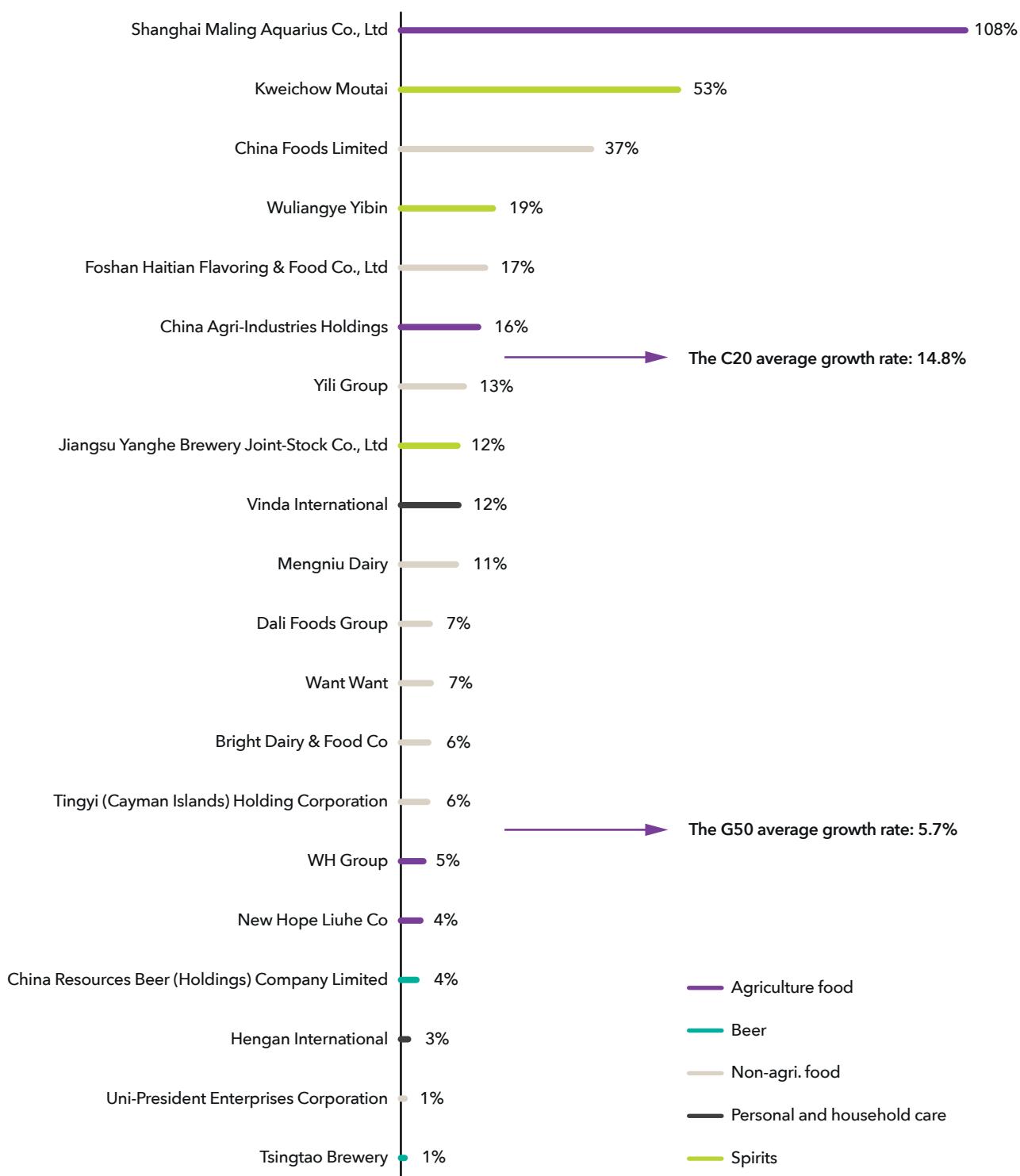
Despite the stronger overall growth rates, not all Chinese Dragons enjoyed the same success due to four major challenges.

