

Dairy Products China News

Guaranteed Exclusive Analysis

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Welcome to the February issue of Dairy Products China News.

Data released yesterday showed that a decline in Japan's economic output in Q4 2010 now places China as the world's second-largest economy. It should take over the No. 1 slot in the 2020's at some stage – resuming its position as the world's biggest economy. This is in reality a position which it has held for the vast majority of the last 2000 years, with the recent Western ascendancy in this respect the exception to the general rule.

The waves from this trend continue to rise: I read today that several luxury retailers in London have recently installed China Union-Pay debit card terminals, rarely seen outside China itself, to cash in on the rapid growth in spending by Chinese millionaires, and some stores now accept RMB payments. But the trend is set to become much more profound still as the country's middle classes start to travel more often and further than ever before, their tastes changing as a result.

The apparent involvement of Mengniu and Bright Food in the recent bidding for the 50% share in the Paris-based Yoplait held by the private equity firm PAI Partners is symbolic of the future – an increasing quest for international dairy sector investments by the Chinese majors seems likely. Whether it is advisable for the key players to seek growth overseas at a time when there is clearly so much to do to right the problems in their domestic industry must be debatable – but at all levels spending patterns are changing, so we must expect future deals of this sort!

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Headlines

- ▶ Mr. Guan, director of QQX Dairy's administration department, expresses his views on the development of the company and Guangdong's dairy market
- ▶ Key dairy processors make moves to restructure the distribution systems, aiming at both promoting sales and tackling the problem of increasing costs
- ▶ In January a survey on yaolan.com looks at Chinese mothers' key criteria when choosing infant products, highlighting the importance of food safety and brand reputations to their mindsets
- ▶ The CBIA proposes a tax cut for China's beverage industry, which would benefit beverage processors and some dairy processors if adopted by the government
- ▶ Feed grade whey powder prices have fallen slightly since November 2010, but still seem set to increase in the following months
- ▶ A seminar about infant formula is held in Heilongjiang in January, with particular focus in discussions upon the development of integrated supply chains
- ▶ AQSIQ issues the draft version of regulations for dairy import and export trade for feedback
- ▶ Regional governments are implementing a range of measures to supervise the local dairy industry and respond to the Central Government's recent policies
- ▶ Qianjin Dairy, a leading dairy processor in Yunnan, suspends production, with the latest stricter requirements for local dairy processors being one of the key factors behind this move
- ▶ Yantang Dairy holds an Opening Ceremony in January, marking the completion of its capital restructure and possibly pointing the way towards a listing
- ▶ The Gansu provincial government plans to invest more for local dairy insurance, aiming to protect farmers' profitability, a move which could boost the development of the local dairy industry
- ▶ Tianyou Dairy and Gonda Group, two leading dairy processors in Chongqing, launch premium UHT milk products to compete with Mengniu and Yili, the key players in the category
- ▶ Quantum High-tech lists on the SZSE as part of its plans to expand in China's promising FOS & GOS market

Major Companies and Sites Mentioned in This Issue



Special Report

QQX Dairy Focuses on Farming & OEM Production

Qiangqiangxing Dairy Co., Ltd. (QQX Dairy), a private enterprise located in Guangzhou, Guangdong province, was established in 1999 with total assets of USD7.5 million. The company has four dairy farms in Guangzhou City with a total of 2,000+ cows, producing close to 40 t/d, and is currently planning to expand its dairy farming business.

As the demand for dairy products is strong in Guangdong, many of the leading dairy processors are looking at entering the local market, especially in the categories of pasteurised milk and yoghurt. However the limited local milk supply is a key obstacle to building a business based on fresh milk in the province. One route is to contract with local dairy farms for milk supply and local processors who can produce on an OEM basis. This puts QQX Dairy in a very promising position, as one of Guangdong's leading milk suppliers and OEM dairy processors.

Mr. Guan, director of the company's administration department, outlined his thoughts on QQX Dairy's development and Guangdong's dairy market when interviewed:

CCM: Can you introduce your company?

Mr. Guan: QQX Dairy's business is based on dairy farming with milk supply of 40 t/d and milk processing capacity of 110 t/d at present. At the moment we are expanding our business: the milk processing capacity will reach 120 t/d when we start a new production line in May 2011, and our new dairy farm with 5,000+ cows launches in Zhanjiang City in February 2011, making QQX Dairy the largest fresh milk supplier in Guangdong.

CCM: At present, many processors are targeting Guangdong's dairy market. Does this exert great pressure on QQX Dairy?

Mr. Guan: No, we are committed to strengthening our dairy farming operations, and our position as an OEM producer of dairy products for other processors means that competition in the end market has relatively little influence on our business. At present, 25% of our fresh milk is sold to Hong Kong, 15% is sold to other processors like Bright Dairy, 10% is used for producing yoghurt and fresh milk under our own brands Lianshi and Qiangxing and 50% is used for producing yoghurt for Mengniu. We need to increase our milk supply, as does the overall province, so I believe we will prosper in the marketplace as we do so.

CCM: So QQX Dairy welcomes such competition?

Mr. Guan: Yes, I believe that it will strengthen the development of Guangdong's dairy industry. If the industry develops scale and attracts consumers' attention it will serve to counter the negative news stories which have often surrounded the dairy sector and given the public a very one-sided impression.

CCM: QQX Dairy also produces yoghurt for Mengniu, can you tell me why the company chose Mengniu as a partner?

Mr. Guan: QQX Dairy started to cooperate with Mengniu early in 2007 due to the Inner Mongolian group's consistent and significant demand. This permitted our two companies to operate in a mutually beneficial, stable production environment.

CCM: So the stable demand was the key motivation for QQX Dairy?

Mr. Guan: Yes, but simply reaching a deal which works for both sides has been another factor. We had been in negotiations over OEM production for both Yili and Danone and in each case these discussions had foundered over cost.

CCM: Now that Mengniu has built its new plant in Qingyuan City, does this affect the cooperation between QQX Dairy and Mengniu?

Mr. Guan: Of course not. Mengniu's new plant in Qingyuan doesn't have a plain yoghurt production line. QQX has nine production lines for pasteurised milk and yoghurt, and will continue to produce plain yoghurt for Mengniu.

CCM: Recently, the government has brought in requirements for all dairy processors to reapply for their production license. Is this process underway at QQX Dairy, and does this cause a problem for the company?

Mr. Guan: QQX Dairy has reapplied for the license as required. However this is an expensive process, and the measures are rather severe: for example, some requirements, such as tests for minerals like sodium, potassium and magnesium, etc., don't need to be tested every day – it ought to be possible for some of these minor tests to be entrusted to other organizations instead of companies being required to undertake them all in-house.

Market Dynamics

Dairy Processors Restructure Distribution Systems

Recently, some domestic dairy processors' moves suggest their plans to restructure their distribution systems, with the aims of increasing sales and tackling the increasing production costs.

