

“You get three or four or five deals done, build them consecutively, train the crew consecutively so you have on the money. So when a truck goes out from the distribution center, it’s not carrying one store, it’s carrying the products for three to five.”

–Tim Fenton CEO McDonald’s Asia

Shanghai’s Beverage Distribution Industry

Over the next several months, ChinaVest will continue to provide summary research on the logistics infrastructure in China. Our firm, a merchant bank based in Shanghai, has been operating in greater China since 1981. ChinaVest has a strong connection to the logistics industry. We have owned logistics companies such as TAIT, through which we have distributed consumer products in China, including Evian and Heineken. ChinaVest has also been the M&A advisor to a number of multinational firms that utilize China’s interconnected system of ports, highways, and railroads.

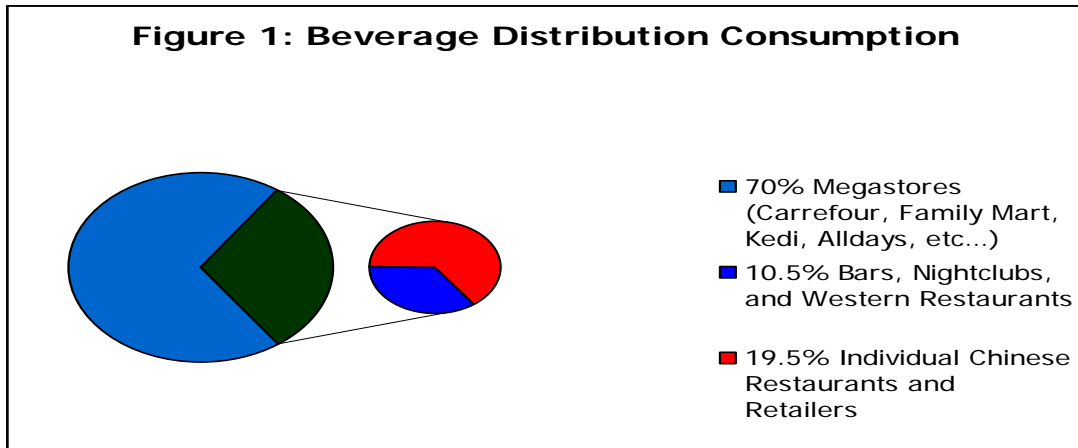
Beverage Distribution

This report covers the structure and operations of China’s beverage distribution industry and is a continuation in our installment of reports on logistics. We will begin by discussing the current makeup of beverage distribution in Shanghai, including market providers, consumers, and chain of distribution, followed by a recent history of the market and dramatic changes that have occurred, including ChinaVest’s own direct involvement. The information in this report provides a comprehensive framework for understanding the exciting opportunities that exist within this industry in Shanghai, and China as a whole.

Market Structure

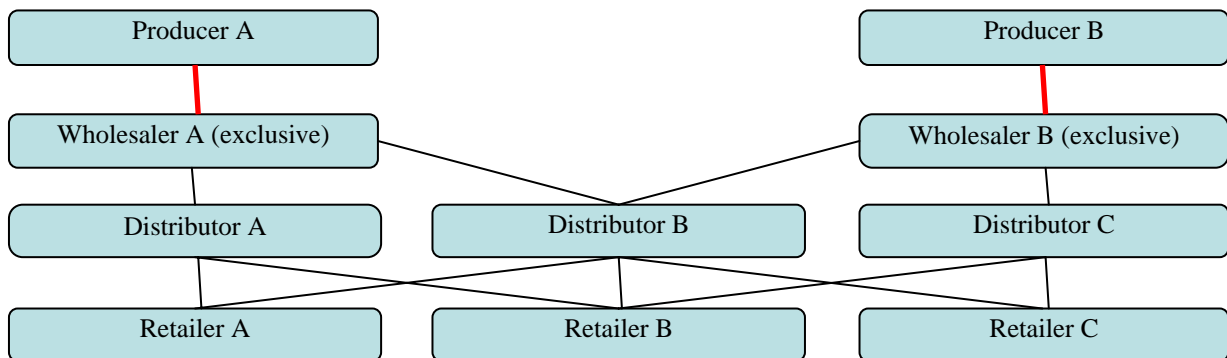
Beverage distribution in Shanghai is highly fragmented (as it is throughout the country), both in terms of consumption and distribution. Consumption can be divided into three categories: megastores, nightlife (including Western restaurants), and domestic restaurants and individual retailers. While megastores account for 70% of the distribution customer base, there is still a large percentage of the market dedicated to on-trade consumption. Of on-trade, 35% of the market demand stems from nightlife, with the remaining 65% from domestic restaurants and individually owned and operated retailers. Although not specifically mentioned, hotel consumption is factored into the nightlife section of the graph in Figure 1 and its accompanying statistics.