- 1 The market tends to be winner takes all with skewed growth rates towards a few 'star' companies
- 2 Scale does not necessarily translate to strong profits, with profitability, especially on a gross margin level, materially lower than the Global 50
- 3 Competition is becoming even more intense, with both established international players as well as local disruptors entering the market
- 4 Shifting customer demographics and evolving technology have changed the means to reach out to, and capture customers

The high overall growth of the Chinese Dragons was highly polarized with the top three Dragons capturing nearly 50% of the growth in 2017

Firstly, the high overall growth of the Chinese Dragons was highly polarized with the top three Dragons capturing nearly 50% of the growth in 2017. The majority of other Dragons struggled to reach the average growth of 15% and six of them grew below the Global 50 average.

GROCERY REVENUE GROWTH IN 2017, BY CHINESE DRAGONS¹



The picture is even starker when we compare the growth of some of these companies to their performance back in 2010, with a number of Dragons registering decelerated growth from over 30% in 2010 to below 8% in 2017. These Dragons are facing increasing challenges from mature market penetration which limits their volume growth potential, and intensified competition due to lower entry barriers from production technology enhancement and online retailing. Some have also placed an over-reliance on their "star" products and failed to invest in product innovation to align with changing consumer needs.

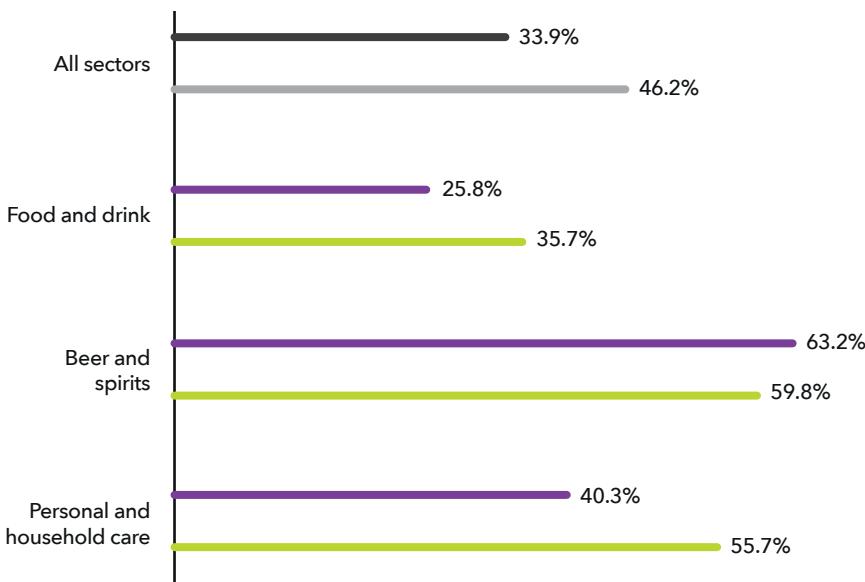
Secondly, the battle is trickier when it comes to profitability. Apart from the Beer and Spirits sector, Chinese Dragons in other FMCG sectors achieved significantly lower gross margins of 10-15 percentage points on average compared to their global rivals in 2017. The large gap reflects challenges from rising production costs and pricing pressures driven by growing competition. Although the difference when it comes to net margins is much closer, Chinese Dragons remained less profitable at 15% of net margin versus 17% for their global rivals. The improved net profitability gap was partly achieved from lower marketing and R&D spending than the global brands, hinting at the risk of potential underspending on brand building and product innovation which could impact future growth.

The third challenge is competition. In China, competition comes not only from large established competitors internationally or domestically, but also from the emergence of smaller companies and new disruptive models.