A prominent example is Mengniu, which invited about 4,200+ 1st level franchisers to attend the company's largest UHT Milk Marketing Centre's Clients Conference held on 2-3 January. (These sell mainly to lower level distributors and wholesalers – as opposed to the 2nd and 3rd level franchisers, which sell to retail outlets ranging from supermarkets to small shops.)

The group is in the early stages of restructuring its distribution system by upgrading more 2nd and 3rd level wholesalers to 1st level status, and expanding the salesforce in its sales companies, aiming to simplify its distribution system. Under the current system, Mengniu mainly sells its products to 1st level franchisers which then distribute to wholesalers. The plan is to upgrade more 2nd and 3rd level wholesales to 1st level status, and then sell directly to supermarkets. In addition Mengniu will employ its own salesmen in the retail stores instead of those formerly sent in by the distributors, the expectation being that this will allow Mengniu to manage its distribution network more effectively. In addition it will cooperate with its franchisers and wholesalers to launch more 1st level franchise stores (which only sell Mengniu products).

The simplification of Mengniu's distribution system has the potential to help the company manage its distributors more effectively. For example, a source at Mengniu's franchiser in Qingdao explained that some franchisers are in a disproportionately powerful position in their cooperation with Mengniu. This

is because in some regions Mengniu is effectively compelled to sell its products through them, due to the lengthy relationship in place based around strong local sales networks. In the future, Mengniu may well establish its own sales companies in some such cases

Therefore, the restructuring will benefit Mengniu's business in the long term, although in the short-term it is a costly process to organise. The franchise stores – retailing only Mengniu's products – are small-scale and often less profitable than selling through the retail key accounts like Wal-mart, Carrefour, etc.

Yet in fact Mengniu's move lags behind its main competitor, Yili, which started to restructure its distribution system early in 2006. At present, Yili has built a sales network covering 500 cities, and plans to expand its distribution network into 2nd and 3rd tier cities, villages and towns, and to increasing penetration of the country's growing number of city suburbs and university campuses (*please see Dairy Products China News Vol.4 January issue, p7*).

A Mengniu manager provided an interesting perspective on Yili's position: “*ST” was added as a prefix to Yili's stock name in May 2009 – this designates special treatment, meant to warn investors that a company is at risk of delisting. Of course one reason for this was the impact of the 2008 melamine scandal, but another one is allegedly that Yili has over-committed in its investments to expand its business nationwide in terms of milk supply and distribution network, damaging its financial performance since as a result. Whatever the truth of this, nevertheless Yili has completed the process relatively recently, which should put it in an advantageous position going forward.

Wahaha – the country's largest milk beverage processor and an undoubted expert in building distribution networks in China, also has plans to restructure its distribution system in 2010. However this is being done in a different way to Mengniu. According to Mr. Zong, President of Wahaha, the company will build a new distribution system (Wahaha →franchiser→stores) to supplement its original distribution system (Wahaha→franchiser→wholesaler→stores). This is part of its drive to reach a turnover of USD15.19 billion (RMB100 billion) in 2013. After the restructure, Wahaha will have about 10,000+ franchisers instead of the current 4,000+, enabling it to expand its sales network into more 3rd and 4th tier cities.

These moves to restructure distribution operations are especially designed to help Wahaha sell into supermarkets more efficiently. The strategies of both Mengniu and Wahaha in this respect seek to “flatten” their distribution system. This process is expected to deliver cost reductions over time, but demands significant investment in the short term, at a time when increasing costs are already exerting considerable pressure on domestic dairy processors (*please see Dairy Products China News Vol.3, December issue, p3*).

Processors are also currently feeling the strain of their marketing costs. According to a report from one local research firm, Shanghai Business Information Centre, suppliers' satisfaction with the supermarkets fell in 2010 as expenses such as slotting fees – which were forbidden by the government in 2006 but continued and escalated last year – increased in 2010. This has happened whilst sales often failed to meet processors' expectations. Carrefour, currently under

TABLE I: Customers' Purchase Methods for Key Infant Formula Brands, 2009

| Purchasing way | Dumex | Wyeth | Mead Johnson | Abbott | Nestle | Beingmate | Yili |
|--------------------|-------|-------|--------------|--------|--------|-----------|-------|
| Supermarket | 35.3% | 32% | 39.9% | 20.1% | 31.6% | 16.9% | 39.5% |
| Franchise store | 34% | 33.7% | 22.1% | 36.1% | 32.6% | 27% | 31.6% |
| On-line | 30.2% | 30.9% | 37.2% | 38.3% | 34.8% | 43.5% | 28.9% |
| Direct to consumer | 0.6% | 3.4% | 0.8% | 5.5% | 0.9% | 12.6% | 0.03% |

Source: China.com

fire for alleged false discounting and other pricing infringements after a study by the National Development and Reform Commission (NRDC), ranks 1st in terms of costs with an index score of 3.80, but 15th with a score of 3.14 on the supplier satisfaction index.

However, processors are unable to raise prices freely before March 2011, as it is a critical period due to the recently increasing food prices. As a result the government (in the form of the NRDC's regional offices) has to approve any proposed price increases. The impact of increasing costs and the government's stricter supervision make it probable that many small dairy processors will go to the wall: the distribution system restructures will be important means for the larger processors to build their volumes to fill the gap in the market which is expected to result.

E-commerce is another potent means for dairy processors to refine their distribution system and tackle the pressure of increasing costs. Many of the main dairy processors have gone down this route, including Mengniu, Yili and Bright Dairy. For example, in January 2010 Mengniu launched its products on Womai.com – a B2C trading platform operated by China National Cereals, Oil & Foodstuffs Group (COFCO) (please see *Dairy Products China News Vol.3, January issue, p8*). This boosted its sales and led to the company winning an award for "Top 10 E-commerce Application in Conventional Enterprises" in September 2010.

Beingmate is another example: it achieved sales and net profit of USD488.4 million and USD56.58 million in 2009, up 67.4% and 242% respectively over 2008. E-commerce was central to this performance, supported by the company's substantial investment in online advertising. According to a domestic survey from China.com.Inc. at the end of 2009, about 43.5% of Beingmate customers were buying online. One factor behind this seems likely to have been that the company expanded so rapidly in 2009 that its distribution coverage lagged behind, and still remains far from national at this stage (please see *Dairy Products China News Vol.3, August issue, p5*).

Chinese Mothers' Purchase Criteria for Infant Formula

On which criteria do Chinese mothers base their decisions when purchasing infant products? An insight to this was provided in January by www.yaolan.com, a leading local parenting website. It ran a survey throughout December 2010 which confirmed that food safety and brand reputation have become the two main factors for these most demanding of consumers.

The survey shows that 89.4% of respondents see food safety as their key concern when purchasing infant products, especially infant foods, followed by 71.4% for brand reputation, 63.5% for quality/raw materials, 55% for the price level and 53.6% for recommendations made online or through word-of-mouth.