Figure 1: Beverage Distribution Consumption



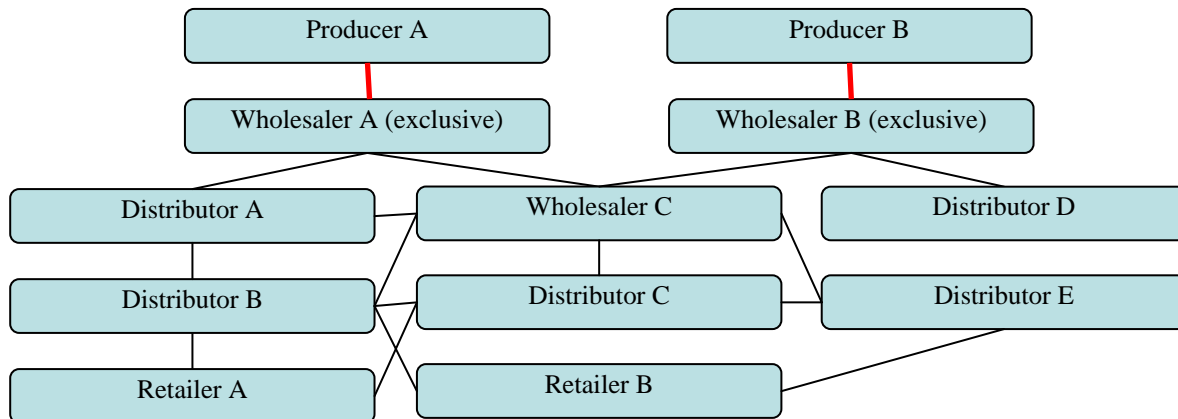
Even more fractured than consumption is the distribution structure. A company occupies one of three roles along the chain of distribution: producer, wholesaler, or distributor. In an efficient consolidated distribution network in a more advanced market (as represented in Figure 2), a producer would supply a wholesaler, which would in turn supply the distributor that sells directly to various retailers. In this system, the wholesalers are restricted from distributing a competitor's product. In Figure 2, this means that if A and B are types of beer, each wholesaler can only vend one type. Distributors, however, are free to sell competing products and are able to purchase from various wholesalers without any obligation to one or the other.

FIGURE 2: CONSOLIDATED DISTRIBUTION NETWORK



In this type of network, each distributor is contractually obligated to purchase a quota from a wholesaler, and is only free to purchase from other wholesalers as long as that quota is met. Likewise, retailers have an obligation to only a limited number of distributors in order to ensure the consistency of a customer base. A consolidated distribution chain, which is not much different from operations in the United States and Europe consists of three tiers, four tiers at most.