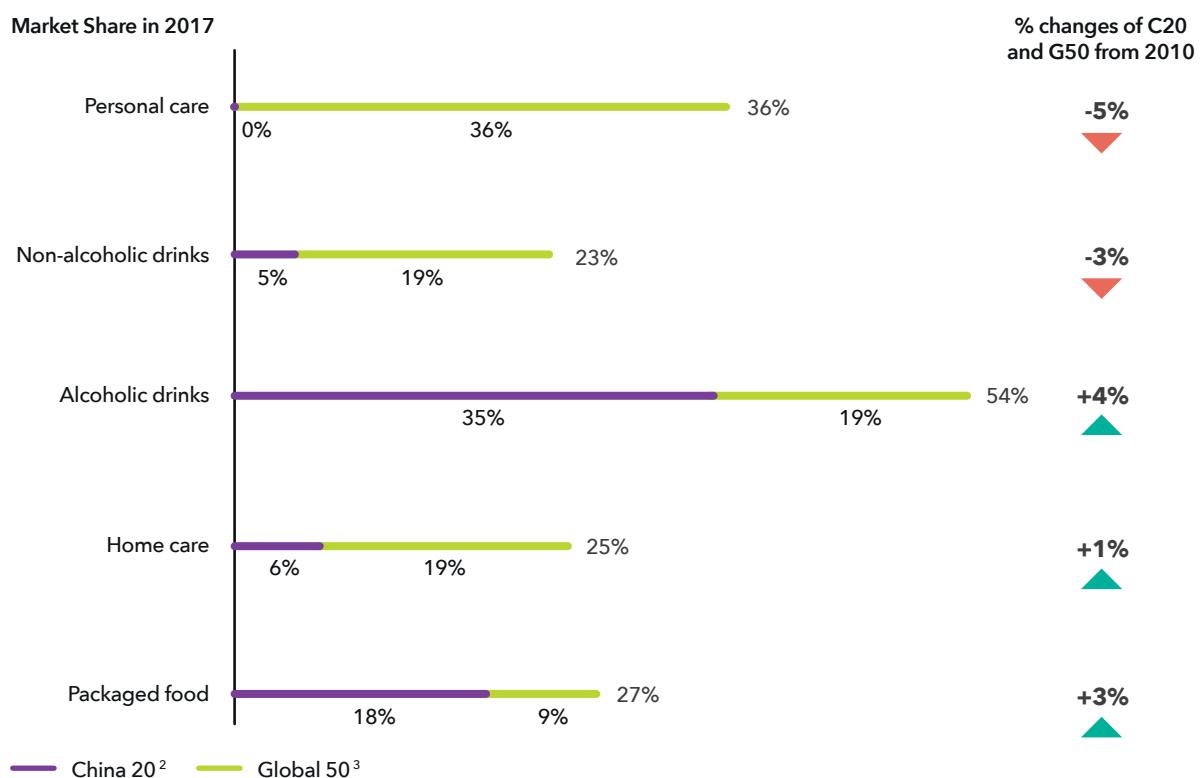
While conventional wisdom suggests that scale and having prestigious brands are important factors in the FMCG market, these traditional success factors no longer guarantee a lasting competitive advantage. In fact, large FMCG companies, both local and global giants, have failed to increase their market share significantly despite their rapid growth between 2010 and 2017. In particular, smaller brands have been stealing share from large FMCG companies in the personal care and non-alcoholic drinks sectors.

Chinese Dragons in other FMCG sectors achieved significantly lower gross margins of 10-15 percentage points on average as compared to their global rivals in 2017

GROSS MARGIN OF CHINA 20 VS GLOBAL 50 BY SECTOR COMPARISON, 2017



CHANGES IN MARKET SHARE DISTRIBUTION OF CHINA 20 AND GLOBAL 50 IN 2010 AND 2017, BY SECTOR COMPARISON¹



1. WH Group is in both C20 and G50 group in 2017 and is grouped in C20 for this analysis

2. 14 out of 20 companies

3. 41 out of 45 companies (excludes 5 tobacco companies)

Due to the readily available capital-raising environment, China's FMCG market has become ever more crowded with thousands of SMEs attracting a significant amount of investment in the past decade. The rapid rise of online retailing has also significantly lowered the entry barrier and enabled start-ups to reach out to an extensive pool of consumers at a lower cost, particularly those in lower-tier cities where the penetration of traditional offline retailers has yet to be saturated.

In particular, PinDuoDuo, an online disruptor which specializes in group discounts for consumers, plays a leading role in FMCG product distribution for lower tier cities and has been growing rapidly since its establishment in 2015, with market capitalization reaching 20bn USD after its IPO. Coupled with its support for the produce sales for rural farmers, it has intensified the FMCG battleground by acting as a high-speed distribution avenue for millions of small local businesses. Many of these new brands were started purely to serve the PinDuoDuo platform and leverage existing factories with spare capacity.