The impact of the 2008 melamine scandal in raising food safety up the agenda is evident, but the results underline the importance of processors' efforts to improve their brand images.

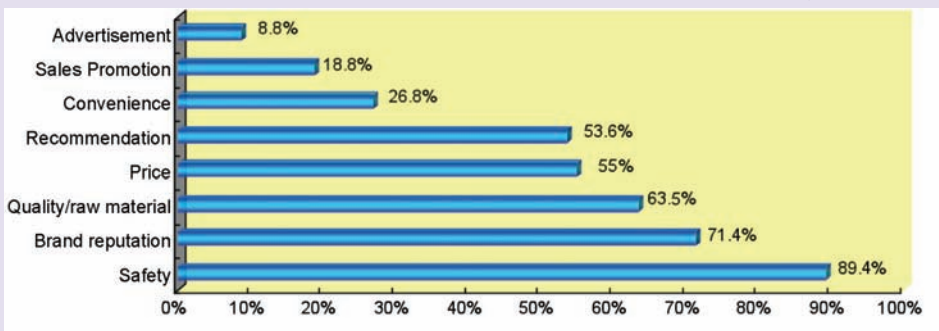
Searching on the internet is the main way for mothers to obtain information about infant products: it has played an important role as most of them have not had sisters' experiences from which to learn, of course, a marketing angle which has been played upon by at least one international brand. The survey showed that 77.1% of respondents obtained information on the subject through recommendations on internet forums or amongst friends and 72.6% via internet searches.

However, although the internet plays an important role as a source of information, Chinese mothers prefer purchasing infant products from supermarkets or franchise stores: these are used by 75.75% and 76.27% of total respondents respectively, while only 42.4% of respondents preferred purchasing over the internet.

Many mothers revealed that they won't purchase infant foods/formula through internet due to concerns about food safety. This position is borne out by AC Nielsen's data: online sales of infant formula in March 2009 only made up 6% of the total, compared to 42% and 25% were sold through supermarkets and hypermarkets respectively.

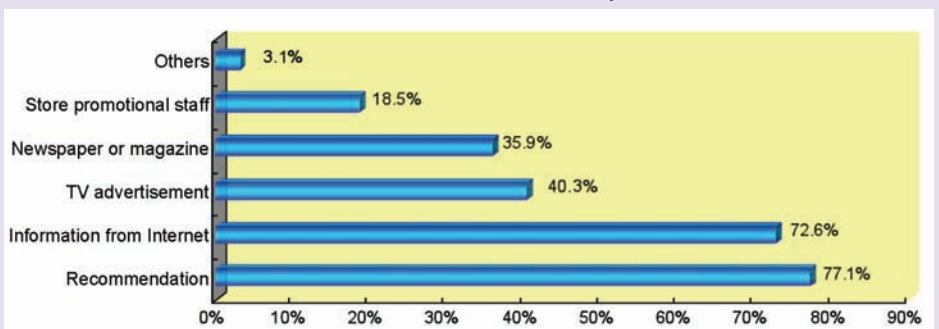
However, the situation is different for the brands with stronger reputations. According to a domestic survey from China.com.Inc. at the end of 2009, about 30.2% of

FIGURE 1: Chinese Mothers' Purchase Criteria for Infant Formula, 2010



Source: www.yaolan.com

FIGURE 2: Chinese Mothers' Information Sources, 2010

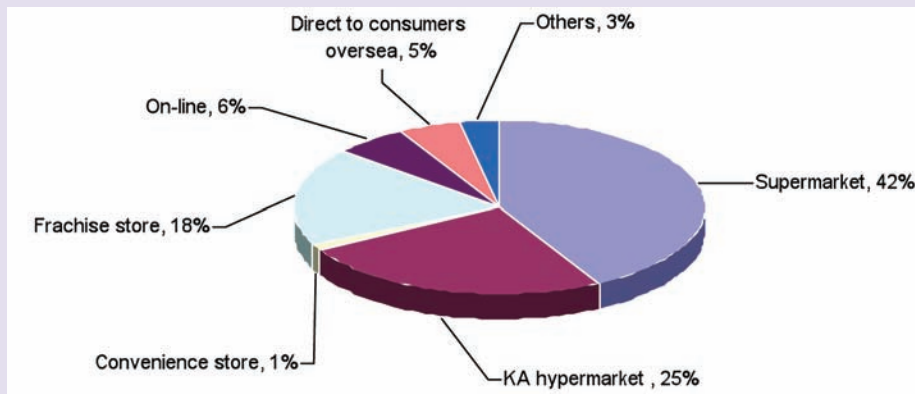


Source: www.yaolan.com

Dumex customers buy online, with similar levels shown for the other main brands: 30.9% for Wyeth, 37.2% for Mead Johnson, 34.8% for Nestlé, 38.3% for Abbott (please see *Dairy Products China News Vol.3, August issue, p5*). So brand image seems a key determinant of consumers' purchasing behaviour, a fact which shows that local processors have much work to do to rebuild their reputations.

The survey also highlighted that price levels have varying impacts on purchasing amongst different groups of consumers. This is supported by other past research. A report issued in March 2009 by Sina.com (a leading local web portal) and Beijing Answer-child Consultant Co., Ltd. (a consultancy company focusing on infant and child products) pointed out that some local consumers, especially those consumers with higher incomes, are very price insensitive when it comes to infant formula. Such findings have underpinned many dairy processors launching more premium infant formula in 2010.

FIGURE 3: Infant Formula Distribution Channels in China, 2009



Source: AC Nielsen

TABLE 2: Infant Formula Selection Criteria by Income Level, 2009

| Income level | Quality | Brand | Nutrition | Baby's Preferences | Introduction from friends | Price | Packaging | Other |
|----------------------|---------|-------|-----------|--------------------|---------------------------|-------|-----------|-------|
| <USD304/month | 85.5% | 74.1% | 68.6% | 28.2% | 26.6% | 34.9% | 9.1% | 1.3% |
| USD304-608/month | 87.3% | 77.3% | 70.9% | 29.7% | 26.8% | 30.6% | 8.3% | 0.6% |
| USD608-912/month | 85.6% | 81.2% | 68.9% | 29.5% | 29.8% | 26.6% | 8.2% | 1% |
| USD912-1,216/month | 86.4% | 78.3% | 68.2% | 28% | 29.7% | 23.2% | 8% | 1.4% |
| USD1,216-1,520/month | 86.4% | 82.4% | 66.5% | 31.7% | 30.8% | 21.3% | 8.1% | 1.2% |

Source: www.Sina.com & Answer-child Consultant

Possible Tax Cut for Beverage Industry

Beverage producers in China are also under considerable pressure from increasing production costs. This has led the China Beverage Industry Association (CBIA) to propose a tax cut recently, a measure with the potential to benefit some dairy beverage processors if it is adopted by government.

The CBIA issued a report with this proposal in late December 2010, following this up with a meeting on 5 January centred upon how to help beverage processors deal with the current challenge to their profitability.