FIGURE 3: SHANGHAI BEVERAGE DISTRIBUTION CHAIN



In Shanghai's system (represented in Figure 3), however, the complex structuring of beverage distribution results in lower profit margins at every level. As evidenced above, the distribution network in China can have as many as seven tiers at any given time, with no quotas or exclusivity deals the process becomes extremely muddled. Producers A & B have exclusive agreements with wholesalers in various cities, though there is no guarantee that Wholesaler A has Producer A's business throughout the country, rather exclusivity agreements are on a city-by-city basis. Wholesaler C in the above diagram represents megastores such as Carrefour or Wal-Mart, which often times in lieu of their own distribution and logistics center utilize local companies' instead. Distributors purchase goods from these wholesalers and proceed to sell beverages to retailers, however, due to the sheer number of retailers and the competitiveness of the distribution industry, market share is evenly divided among a large number of companies.

Shanghai, like many other major Chinese cities has laws in place that limit the use of trucks on city roads during daylight hours in an attempt to alleviate traffic congestion. As such, large-scale distribution is difficult, with multiple smaller trucks, vans, and even sedans used to transport beverages around the city. Distribution companies either require a fleet of smaller cars and vans or face paying exorbitant taxes and fees to use trucks. These high transportation costs, combined with low sales margins create an ultra competitive and fragmented industry.

In addition to its inefficient structure, Shanghai's beverage market has a skewed target consumer base, which results in restrictive pricing and prevents access to domestic vendors. Even though 65% of the retail market is made up of domestic restaurants and individual counter-shops, wholesalers and distributors base their pricing methods on the 35% consisting of nightlife and western restaurants. The hope is that they can maintain higher pricing and sell top-shelf beverages in order to increase their profit margin. By maintaining a higher baseline price, the distributors are cutting out domestic retailers, who, in turn, either purchase beverages from megastores and convenience shops that offer lower pricing, or simply restrict their own sales to cheap, domestic substitute brands. These higher prices are also the reason that established brands like Coca-cola

struggle to seize market share in China. Although Coke was and continues to be the number one, most widely distributed beverage in China, with 95% brand recognition. 70% of its business is done through McDonald's chain restaurants. Simply put, Coke's unwillingness to lower its price mark up to wholesalers is in effect, significantly limiting its market. If Coke were willing to lower its prices, it would effectively double its potential market.

Pricing restrictions, combined with a lack of centralization in the domestic market makes it particularly difficult for distributors to reach the domestic mom and pop restaurants and retailers. Due to the current distribution system, even if pricing were less prohibitive, it would still require significant effort and contacts for any distributor to effectively satisfy a profitable number of domestic consumers.

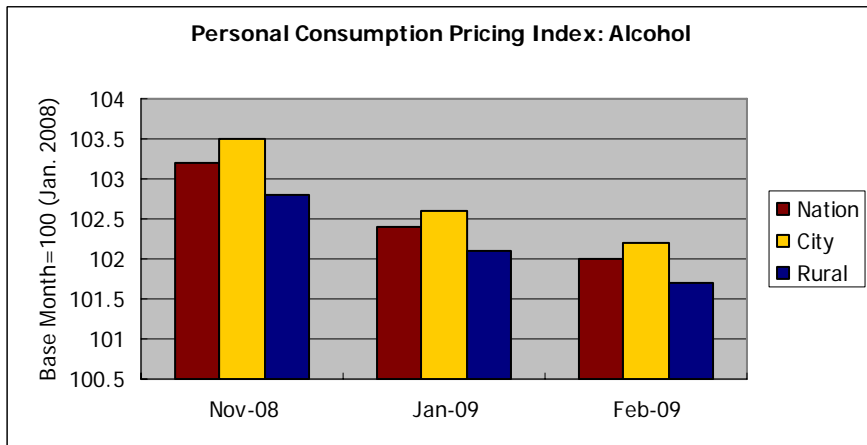
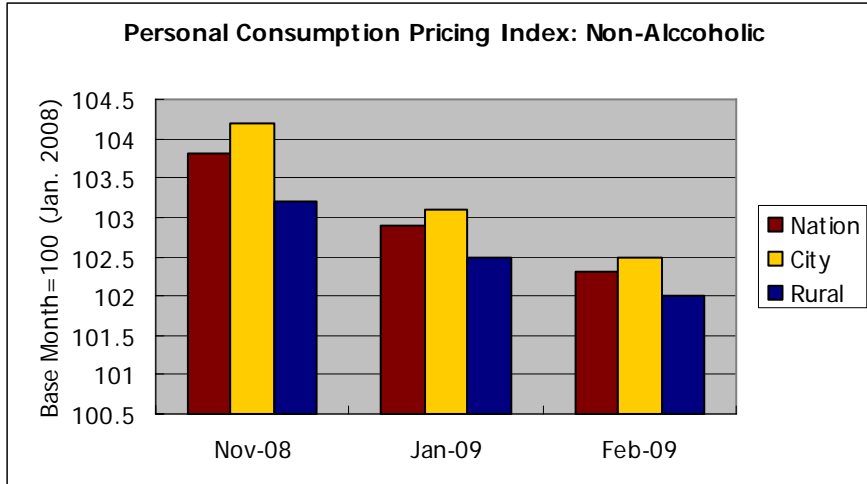
A Recent History of Beverage Distribution