Winning start-ups often employ a direct-to-consumer (D2C) model to align their product offerings to consumer needs through first-hand data collection and build their brand with close interaction with consumers. For instance, Le Pur, a premium yogurt company, has leveraged online channels including Tmall and WeChat to employ D2C to build a direct relationship with over 1 million consumers in three years. Coca-Cola recently invested in this start-up to leverage its ability in product incubation and digital innovation, reflecting their efforts in participating in the D2C model and innovation.

Lastly the younger generation, especially millennials and Generation Z, are becoming the new spending engine with their growing income and low saving behaviors. By 2021, they are expected to represent more than 50% of urban consumption. With their rising importance, large FMCG brands face challenges in acting fast to cater to these emerging demands in the markets. The consumption behaviors and needs of the young generations differ from their parents. Besides product needs on quality and convenience, they are extremely tech-savvy and demand a more personalized and interactive shopping experience.

As such, large FMCG companies can no longer simply ride on their "star" products to strengthen their position, but need to reorient their product portfolio and distribution model to address the needs of the younger generations.



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How the large FMCG companies win the battle

Despite the challenges, we have seen cases of Chinese Dragons succeeding in this increasingly difficult environment.

Not only have they stayed ahead in growth, they have also improved their profitability through portfolio optimization. They also recognized the importance of changing consumer demographics and have placed strong emphasis on marketing investment to build a better brand together with online channel expansion.

Through examining the performance and business model of the top 20 Chinese Dragons, we have identified four major building blocks of winning strategies from top performers who achieved fast-pace growth with solid profitability.

ENHANCE CATEGORY THROUGH PORTFOLIO RATIONALIZATION AND PRODUCT INNOVATION

- During the past decade of fast business growth, large FMCG companies can sometimes lose sight of their product portfolio expansion and can lead to an overly complex portfolio with a long tailwind and no key products that caters well to new customer needs. In recent years, we see a trend of product rationalization among Chinese Dragons.
- Kweichow Moutai, one of the top performers, achieved 53% growth partly through portfolio optimization. Since 2017 it has reduced its brands down from 214 to 51 to optimize production and distribution while introducing new products with middle-tier pricing as a play against consumption upgrade from mass to middle-tier products.
- In the wave of consumption upgrade and rising competitive pressures from small companies, new product innovation has become ever more important and winning FMCG brands are investing in R&D or partnering with global brands to boost their product development.

LEVERAGE COST EFFECTIVE GO-TO-MARKET TO DRIVE PENETRATION WHILE LEVERAGING ONLINE RETAILING TO CAPTURE GROWTH

- Although FMCG market growth has slowed down, there are still opportunities to capture unmet needs in lower tier cities as the traditional chained retailers have relatively lower penetration.
- Foshan Haitian expanded its city coverage by more than 10% in 2017, strengthening its penetration in lower-tier markets such as the western region and achieved double-digit growth in 2017. At the same time, Haitian continued to expand its product portfolio to meet the different needs of the expanded consumer segments.
- With strong growth in the FMCG e-commerce market we see many large companies investing into digital channels however not many have managed to ride on this trend as well as their smaller rivals. Star performers also need to move beyond viewing digital as just a sales channel, but to also leverage large scale data analytics to drive sales conversion and product development.
- For instance, Yili, a leading player in the dairy market, successfully leveraged Tmall and JD's B2C platform and increased sales by 130% in 2017. The growth was driven by Yili's close collaboration with the e-commerce giants, from data analytics for new product development to logistics infrastructure establishment to support same-day delivery.

RECOGNIZE THE RISING POWER OF EFFECTIVE DIGITAL MARKETING IN BRAND BUILDING AND SALES CONVERSION TO ENGAGE CONSUMERS THROUGH DIGITAL MEDIA

- In 2017, while Chinese Dragons on average spent much less than their global rivals on marketing, winning Dragons were able to effectively utilize marketing by placing greater emphasis on brand building via multiple channels with innovative concepts to connect better with consumers, particularly younger generations.

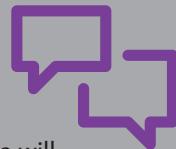
- In the Beer & Spirits sectors, Wuliangye spent the highest investment in brand building via poster and video advertisements through a mix of online and offline channels. It also joined the collaboration initiated by top online retailer JD.com to build an omni-marketing ecosystem to integrate Chinese drinking culture into products and brands. During annual sales event, JD.com leveraged live streaming with gaming elements and pop-up stores to connect younger generations with brands through fun and interactive experiences.