The beverage industry's production costs increased greatly in 2010, with rises in the prices of agricultural inputs as

well as other cost elements. The CBIA's data showed that the average prices of apple juice concentrate, WMP, nut, peanut kernel and sugar in 2010 were 60%, 50%, 17%, 10% and 70% higher respectively than in 2009. Meanwhile, the costs of packaging materials, energy and labour also increased greatly.

As a result, some beverage processors' gross profits fell by about 50%+, according to the CBIA. A factor exacerbating the problem has been the new approach that the companies have been forced to take in respect of stocks. In the past, the companies stocked up on various key raw materials to allow them to deal with the sudden upturns in demand seen in the peak season. However they

held lower stock levels in 2010 as they were forced to purchase less in terms of potential requirements and more closely in line with production volumes, a shift which has often proven detrimental to their production and other operations.

Wahaha, China's leading beverage business, is a good example: in 2010 it achieved sales of USD8.35 billion (RMB55 billion) against a target of USD10.63 billion (RMB70 billion), leading to a gross profit of USD0.911 billion (RMB6 billion). These figures compared with sales of USD6.56 billion (RMB43.2 billion) and a gross profit of USD1.22+ billion (RMB8+ billion) in 2009. Mr. Zong, President of Wahaha, indicated that a key factor behind the fall

in profitability had been the impact of inflation on its production costs.

The CBIA indicated that beverage processors have taken many measures to tackle the increasing costs, such as management rationalisations, steering the product mix towards higher margin products and, where possible, pre-emptive early purchasing of raw materials to lessen the impact of increasing prices.

However, it noted that the results showed that the measures were utterly inadequate, and predicted that processors will have to increase product prices, lay off employees and even halt production if the costs continue to escalate. So far a number of large beverage processors such as Wahaha, Huiyuan Juice, Coca-Cola and Pepsi Cola have raised their prices. Now

is not the time to look for new price hikes, as the just-passed Spring Festival marked the peak season with many suppliers running promotional campaigns with discounts, but most processors are likely to increase their prices in March 2011.

The CBIA provides some suggestions for beverage processors and the government, such as improving management systems continuously, setting reasonable prices, moving from price competition to differential marketing strategies and providing subsidies for processors of agriculture raw materials. However the central proposal is that the government should introduce a preferential tax policy for the industry, involving measures such as reducing VAT from 17% to 13-15% and reducing enterprise income tax from the current 25% level.

The government's response is awaited, and the issue will presumably receive consideration during the National People's Congress (the NPC) and the Chinese People's Political Consultative Conference (CPPCC) held in March 2011. If adopted the proposal will certainly prove a helping hand for a number of dairy processors such as Wahaha, Mengniu and Yili. Mr. Zong, who is also a member of the NPC, suggested in the province's People's Congresses and CPPCC held from 15-21 January that the government of Zhejiang Province (where he and Wahaha are based) should reduce the tax rate, and indicated that he will send the suggestion as a proposal to the NPC & CPPCC in March.

Feed Grade Whey Powder Price Slightly Decreases

The feed grade whey powder price has eased slightly since November 2010, from USD942/t in November 2010 to USD884/t in January. However this latest level is still up 29.4% over the price in August 2010 (last year's lowest price, at USD683/t), according to data from www.feedtrade.com.cn.

It is notable that demand for feed grade whey powder has decreased in the last two months. As the pig industry has been recovering since August 2010 a number of its businesses have taken advantage of the low prices at that time by stocking up on such ingredients, whilst distributors had acted in a similar fashion. Some processors still have stocks of whey powder whilst some distributors have been selling off their stocks, thus leading to a relaxation in prices.

Overall demand for feed grade whey powder decreased in 2010, affected by the decline in the pig industry in late 2009 and the first half of the following year. After suffering widespread losses during H1 2010, the pig industry only gradually resumed making profits, as the rises in pig prices outstripped those occurring in pig feeds. The decline in price was especially notable in H1 2010 – when imports of whey powder overall were 120,177 tonnes, down 15.1%. A key factor was also the oversupply in 2009 which meant that some distributors had no alternative but to reduce prices in the first half.

However, many distributors believed the feed grade whey powder prices would increase again over the winter and into 2011. According to a survey launched by www.feedtrade.com.cn in November 2010, 65.9% of respondents consider that this will happen, while 27.4% believe the opposite and only 6.7% express uncertainty.

So far this has not turned out to be the case. However the pig sector looks set to prosper this year once the poor weather ends, by which time there will be few stocks of feed grade whey powder held, so higher prices do seem likely, and this recognition will probably in itself boost demand of course. One can also conjecture that there will be increased temptation for some food processors to buy feed grade to substitute food grade whey powder. Suppliers of feed grade whey powder and whey permeate will no doubt benefit from this situation this year. It goes without saying that were whey permeate to be viable in food applications in China this would present an interesting opportunity for many.

FIGURE 4: Market Prices, Feed Grade Whey Powder, Jan. 2010 - Jan. 2011



Source: www.feedtrade.com.cn

An Integrated Dairy Supply Chain?

On 8 January a seminar on infant formula quality and safety in China was held in Qiqihar in Heilongjiang province. This was organised by the China Dairy Industry Association (CDIA) and other bodies such as the China Youth Concern Committee for the Advancement of Health and Physical Culture Development (AHPCD) and the China Milk Powder Love & Trust League set up by Feihe Dairy in the preceding month.

The concept of integrated dairy supply chains – involving manufacturers controlling the production chain on a “cow to consumer” basis – was discussed and advocated. There was a wide level of consensus on measures such as designating some regions as national production zones for infant formula, increasing investments in certain large-scale farms and helping processors to develop their own milk supply chains.

The approach had first been propounded in late 2008 after the melamine scandal, as the industry saw its reputation shattered and searched for way of rebuilding its tarnished image. It is supported by Mr. Song, President of the CDIA, who notes that it has become a government imperative to move in this direction: according to the Guideline for Dairy Industry Rehabilitation launched in November 2008, dairy processors must be able to supply 70% of their own milk need.

However Mr. Song also pointed out that the approach will not solve all the industry’s problems and reflected that in fact the domestic industry has no alternative. He indicated that the approach contradicts the view that processors should stick to what they know – processing – but that as it is the only means to help the industry recover consumers’ confidence, it is the only way forward.

However, at present in China the proportion of dairy processors’ milk supply deriving from their own dairy farms is only 10-15%, with around 25% from milk collection stations and 60%+ from small milk processors, so the approach will be a challenge to implement on a nationwide basis in reality.

Feihe Dairy, a leading local infant food processor in China and the founder of the China Milk Powder Love & Trust League, put forward its own integrated supply chain approach. A total of USD150+ million has been invested in the company’s dairy farming operations, which include three farms of around 10,000 head. Mr. Leng, President of Feihe Dairy, believes that the approach has provided the basis of the company’s long-term competitive advantage.