Prior to 2008, the Chinese beverage distribution industry began to show signs of consolidation. The major industry players: Nestlé, Danone, and Procter & Gamble were building up their collective market share throughout the first part of the decade by leveraging their preexisting relationships with beverage producers as well as past experience in other markets to dominate China's coastal cities' high end retail clientele. The big three focused on businesses they knew and understood, dealing largely with western clients, such as hotels, bars, night clubs, and western restaurants.

These major distributors' relatively narrow business focus left a large window for local competition to thrive. In 2007, the domestic distribution industry, which was still largely undeveloped, saw record growth, with some estimates as high as 40% sales growth for importers and basic suppliers, and 25% sales growth for local distributors and retailers. As the credit crisis of 2008 set in, the big three international supply companies started to scale back their businesses. Foreign firms massively cut back operations, particularly in the second quarter of 2008, as final sales fell by roughly 50%. By year's end, over 80% of sales directors for first and second tier distribution companies had lost their jobs, and foreign companies operating in China's coastal cities had much diminished operations. The scale back from foreign players left a gap for domestic companies to gain market share. Domestic giant, China COSCO (China Ocean Shipping [Group] Company) took much of the foreign companies' coastal market, the industry's hardest hit region, while maintaining its strong presence in poorer, inland cities and regions.

The demographics of China's coastal cities' have changed much more than that of their landlocked counterparts. Cities like Shanghai and Beijing have seen the development of larger markets for western tastes, particularly alcoholic beverages. Beer and liquor companies expect to do much of their business between the months of June and August, with some companies like Budweiser and its Chinese partner Tsingtao reporting nearly 70% of sales occur in the summer months. While the summer of 2008 was profitable for much of coastal China, particularly Beijing thanks to the Olympics, the second half of the year could not hold up. Demand for mid-level to premium drinks diminished as clientele of clubs, bars, and western restaurants slowed. Retail outlets that relied on already low margin drink sales (margins kept low by stiff competition in the distribution industry) could not afford to uphold their agreements with distributors and were forced to shut their doors. The retail outlets that have been able to keep themselves in business have done so by continuing to cut prices on the final goods. As evidenced below, distributors' alcohol prices have fallen relatively further than non-alcoholic drinks.

Figure 4: Pricing Indices: Non-Alcoholic vs. Alcohol Beverages



Source: National Bureau of Statistics & ChinaVest

Meanwhile, in the inland markets China COSCO has seen a much less dramatic decrease in sales than its international competition. China's second- and third-tier cities have never relied on the extremely wealthy and expatriate populations for their target markets, but rather on Chinese nationals. Interior cities' distribution markets are even further skewed away from western outlets as the final destinations for their beverages, meaning the drop off in their sales rates in 2008 were not as harsh. For companies to be successful going forward, they will need to focus more on off-trade sales outlets and non-western retailers than on-trade sales markets, which may require a change in the traditional business plan.

