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China's Baby Formula Market

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Report Highlights:

China's baby formula market is huge and growing, with total sales growing by 25% in 2012 to reach RMB 77 billion (\$12.55 billion USD). The mainland is home to around 130 domestic baby formula companies, producing around 600,000 tons of baby formula powder on a yearly basis (Food Navigator Asia). However, the domestic formula producers are struggling to compete with more reputable international players. In 2011, in the wake of a string of well-publicized food safety outrages, China's General Administration of Quality Supervision, Inspection and Quarantine (GAQSIQ) raised the quality standards for baby formula which forced 475 of around 600 Chinese firms to shut down their operations. Post believes the Chinese government will encourage even more consolidation in the coming years.

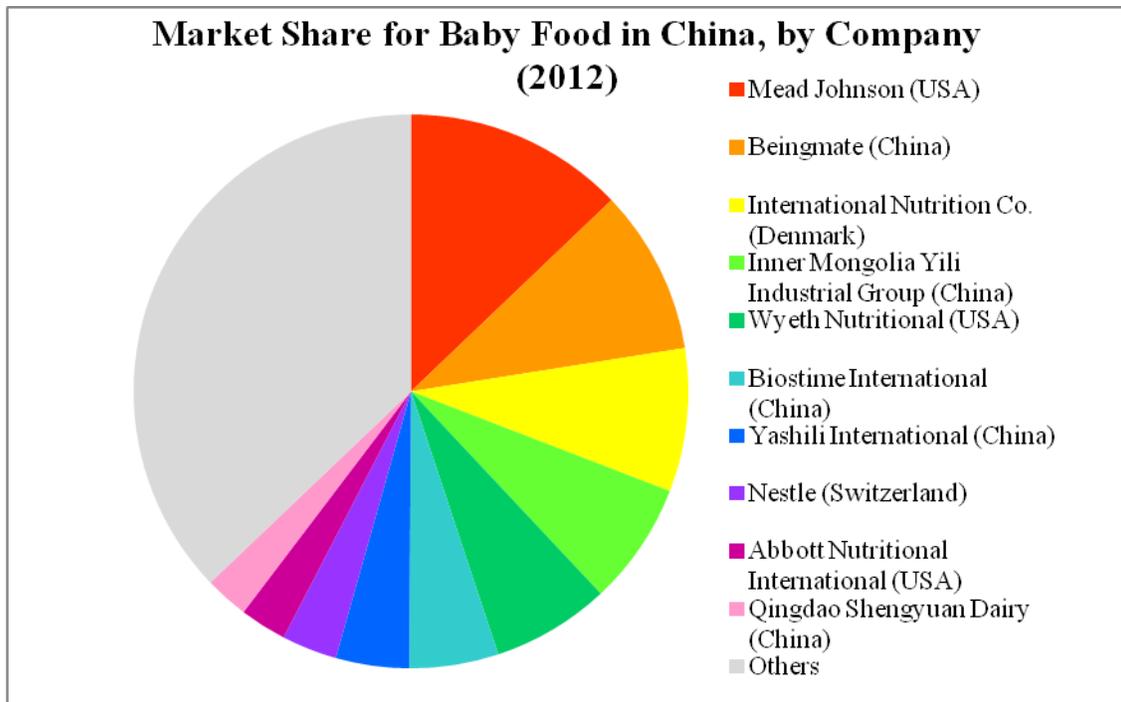
Executive Summary:

Overview of China’s Domestic & Imported Baby Formula Market

China’s baby formula market is huge and growing, with total sales growing by 25% in 2012 to reach RMB 77 billion (USD 12.55 billion). The mainland is home to around 130 domestic baby formula companies, producing around 600,000 tons of baby formula powder on a yearly basis (Food Navigator Asia). However, the domestic formula producers are struggling to compete with more reputable international players. In 2011, in the wake of a string of well-publicized food safety outrages, China’s General Administration of Quality Supervision, Inspection and Quarantine (GAQSIQ) raised the quality standards for baby formula. According to the food administration deputy director Teng Jiakai, these changes forced 475 of around 600 Chinese firms to shut down their operations.