At present, consumer confidence in domestic infant formula remains shaken, hence the increase practice of purchasing imported infant formula through networks or independently in Hong Kong: currently many of the imported formula brands are out of stock in Hong Kong. This situation and the rising imports of infant formula have created a serious cause of concern for the government.

Despite higher prices, most consumers still prefer imported infant formula if they can afford to make the choice. It is clear that there is significant parallel importing in the market which is very hard to quantify, moreover. In this market environment the integrated supply chain approach seems to be the way forward. Yet however necessary, it is nevertheless a direction which has proven difficult for Feihe Dairy. The company made a loss of USD20.7 million in Q2 2010, according to the company’s financial report, due in particular to the substantial investment required in the construction of its dairy farms. The result was that Feihe Dairy felt obliged to issue 2.1 million additional common shares to Sequoia Capital for USD47 million to address this issue.

Governmental Direction

Regional Government Supervision of the Dairy Industry

Data from the Government indicates that 2,132 tonnes of melamine-tainted milk powder produced before the melamine scandal was found during July-December 2010. In addition to the policy responses from China’s Central Government, this parlous situation has forced regional governments to act.

For example, the Administration for Quality Supervision and Inspection and Quarantine (AQSIQ) launched new regulations for the dairy/formula industry in November 2010 (*please see Dairy Products China News Vol.3 December issue, p4*), requiring all processors to reapply for their production licenses before the end of the following month. All the regional governments then issued announcements on this point in December

2010 and the local departments of the AQSIQ have recently started formal examinations.

Many small processors, which can’t meet the new regulations, have still adopted a wait and see mode. However, Mr. Zhi, Director of the AQSIQ, reaffirmed the implementation of the new regulations at the meeting held on 6 January, suggesting the process will be stepped up in the regions shortly.

Besides examination of production licenses, regional governments are also taking other measures to strengthen supervision of the production and circulation of dairy products. For example, Anhui province recently committed to strengthen its checks in 2011, with a focus on infant formula

in particular: this will involve it sending supervision personnel to each infant formula plant throughout 2011, with the supervision personnel based in the plants on a continuous basis.

Similarly the government of Luoyang in Henan province revealed that it will conduct spot-checks on formula once a week in each distributor/supermarket and once a month in each small retail store. In Jiangsu province in Eastern China the local government has established a food rating supervision system which divides foods into three levels according to the risk level: A, B and C. Dairy products fall under level A, designating that they are a form of food most easily involved in food safety incidents. Here the local government

will conduct weekly spot-checks of 1.5% of the dairy products found in-store.

Some of the regional governments' actions are innovative and could encourage other provinces to follow suit. For example, the Shanghai government launched a new draft version of a food safety regulation recently, according to which it will encourage processors of high risk foods like infant formula to put in place food quality and safety liability insurance (the mechanism for achieving this was not clarified, but this will probably be done through implementing some preferential policies for this purpose).

The government of Jinhua in Zhejiang province (the city is near Shanghai and a leading dairy production region in Eastern China) established a centralised purchasing system recently. This entailed its bringing together 27 dairy and milk beverage processors, 5 ice cream processors, 13 cake processors and 6 confectionery processors to engage in joint purchasing and freight on raw materials.

However, such measures can only go so far. For example, the food quality and safety liability insurance can protect consumers to some extent, but ultimately cannot ensure product quality. Some

observers are even worried that processors might neglect their production standards after putting the insurance in place. Likewise there are concerns that moves to centralised procurement effectively add links to the supply chain and increase costs, meaning that this approach only suits small processors or processors purchasing small volumes: for instance, Jinhua has 40,000+ cows with milk production of 100,000 t/yr, so the city only needs to purchase about 1,500+ t/yr milk powder from other regions.

Draft Rules for Dairy Imports and Exports

On 27 December 2010, China's Administration for Quality Supervision and Inspection and Quarantine (AQSIQ) issued a draft version of its proposed Administrative Measures for Import and Export Dairy Products' Inspection, Quarantine and Supervision. It has done so to solicit opinions from the dairy industry and the public: the period for receiving comment lasted for 13 days, closing on 8 January.

The measure is intended as China's first uniform policy for the dairy trade, aimed at strengthening supervision over imports and exports. It compiles a number of regulations on the topic, and some overall points can be observed:

- **Dairy Imports:**

According to the new measure, AQSIQ will assess the condition of the dairy exporting country: "if it is new to exporting raw milk or dairy products made from raw milk" to China, AQSIQ will look at a range of aspects in terms of the legal, veterinary and hygiene controls put in place by the country's government, and will evaluate the country's supply sources, production and processing technology, use of ingredient and additives etc.

Foreign dairy processors which export dairy products to China are required to register in China, and foreign agents are required to be put on the records in AQSIQ.

All imported dairy products should have health certificates from exporting countries' governments; these are required to include commitments that all dairy inputs come from healthy animals, that the dairy products will not carry/spread diseases, that the dairy processors are operating under government supervision and that the dairy products are proven to be safe by testing and can meet China's national food standards, etc.

The recipients of imported dairy products should also be recorded and must apply for inspection from the various provinces' inspection and quarantine departments. They must keep detailed records of their dairy trading activities and sales which are to be maintained for two years. Local

inspection and quarantine departments will establish a black list for any recipients which fail to meet these requirements and are fined as a result.

- **Dairy Exports:**

The government also places strict requirements upon dairy exporters, which must set up and maintain detailed records of their trading and of the test systems employed to ensure the quality and safety of the products.

- **Governmental Supervision:**

The government will take many measures to supervise dairy trading; the highlight is that it will set up a risk monitoring and evaluation system. Under this companies involved in dairy import and export have to establish their own risk information report systems: they must prepare contingency plans to ensure the safety of the dairy products they trade, with dedicated emergency liaison and risk information reporting personnel.

According to the new system, if imported products are found to present safety problems, their recipients are to recall the products, report the information to the local inspection and quarantine departments and release the information to the public. If this does not take place those departments will issue a recall order and report to AQSIQ. AQSIQ will then issue a risk warning notice and adopt further measures which could involve restricting imports (through stricter supervision and testing and recall orders), banning imports etc.

Industry sources believe that the new measures – which are now to apply to international processors for the first time – should help the government get a closer grip on supervising the safety and quality of imported dairy products. However, there are some disputes over who should have the right to recall products of international companies. Some such companies have taken the view that products should be recalled by the foreign production company rather than by the China subsidiary, arguing that although the subsidiary company and the overseas producing site share the same brand, they are still two different corporate entities.

AQSIO emphasised that formula bought by consumers from abroad, either directly online or via expatriate friends and relatives, are unaffected by the new measures or any subsequent recalls. The government launched a new regulation on 2 July 2010 raising the duty such purchases from 1 September 2010; this followed the recognition that online sales of infant formula in China amounted to at least USD73.85 million in 2009 (*please see Dairy Products China News Vol.3 August issue, p9*).