Competitive Pricing

As illustrated in Figure 3, the Chinese distribution chain can often have as many as seven tiers or steps in the process of getting from the producer to the retailer. The complicated process and number of parties involved in reaching the final transaction creates a low-margin business and builds an environment that is not conducive to consolidation. The lack of a reliable and efficient national transportation system also leads to localization of distribution chains, resulting in major producers having multiple relationships, contracts, and agreements to manage. With such a wide range of relatively isolated markets, national exposure is particularly difficult to achieve. Within the preexisting distribution model, high profit margins are extremely difficult to come by, but as long distance transportation becomes easier and more reliable, and if distributors can circumvent current domestic distribution processes, then sales and profit margins could increase.

Currently the average price of a pint of beer in China is US\$2.21 compared to US\$3.20 in the United States. Obviously prices vary wildly in both countries, with some beer in China priced as cheaply as US\$0.25 for a pint at local convenience stores, and certain retailers in the United States offering significant discounts, but either way beverages in China are still significantly cheaper than those in the U.S.

China's extended distribution chain creates a low-margin industry out of a potential high-margin one. Beginning with producers, prices are marked up roughly 20-30% in sales to exclusive wholesalers. Thanks to the exclusive nature of their business, wholesalers can then afford to increase sales prices again to local distributors, by roughly the same amount, between 15-30%. These wholesalers however, do not keep as high a ratio of profits as producers do. In return for their exclusive rights to sell these products, wholesalers give a cut of their own mark up back to the major beverage producers.

It is then the distributors that are forced to keep prices low, as their business is based purely on sales to retail outlets. In many cases distributors' mark-ups top out in the mid to high single digits, meaning these localized companies rely nearly entirely on pure quantity of sales to turn profits.

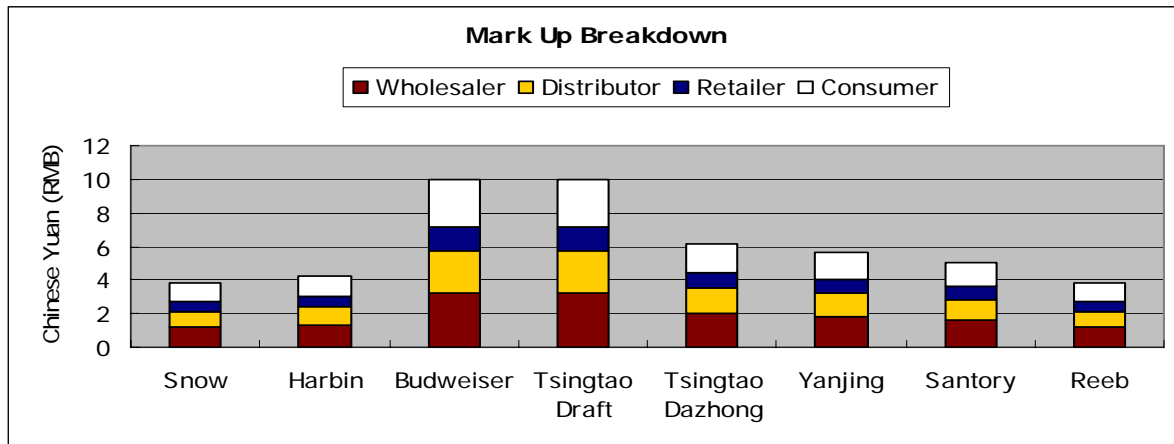
In the current system, distributors cannot afford to mark-up prices up, as the competitive nature of the industry is such that any excess mark up instantly makes them uncompetitive, and without exclusivity deals with retail outlets or wholesalers, they lose what little profitability they have.