Now, according to Euromonitor, foreign companies account for as much as half of the top 10 merchants of formula – presenting enormous challenges in the years to come for China’s own formula producers. This year, 5 of the top10 sellers of baby formula in China were from overseas, and these five companies alone – Mead Johnson, International Nutrition Co., Wyeth, Nestle, and Abbott - commanded 34% of the formula market in China (China Market Research).

General Information:



Source: Euromonitor, 2012

Company Profiles

Below are profiles of the top ten companies for baby food in China. They are listed in descending order, in terms of market share. Note that just these ten companies control well over 50% of the entire baby food/formula market in China, which includes hundreds of companies from both China and overseas.

N.B.: International companies' names appear in **bold**.

<i>Name of Company</i>	<i>Market Share</i>	<i>Description</i>
Mead Johnson	12.86%	<ul style="list-style-type: none"> • Founded 1895, headquartered in Illinois, USA • Flagship product is Enfamil infant formula • 2/3 of average annual revenue comes from outside of the USA • Wide distribution coverage and marketing activities • Gaining a strong presence in emerging markets • Reports published in 2012 claimed that Mead Johnson's milk formula contained vanillin. These proved to be erroneous, and Chinese government apologized • Asked by Chinese gov. to cut prices in 2013 amidst investigation into antitrust violations/price-fixing by 5 foreign infant milk companies
Beingmate	9.63%	<ul style="list-style-type: none"> • Expected to retain its leading position in baby food in years to come • Founded 1992, headquartered in Hangzhou, PRC • Specializes in R&D and independent production lines of infant food including baby formula • Strong brand image as "baby nursing experts" • <u>Not</u> implicated in 2008 melamine scandal (or other similar scandals); enjoyed strong profits & growth following the incident • Poses a strong challenge to dominance of international brands • Benefits from a partnership with Swiss food group Hochdorf Holding AG
International Nutrition	8.37%	<ul style="list-style-type: none"> • Founded 1990 in Denmark • Produces milk powder, liquid milk, cereals, supplements, etc. • Also provides consumers with expert information on child nutrition/advice/recipes • Markets products in emerging markets (China, Thailand, Malaysia, Brunei, the Philippines, Russia, India, Middle East & E. Africa)
Inner Mongolia Yili Industrial	7.16%	<ul style="list-style-type: none"> • Founded 1993 in Hohhot, Inner Mongolia, PRC • Processes & manufactures milk products; was once known as a "Chinese national brand" • Implicated in the 2008 melamine-contaminated milk scandal; lost its status as a "Chinese national brand" • Suffered further losses in 2012 when GAQSIQ found unusual levels of mercury in its baby formula
Wyeth Nutritional (Nestle)	6.89%	<ul style="list-style-type: none"> • Founded 1860 in Pennsylvania; headquartered in New Jersey, USA • Large, research-driven pharmaceutical and healthcare company • 85% of business is done in emerging markets • Infant formula company bought by Nestle in 2012 • Asked by Chinese gov. to cut prices in 2013 amidst investigation into antitrust violations/price-fixing by 5 foreign infant milk companies
Biostime Int'l	5.20%	<ul style="list-style-type: none"> • Premium series, Illumina, has higher ratio of nutrients • Founded 1999 in Guangzhou, PRC • Products include infant formula, probiotic supplements, nutrition supplements, dried baby food, etc. • Growing very quickly: revenue grew six-fold between 2009 and 2012, to RMB 3.4 billion; wide distribution network and high penetration