On the other hand, multinational processors can build their reputation if they do include such purchases in any recall

notices they are forced to issue. For instance, Abbott recalled some of its Similac products internationally in September 2010: although the products in question had not even been on sale in China, the subject was raised by some Chinese media. During the following month the company decided to “recall” the products in China, gaining many plaudits in the process: despite the fact that it was in reality an empty gesture, the PR value of the exercise is believed to have boosted its image amongst Chinese consumers.

Company Developments

Qianjin Dairy Halts Production

Kunming Qianjin Dairy Industry Co., Ltd. (Qianjin Dairy), a leading dairy processor in Yunnan province (in Southwest China), has halted production since 28 December 2010. This action was taken because of local urban redevelopment work as well as the stricter requirements now in place for dairy processors.

Qianjin Dairy has been in operation for 54 years experience; the company has annual production capacities of 3,000 t/yr milk powder and infant formula and 30,000 t/yr liquid milk. It is the only processor licensed to produce infant formula in Yunnan, and exports to provinces in South China and countries in SE Asia besides selling locally. Meanwhile, the company has contracted with suppliers with a total of approximately 11,000 cows and a milk supply capability of 55 t/d.

Mr. Ma, secretary to the President of Qianjin Dairy, gives three reasons for the cessation of production:

- Firstly, the urban construction underway in Kunming – the capital city of Yunnan. The city government plans to build a commerce zone, so requiring Qianjin Dairy to relocate its existing plant before 15 February
- The second factor is the government’s new requirements for dairy processors to reapply for their production licenses before the end of December 2010: those failing to be granted licenses by 1 March 2011 must halt production until the situation is rectified (*please see*

Dairy Products China News Vol.3 December issue, p4). As Qianjin Dairy has to relocate its current plant but cannot build its new plant in this timeframe, it has already missed its chance to reapply for the license, so it has to halt its production. However, it is also known that the Yunnan government began to re-examine local dairy processors’ production conditions in December 2010 and sources indicate that Qianjin Dairy cannot meet some requirements of the new stricter regulations

- In addition, the Qianjin Dairy plant uses coal to meet its energy needs, which is forbidden by an environmental protection regulation launched by Kunming government in late 2008. Kunming’s environment department was also requiring Qianjin Dairy to rectify the situation!

At present Qianjin Dairy is searching for a site to build its new plant. However this is challenging and it is even more difficult for the company to apply for a new production license. According to a senior local urban reconstruction official in Kunming, the company was offered a potential new site but refused the high price. The company still has not determined a specific date to build a new plant as a result.

Qianjin Dairy’s production halt surprised many in the industry, including Mr. Mao, Director of the Yunnan Dairy Association. He points out that this is a warning for the local dairy industry: dairy processors which can respond promptly and effectively to the policy

requirement will place themselves in an advantageous market position.

The production halt will also change the market situation in Kunming, as other brands will fill the gap in the retail market – Qianjin Dairy accounted for up to 20% of the local dairy market. Other manufacturers will also take up the local milk supply – producers formerly contracted with Qianjin Dairy are already selling their milk to other processors.

Diequan Dairy and Xuelan Dairy – both of which are subsidiaries of New Hope Dairy and combine to make up two thirds of the local dairy market – may benefit from the production halt of Qianjin Dairy. However, Mr. Jiang, Manager of Xuelan Dairy, indicated that it has yet to make any specific decisions due to Qianjin Dairy’s shutdown.

Mr. Mao indicates that about two thirds of local dairy processors can’t meet the new requirements stemming from AQSIO’s new regulations for dairy industry. The situation in Yunnan is far from unique of course: for example, the Quality Supervision Bureau in Jinhua in Zhejiang province recently revealed that of the city’s 7 dairy processors only 5 had reapplied for their licenses whilst 1 went bankrupt and 1 simply gave up operating.

Yantang Dairy Completes Restructure

Guangdong Yantang Dairy Co., Ltd. (Yantang Dairy), the province's largest dairy processor, changed its name to Guangdong Yantang Dairy Joint Stock Co., Ltd. and held an Opening Ceremony on 11 January. This suggests that the company has completed its capital restructuring, making its next move likely to involve seeking a listing.

Yantang Dairy was once a state-owned company, and the company issued an announcement in April 2010, declaring its intention to sell 19.7% of its shares (please see *Dairy Products China News Vol.3 June issue, p11*). It has since then divested some of its shares to various parties, notably a 9.8% stake to Guangdong Zhongke Cloud Investment & Management Co., Ltd. and a 7% interest to Guangdong Zhanjiang State Farms Group Co., Ltd.

These changes should make Yantang Dairy better funded and enable the company to pursue a greater degree of self-sufficiency in milk supply through building more farms. Although the company declares that it has 15 farms with a total of 20,000 head, in reality it has just signed contracts with these farms or owns a small stake in them, rather than truly having direct control of them.

In December 2010 Guangdong's dairy processors and producers had reached a stalemate over milk prices with farms planning a 15% increase in milk prices for this year but processors refusing to accept more than 10% (please see *Dairy Products China News Vol.4 January issue, p11*). Most farms in Guangdong have now signed contracts with price increases of 12-13%, but the whole issue will probably prove to be a catalyst for Yantang Dairy to build its own farms. So far it has established a farm in Zhanjiang to the west of the province – it can house 5,000 cows, and the company introduced a shipment of 700+ cows from New Zealand on 18 January.

Although Yantang Dairy has yet to declare its strategy publicly, a listing seems on the cards. This would follow a similar direction to that taken by Bright Dairy, which reformed its shareholding first in 2000 and then listed in 2002.