UNFOLD POTENTIAL OPPORTUNITIES IN OVERSEAS EXPANSION THAT CAN STRATEGICALLY STRENGTHEN DOMESTIC POSITION AND OPEN UP NEW GROWTH OPPORTUNITIES INTERNATIONALLY

- Over the past few years, Chinese Dragons across FMCG sectors have been investing internationally with objectives ranging from new product development, product premiumization, and expanding their global reach.
- In the dairy market, both Mengniu and Yili have been investing in overseas R&D to enhance their product development capabilities and supply chain infrastructure for quality improvement and sustainability. Their global move has contributed to strengthening their leading position in the China market while creating new growth engines overseas.
- Vinda, a leading player in the Personal Care sector, has succeeded in diversifying its product portfolio through overseas acquisition of SCA (Asia). Besides driving its domestic business, this expansion also enlarged its potential consumer base by 40% in Asia, opening up further growth opportunities for Vinda.

Going forward

The China market will remain attractive but the battleground is becoming more crowded and challenging.



To be successful, we believe a successful FMCG company in China will need to have their own answers for the following five questions:

- 1 Do you understand the behaviors of millennials or Generation Z consumers and have appropriate offerings tailored to these future consumer needs?
- 2 Have you established an optimal go-to-market model and partnership to reach out to consumers in lower-tier cities?
- 3 Do you have your e-commerce strategy ready to navigate between different models, e.g. B2B and B2C and technologies to win in the dynamic online landscape in China?
- 4 Do you have direct to consumer brands or capabilities to capture new opportunities?
- 5 Is your operating model and organization set up to respond quickly to new trends and opportunities?

If you would like to develop a winning position in the FMCG market in China, then please get in touch with us and we'd be delighted to discuss how we can help you succeed.

Appendix

TOP 20 CHINESE FMCG COMPANIES

Rank	Company	Chinese Company	Sector	Grocery Sales ¹		
				In million USD ² in 2017	In million RMB in 2017	% Change in local currency sales 17 vs '16
1	WH Group	万洲国际	Food and Drinks	\$21,303	¥143,982	5%
2	China Agri-Industries Holdings	中国粮油	Food and Drinks	\$10,152	¥68,612	16%
3	Yili Group	伊利股份	Food and Drinks	\$9,984	¥67,480	13%
4	Mengniu Dairy	蒙牛股份	Food and Drinks	\$8,814	¥59,570	11%
5	Tingyi (Cayman Islands) Holding Corporation	康师傅	Food and Drinks	\$8,450	¥57,110	6%
6	Kweichow Moutai	贵州茅台	Beer and Spirits	\$7,663	¥51,790	53%
7	China Resources Beer (Holdings) Company Limited	华润啤酒	Beer and Spirits	\$4,290	¥28,995	4%
8	Wuliangye Yibin	五粮液	Beer and Spirits	\$3,765	¥25,448	19%
9	Tsingtao Brewery	青岛啤酒	Beer and Spirits	\$3,592	¥24,278	1%
10	New Hope Liuhe Co	新希望	Food and Drinks	\$3,243	¥21,917	4%
11	Uni-President Enterprises Corporation	统一	Food and Drinks	\$3,052	¥20,628	1%
12	Want Want China Holdings Limited	旺旺	Food and Drinks	\$2,814	¥20,275	7%
13	Bright Dairy & Food Co	光明乳业	Food and Drinks	\$2,803	¥18,946	6%
14	Jiangsu Yanghe Brewery Joint-Stock Co., Ltd	洋河股份	Beer and Spirits	\$2,774	¥18,749	12%
15	Hengan International	恒安国际	Diversified	\$2,767	¥18,705	3%
16	Dali Foods Group	达利食品	Food and Drinks	\$2,748	¥18,570	7%
17	Shanghai Maling Aquarius Co., Ltd	上海梅林	Food and Drinks	\$2,681	¥18,119	108%
18	Foshan Haitian Flavoring & Food Co., Ltd	海天味精	Food and Drinks	\$2,087	¥14,103	17%
19	China Foods Limited	中国食品	Food and Drinks	\$1,980	¥13,384	37%
20	Vinda International	维达	Household & Personal Care	\$1,727	¥11,674	12%

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