Yashili Int'l	4.27%	<ul style="list-style-type: none"> • Founded 1983 in Chaoan, Guangdong, PRC • Leading privately-owned infant formula/soymilk company in China • Infant formula accounts for 80% of sales. Target consumers are in middle- to high-end market. Distributes to over 105,000 retail outlets • 3 different Yashili brands were implicated in 2008 melamine scandal, suffered RMB 787 million in losses due to recalls and decreased sales • Since 2010, the group has sourced all of its infant formula products from New Zealand
Nestle	3.22%	<ul style="list-style-type: none"> • Founded 1905 in Switzerland • Produces huge range of goods: baby food, bottled water, cereals, coffee, candy, dairy products, snacks • Annual sales of USD 1 billion • In 2011 was listed as no.1 in Fortune 500 as the world's most profitable corporation • Has been widely criticized for methods used to market baby formula in developing markets • In 2008 melamine milk scandal, Taiwan health ministry reported that 6 types of Nestle's milk powder produced in China contained traces of melamine, which were recalled • Asked by Chinese gov. to cut prices in 2013 amidst investigation into antitrust violations/price-fixing by 5 foreign infant milk companies. Nestle agreed to cut formula prices by 11%
Abbott Nutritional	2.73%	<ul style="list-style-type: none"> • Founded 1888 as part of Abbott Laboratories, headquartered in Illinois • Specializes in baby food (flagship formula Similac, Isomil, and Gain) and other health products • In the past 5 years has spent hundreds of millions of dollars on new manufacturing/research plants, to capitalize on China's growth • Total pediatric sales in 2013 increased 2.5% to USD 987 million • Asked by Chinese gov. to cut prices in 2013 amidst investigation into antitrust violations/price-fixing by 5 foreign infant milk companies. Abbott is cooperating with government requests
Qingdao Shengyuan	2.55%	<ul style="list-style-type: none"> • Founded 1998 in Qingdao, PRC • Produces milk formula and other dairy products • Abbott Nutritional is considering acquiring Qingdao Shengyuan • Sheng Yuan brand infant milk formula was implicated by AQSIIQ in 2008 melamine scandal

Opportunities for Growth in the Imported Baby Formula Market

China's young population makes its demand for baby formula – and other baby food - one of the highest in the world, accounting for 23% of the USD 41 billion global market (Euromonitor). Despite China's one-child policy and slower birth rates than previously, its population continues to grow at a remarkable pace of 16 million births per year. Interestingly, 2012 – the Chinese year of the dragon – was considered the ideal year for young couples to have a child, leading to a 5% spike in birth rates (BBC News). This has had a tangible effect on the baby formula market, and will continue to affect demand for toddler and children's food products.

More specifically, *imported* baby formula is especially desirable, due to both persistent concerns over food safety on the mainland, as well as the tendency for busier, wealthier mothers to prefer feeding their babies with bottled milk over traditional breastfeeding.

In spite of government efforts to encourage mothers to breastfeed their newborns, breastfeeding rates in China are surprisingly low – hovering at around 30% (Euromonitor). This phenomenon can be attributed to a number of factors, including aggressive, and potentially misleading, advertisements promoting the

supposed nutritional benefits of baby formula, and the (possibly illegal) deal-cutting between hospital staff and formula companies.

Controversies: Domestic & Imported Baby Formula

Babies are by definition the most vulnerable consumers out of any age group, due to their rapidly developing bodies and susceptibility to sickness. So the safety standards for the food they consume must be high enough – and implemented effectively enough – to ensure their wellbeing and health, as well as their parents' satisfaction. Both domestic and foreign baby formula companies have experienced blows to their reputation, and subsequently, sales. However, Chinese companies have been tarnished the most by concerns of adulterated baby foods, false promises to consumers, and other scandals. The next section will outline some of consumers' sources of concern for both Chinese and international formula companies, and what this means for the baby formula market as a whole.

Domestic Issues

Food Safety

- Although both domestic and international formula companies have experienced food safety crises, Chinese consumers tend to associate the bulk of the problems with domestic brands. Besides the widely-publicized and oft-cited melamine milk scandal in 2008 (during which contaminated milk killed six Chinese babies and harmed 300,000 others), the baby formula industry in China has endured other food safety catastrophes that has diminished its trustworthiness.
- In 2011, China Mengniu Dairy, China's largest milk producer, publicly acknowledged that its milk contained unacceptable levels of toxins, due to fungus-infected feed given to its cattle. A year later, Inner Mongolia Yili Industrial Group, another dairy giant in China (profiled above), was forced to recall milk products containing poisonous mercury. These incidents are just the tip of an iceberg that makes up Chinese consumers' plagued opinions of China's own domestic milk supply.