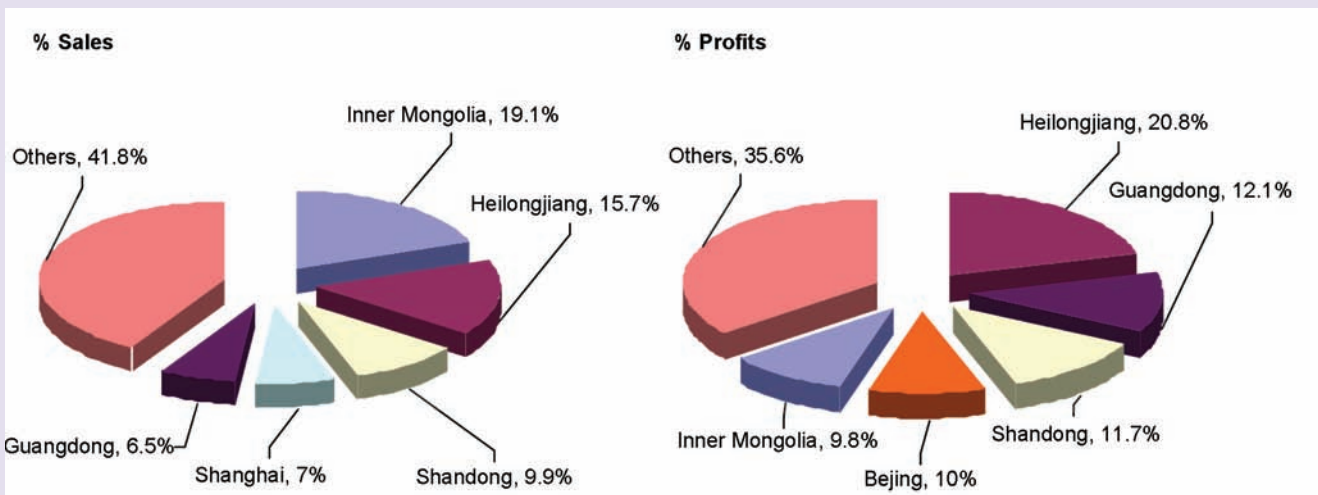
A central driver for Yantang Dairy's move is the fierce competition in the key Guangdong dairy market. According to China's National Bureau of Statistics (NBS), dairy sales in Guangdong were USD1.434 billion (RMB9.441 billion) in 2009, up 12.06% over 2008. This meant Guangdong accounted for 6.5% of the national total, ranking 5th and followed by Inner Mongolia, Heilongjiang (both of which are suppliers more than consumers), Shandong and Shanghai. The Guangdong dairy industry achieved total gross profits of about USD151 million (RMB994 million) in 2009: this gave it 12.1% of the national total and the province ranked 2nd on this basis.

PICTURE 1: Yantang Dairy's Opening Ceremony in January 2011



Source: www.baidu.com

FIGURE 5: China's Top 5 Provinces for Dairy Industry Sales & Profits, 2009



Source: China's National Bureau of Statistics

Obviously, the promising dairy market in Guangdong attracts many competitors from other provinces, both national players such as Yili and Mengniu and regional processors. For example, Changfu Dairy, the largest dairy processor in Fujian Province (to the east of Guangdong) has revealed its intention to expand its business into Guangdong in 2011. As Changfu Dairy has a similar product mix to those of Guangdong's processors, this is sure to intensify the competition levels locally.

However, dairy processors from other provinces may find it hard to enter Guangdong's dairy market: the province has high quality milk, a situation supported by the local practice of establishing contracts between producers and processors. The system ensures stable milk supply by giving dairy producers a clear view of their future business – such a situation is still often lacking in northern China, despite having been a key contributory factor to the 2008 melamine scandal. It is also significant that Guangdong's consumers show a strong preference for drinking pasteurised milk and yoghurt. Such factors make it essential for dairy processors to find or establish high quality milk supply as a means of expanding in Guangdong.

Raw Milk Supply

Gansu Expands Dairy Insurance Coverage

In January, the Agriculture and Animal Husbandry Department of Gansu province declared that the province will increase its investment in the dairy insurance subsidy policy this year in order to protect farmers' profitability – a policy likely to boost the development of the local dairy sector to some extent.

According to the Gansu government's plan, it will provide the subsidy to 120,000 cows in Gansu. This essentially represents the entire local dairy herd in Gansu – affected by the 2008 melamine scandal, the province's cow numbers decreased to 102,000 in 2009 from 127,100 in 2008, according to the local dairy association. Under its terms Gansu's dairy farmers only need to pay 20% of the insurance premium, with the remaining 80% being funded by various levels of government (in 2011 40% by Central Government and 40% by regional governments, compared with 40% and 60% respectively over the past three years).

The new plan also covers about 600,000 yaks, a number equating to about 50% of the overall yak herd in Gansu. Yak farmers only need to cover 10% of the insurance premium.

Gansu is one of China's leading pastoral regions and its largest alfalfa producer area, which should be beneficial for the development of dairying locally. However, the province has tended to supply feedstuffs into other regions and its dairy herd of 102,000 cows in 2009 gave milk production of 370,000 tonnes only. This can be contrasted with the neighbouring province of Shaanxi, which had 629,300 cows and milk production of 1.87 million tonnes (note: this figure is from the Shanxi Dairy Association and compares with data from the national Ministry of Agriculture which shows 1.5 million tonnes).

A number of commentators have suggested that lack of support from the local government has been a factor behind the different performance levels of the two dairy sectors. However, the impact of the latest iteration of the plan will depend to a great extent on how it is implemented. The policy has been operational since early in 2008, but has underwhelmed in its effect. One problem has been that local

dairy farmers didn't want to pay for the insurance even on such favourable terms – it is estimated that only about 20%+ of local producers opted for the dairy insurance. The lower level of funding expected in the new plan may attract more to participate in the future – and perhaps the recent freezing rain and snow in Gansu may lead some to consider the benefits of insurance afresh.

At a national level the subsidy policy covered about 1.6 million cows in 2009, about 6.9% of China's total cow numbers. It seems that the situation deteriorated in 2010: indications are that the total insurance premium decreased by 30% in 2010.

Heilongjiang, which started a dairy insurance pilot project early in 1981, invested about USD32 million in dairy insurance in 2009, aiming to provide the subsidy to 500,000 cows (*please see Dairy Products China News Vol.2 May issue, p5*). However, in practice the scheme covered just 200,000 cows in 2010, down by 60% over 2009.

There are many factors affecting the implementation of dairy insurance: for instance, the insurance companies have recorded significant losses in some regions, which may negatively affect their operations. There have also been problems in the management of the scheme: some departments of the regional governments failed to grant the subsidy fully and on time. As a result the policy still remains work in progress.

New Products, Technology & Packaging

Chongqing's Processors Target Premium Liquid Milks

Chongqing Tianyou Dairy Co., Ltd. (Tianyou Dairy) and Chongqing Gonda (Group) Co., Ltd. (Gonda Group), are the two leading dairy processors in the mega-city of Chongqing. Both companies launched premium UHT milks recently, under the brands of Better and Cow Dream Works respectively. In doing so they are taking on Mengniu and Yili in particular in the category. Premium milks do not constitute a well-defined category, but in local trade parlance mainly comprise milks claimed as providing higher protein/nutritional content, safety levels and often flavour, and sold in notably high quality/luxurious-style packs.

Tianyou Dairy is a subsidiary of New Hope Dairy Co., Ltd. (New Hope) and the largest dairy processor in Chongqing. Tianyou Dairy achieved sales of USD72.66 million in H1 2010, and took about 30% of the local dairy market in 2010 according to the Chongqing Dairy Association. Better is the brand of Tianyou Dairy's premium liquid milk, which was launched by the company three years ago. The new product is marketed under the sub-brand of Youkangli™ and includes the prebiotic β-Glucan, which has purported immune system benefits.

Gonda Group is a new dairy processor established in 2007. It comprises three subsidiaries:

- Gonda Farming – which owns three farms supplying Gonda Dairy
- Gonda Dairy – producing pasteurised milk, UHT milk, yoghurt and milk beverages under the brand Cows Dream Works
- Dream Works Dairy Chain – the sales network selling Gonda products.