Smuggling

- Partly due to the lack of trust in domestic milk formula companies, Chinese parents are increasingly going overseas to stock up on food for their babies, even if it means paying a higher premium, and potentially, breaking the law. In March 2013, Hong Kong issued a limit of two 2-lb tins on the quantity of baby formula air passengers could carry out of its ports. This decision was mainly caused by an alarming shortage of baby formula in Hong Kong, which started in around 2010, due to mainland consumers hoarding baby food products to carry back home.
- The new regulations led to a surge in smuggling of baby food products across the borders, normally perpetuated by desperate parents seeking to provide the very best for their little ones, even at the potential expense of fines of up to USD 65,000. Just a month into the ban, Hong Kong border police had already seized 20,000 lbs of illegally smuggled milk formula, and had made over 800 arrests (Bloomberg). These astonishing statistics provide great insights into the potential for huge profits in China's imported baby food sector.

Irresponsible Advertising

- Marketing and advertising baby formula products has proved problematic in China. Faulty claims made by formula companies, that milk formula designed for newborn babies is as healthy – or healthier – than natural breastfeeding are being clamped down on by the Chinese government. As of right now, the regulations on baby formula marketing and packaging are extremely strict: dairy companies are not allowed to make the claim that milk formula is an identical substitute for breastfeeding. This applies to advertisements produced by imported baby formula companies too. In general, the official line on the matter is to drive parents away from baby formula in general.

Overseas Issues

Price-Fixing

- Last year, prices of imported baby formula rose significantly but unexpectedly, with most of these increases in price occurring within international – as opposed to domestic – brands. Wyeth, Nestle, Abbott Nutrition International, and other international companies, increased retail prices significantly. Food Navigator Asia reported in June 2013, that the imported formula retail prices were up to 50% higher than most domestic brands.
- This phenomenon sparked a strong reaction within China’s governing cabinet: Premier Li Keqiang made an “urgent appeal” in May 2013 to domestic formula brands to stand up more fiercely to international competitors (Xinhua). He claimed that the plummeting levels of consumer confidence in their products posed a crisis to the domestic dairy industry, as the competing international giants command a huge part of the formula market. Chinese authorities are currently conducting an investigation into five overseas formula companies, which they suspect of fixing their prices, and disobeying antitrust and anti-monopoly laws. All of these companies appear to be cooperating and some have lowered their prices.

All of these issues combined have led to a heightened sense of consumer wariness towards the baby formula industry as a whole, and has increased pressure on the Chinese government to become more pro-active in their efforts to maintain public health.

New Regulations

China’s State Food and Drug Administration collaborated with the Ministry of Industry and Information Technology (as well as eight other government agencies) in 2013 to produce a document outlining new regulations for foreign formula imports into China (Food Navigator Asia). These measures require foreign infant formula producers to comply with the same strict product certification system that drug companies are subject to – such as report the ingredients used to the Food Safety Administration, and register their products with Beijing before importing into China. With baby formula now treated as medicine, it is tightly monitored by way of identification, authentication, and tracking.

This could mean the end of a particular strategy used by Chinese baby formula companies, whereby they register their companies to a foreign address, repackaging bulk formula in China, which allows them to market their products as “imported” formula – and charge “premium” prices. This has been a significant problem in mainland China: this year, the New Zealand Baby Formula Export Association reported that only 10% of its >200 “Kiwi” infant formula brands on sale in China actually came from New Zealand.

In further attempts to curb the influx of foreign baby formula products into China, the General Administration of Customs has imposed a series of high tariffs and extra costs on imported dairy products coming into the mainland. These include the following:

The tariff for New Zealand formula products was raised by 5.8% to 10% (December 2012).

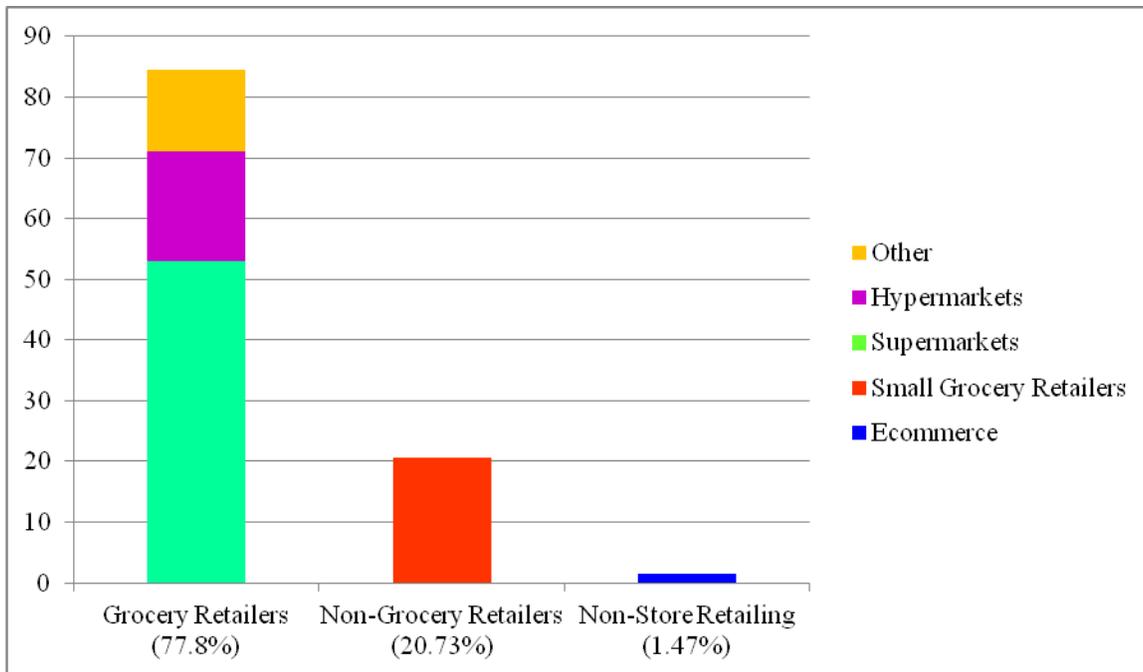
On top of import duties and inspection fees, exporters are also responsible for warehouse costs, which often account for 28-30% of the formula product's original price.

Shanghai Customs levied a tariff of RMB 32 on each kilogram of imported milk powder entering its ports (January 2012).

The Potential for Online Sales of Imported Baby Formula

Ecommerce as a substitute for traditional food retail is growing in China. That said, supermarkets and hypermarkets are still by far China's biggest sellers of baby food, including milk formula. Other types of brick-and-mortar outlets like baby shops, and specialty stores, fall slightly behind. However, due to the extremely low operational costs and investments required, as well as the convenience afforded to increasingly busy consumers, turning to online platforms could be an ideal move for baby formula companies.