It has a dairy herd of about 5,000 cows with milk production of 24,000 t/yr. The company mainly targets the premium liquid milk category and indicates a 100,000 t/yr production capacity for such products, although this volume has certainly not been realised to date – it only uses the milk from Gonda Farming at present.

The company first launched its retail range in 2008 and has about 120+ franchise stores (selling only Gonda products) currently. Since launch it has prospered and now accounts for about 10% of the local dairy market. Its new launch is Gonda Group's first UHT milk, and is marketed as offering high protein content and quality but especially high freshness and safety, based on the company's use of its own fresh milk.

The premium segment of the liquid milk market has grown well in Chongqing in recent years. For example, a source at the Chongqing Department Store Co., Ltd. (which operates 28+ supermarkets in Chongqing) indicates that the chain's sales of premium liquid milk were USD1.511 million in December 2010, which is about 50% of its total liquid milk sales. He notes that processors are drawn to the margins offered by premium milk products, while many factors attract consumers, such as food safety, nutrition and flavour. At times such as the present Spring Festival, premium milks can also be sent as gifts – food items are commonly bought for this purpose.

A survey from a local institute supports this view: the research investigates why consumers choose Tianyou Dairy's premium UHT milk products: 40.6% of respondents cite its higher quality, 26.3% its improved flavour and 20.8% the reasonable price.

Tianyou Dairy and Gonda Group are expected to expand their business in premium milks market and compete with processors based outside the province – especially Mengniu and Yili, who combine to take an estimated 50% of the province's premium milk sales. Mr. Liu, Sales Manager of Tianyou Dairy, suggests that his company is targeting a 50% share in the segment for itself.

To compete with Mengniu and Yili, both Tianyou Dairy and Gonda Group are stepping up their sales efforts, providing free gifts and increasing the number of promotional staff, etc. Tianyou Dairy is the stronger of the two in this respect. Gonda Group's new product has a gift-pack, which will probably attract consumers in the Spring Festival, but the company focuses its promotion only on its franchise stores.

Conversely Tianyou Dairy is an active marketer, for instance advertising the nutritional content of the product, providing gifts and cooperating with a local group purchase website, where consumers purchase products collectively to secure lower prices. etc. On the group purchase website, for example, consumers can purchase the new product at a 20% discount, which seems likely to be an attractive offer on the basis of the research mentioned above. In addition another survey shows 52.7% of respondents believe that advertisements should emphasise the nutritional content of milk products, so Tianyou Dairy's tactics seem well-chosen.

Besides the premium UHT milks, premium pasteurised milk and yoghurt are selling well in the Chongqing Store outlets, and are estimated to make up 40% of total pasteurised milk and yoghurt sales. Tianyou Dairy and Gonda Group both do well in these segments as well, competing with other processors such as Mengniu and Qinghai Xiaoxiniu (Qinghai Traditional Yoghurt).

PICTURE 2: New Premium UHT Milks from Tianyou Dairy (Left) and Gonda Group (Right)



Source: www.tianyoudairy.com & www.gdcow.com

Quantum High-tech Focuses on FOS & GOS

Jiangmen Quantum Hi-Tech Biological Co., Ltd. (Quantum High-tech), the largest fructooligosaccharide (FOS) producer in China, successfully listed on the Growth Enterprise Market (GEM) of Shenzhen Stock Exchange (SZSE) in late December 2010. This move is designed to raise funds to aid its growth in the FOS and galactooligosaccharide (GOS) markets.

Based in Guangdong province, Quantum High-tech mainly produces FOS and GOS currently, with capacities of 11,000 t/yr and 1,000 t/yr respectively. The company has been growing well, with sales of USD15.22 million (RMB100.24 million) and a net profit of USD4.46 million (RMB29.36 million) in 2009, up 3.3% and 26.7% respectively over 2008.

Quantum High-tech plans to raise about USD72.26 million (RMB476 million) to fund its development. This will be mainly invested in the following ways: about USD16.70 million (RMB110 million) for a 10,000 t/yr FOS production line (with packaging facilities included), USD8.05 million (RMB53 million) for a 2,000 t/yr GOS production line and USD3.80 million (RMB25 million) for a new R&D centre. The remaining funds may be used as operating funds or to support its other expansion projects.

The company's expansion is based upon the increasing local demand for FOS and GOS. These ingredients have been widely used in yoghurt, milk beverages, milk formula, confectionery and ice

cream, etc. According to the China National Research Institute of the Food & Fermentation Industries (CNFFI), sales of FOS in China reached about 16,000 tonnes in 2009. The figure divides into 10,000 tonnes of low purity FOS (<55%) and 6,000 tonnes of high purity FOS (≥60%). The volume of 16,000 tonnes represents about 25% of the functional oligosaccharide market overall (taking in other types such as isomalto oligosaccharides, xylooligosaccharides etc). Projections are for a FOS market of 100,000 tonnes in 2014 (62,000 tonnes low purity vs 38,000 tonnes high purity), equivalent to 40-45% of the overall market.

Quantum High-tech will mainly target the high purity FOS segment for the margins it offers: the impressive bottom line growth achieved reflects its strategy of focusing on high-end products (solid low purity FOS, high purity FOS and GOS). The high-end products accounted for 85.2% of the company's overall gross profit in H1 2010, compared with 45.4% in 2007.

Quantum High-tech believes that at present the GOS market is still in its infancy: sales in China are only about 1,500 tonnes, mostly used in premium infant formula. As Chinese consumers pay more attention to food safety after the 2008 melamine scandal, GOS is expected to enjoy rapid development over the next few years, with sales volume reaching 6,000-10,000 tonnes

– domestic GOS production capacity doesn't exceed 2,500 tonnes currently.

As the largest FOS producer in China, Quantum High-tech has many advantages, such as technology, brand and sales channels, which should position the company well for the future. Yet it continues to face fierce competition, especially in FOS. The sector has attracted a number of domestic processors: for example, Baolingbao Biology, the largest local isomalto oligosaccharide processor, raised funds to build a 10,000 t/yr FOS production line in August 2009 (Please see Dairy Products China News Vol.2 September issue, p12). The company's new facility was launched at the end of 2010, making Baolingbao Biology the main competitor for Quantum High-tech.

Another concern for Quantum High-tech is the pressure of inflation in the market: sugar is the main raw material for the company, accounting for 50.6-57.8% of its total costs over the period from 2007 to H1 2010. Sugar prices increased rapidly in H1 2010, pushing down Quantum High-tech's predicted net profit by USD0.2 million in H1 2010 – about 7.2% of its total net profit. Moreover the company's main clients are the main dairy/beverage businesses such as Mengniu, Yili, Bright Dairy and Beingmate – it will find it hard to pass on these growing sugar costs to them, a factor which may well hit its overall results for 2010.

FIGURE 6: Quantum High-tech's Sales Performance, 2007 – H1 2010



Source: Quantum High-tech

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