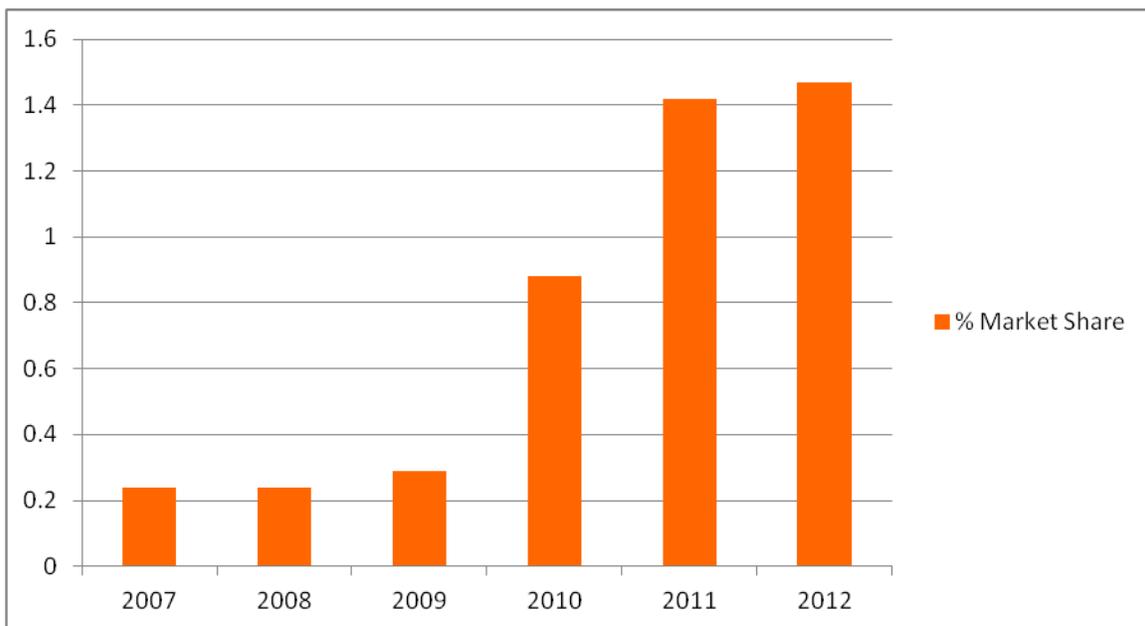
2012 Sales of Baby Food in China by Type of Seller



Source: Euromonitor, 2013

As can be seen in the graph above, ecommerce makes up a very small segment of total sales of baby food in China. However, its market share has been increasing every year since 2007, as evidenced in the following graph:

Growth of Baby Food Ecommerce in China, by % Market Share



The Internet has become a major source for parents to buy imported baby formula since Hong Kong introduced its 2-can limit for cross-border travelers in March. China's market for baby and children's

products is booming, with the rise of disposable incomes, “little emperors” (in plain terms: spoiled only children), and consumption-driven lifestyles.

Many of the issues discussed above point to the high potential for growth of online sales of imported baby formula, which remain unsaturated. Milk formula in general is an ideal product to sell online because, in its powder form (which represents >95% of all formula sold in China) it is relatively easy and cheap to store and transport, especially with technological advances in modern logistics. This means costs of operation are low for potential sellers. This, coupled with the flexibility of selling online, could make online sales a lucrative market for baby formula companies looking to import to China.

In 2011, Taobao, China’s largest online retailer, reported a huge spike in baby formula sales, along with online sellers rushing to capture the local market for baby/children’s nutrition, apparel, toys, and other goods. It reported a RMB 100 million turnover every day for the baby and children segment, and sold 700 tins of milk every minute – a truly astonishing figure. That said, online sales of (imported) baby formula in China tend to be dominated by specialized international mother & baby sites, such as BBTime, OKBaby, Bambino Mio, and Clevamama. These sites, while more expensive than Taobao and the like, are most appealing to image-oriented urban mothers in China.

Threats to Imported Baby Formula Ecommerce

However, not everyone is willing to play by the rules. Savvy to the benefits of ecommerce mentioned above, some entrepreneurially minded Chinese have set up their own virtual Taobao shops, selling imported baby formula at much cheaper prices than those of the foreign formula available in retail stores. They are able to do this by – illegally – bypassing Chinese import regulations and tariffs by smuggling in product from nearby overseas ports.

So far, it appears that Chinese authorities have turned a blind eye to this idiosyncratic trade pattern: a search on Taobao for “private seller of baby formula” yields 6,000 different stores, selling baby formula products primarily from New Zealand and Japan. Chinese consumers say that the high prices are a huge deterrent to their desire to purchase imported formula through legitimate channels, including legal online outlets as well as brick-and-mortar stores. This largely unregulated C2C business could drive significant numbers of customers away from more expensive, but legal, online sellers.

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