Finally, mark-ups in the retail sector vary based on which sector beverages are sold in, megastores, nightlife, or domestic outlets. Megastores, such as French giant Carrefour, Chinese Jiadeli, and to a lesser extent, U.S.-based Wal-Mart act as their own distribution and wholesalers, with packaging and shipping centers strategically located throughout the country. These companies actually mark up very little, but as they rely on China's transportation system and Chinese consumption patterns, profitability is limited. Chinese consumers still buy groceries day to day, and by need, rather than in bulk as these stores often supply.

Nightlife, as we have termed it here in this report, essentially refers to any western retail location or high end bars and KTV establishments. Bars, western restaurants, hotels, and KTVs can afford to mark up the prices on beverages, especially in coastal cities as their target clientele have more disposable income and a higher price threshold that they are willing to pay, high end beverages, like any luxury good experience more price elasticity where disposable incomes are higher.

The last group, domestic outlets, includes everything not yet mentioned: mom and pop stores, convenience stores, and Chinese restaurants, which are particularly important. Due to the sheer number of these outlets in any given city and the variety of clients they serve, they do not mark up prices as much as their western counterparts. Below please find a graph that demonstrates an estimation of a mark-up schedule for a distribution chain in an average Chinese city, under normal business conditions (no Expo, Olympics, or economic crisis).

Figure 5: Pricing Methods



Source: Jiangang Dai and Chen Zhou, "Beer Distribution in China," Center of Excellence: Logistics in China (March, 2008): 10. Additional Research by ChinaVest

Transportation

As of August 2008, China had the second biggest highway and road system in the world, the third biggest rail system in world, and a population roughly the size of the entire European Union residing on the Yangtze River, which accounts for 80% of the inland ports in the country. While the country does not have nearly the number of airports as the U.S. or other global leaders, air freight tends not to account for a large portion of annual total shipping. The country's roads, waterways, and rail systems cover a large portion of the country, however much of the system is poorly maintained and slow going. Roads in the West are particularly notorious for their unreliability. Public works projects are frequently neglected or haphazardly started and stopped, resulting in unexplained and unexpected delays.

Figure 6: Transportation Statistics

	Mileage	Passenger Volume	Freight Volume
Highways	2,224,000	20.5	16.4
Railways	48,466	1.36	3.12
Waterways	>4,000	n/a	>100 Million
Airways	152 Airports	185.8 Million	4.02 Million

Note:

Passenger Volume is calculated in billions of people unless otherwise specified. Freight Volume is calculated in billions of tons unless otherwise specified. Of the country's 2.2 million miles of road, 33,491 miles are expressways. Of the 48,466 miles of rail, 15,161 miles are electrified.

Source: ChinaVest & the China Economic Information Service

The above stated numbers are current as of August, 2008, just short of the Chinese government's announcement of its massive stimulus plan, which included a US\$146.395 billion (RMB1 trillion) fixed asset investment into transportation infrastructure, to be spent over the course of 2009 and 2010. By year-end 2009, the Chinese Ministry of Transport expects to finish 7,456 miles of new expressway, particularly in the West of the country, improving connections between many second and third tier cities. Furthermore, as part of the country's stimulus plan, the Ministry of Communications, which controls toll roads throughout the country has begun to close toll stations on all second-tier highways, which account for nearly 42% of the country's highways. The transfer of these roads from toll roads to freeways will increase speed of travel as well as decrease costs of shipping for large long distance shipments.

The continued rebuilding of Sichuan following the May 2008 earthquake should restore a significant number of roads and railway that were lost. The fractured transportation system in the region contributed to continued difficulties in long haul shipping and transport to western China. In addition to the above stated US\$146 billion, the government has also earmarked a similar amount for Sichuan's rebuilding. Finally, in the most recent 5-Year Plan, the Ministry of Transport pledges to have all 22 Mainland China provinces connected by reliable highways, as well as provide continued maintenance and upkeep. The improvement of China's transportation infrastructure makes a national distribution system more possible, though barriers still exist.

Geographic consolidation of the distribution market under one or a few companies still looks difficult, though the concerns are addressable. Chief among these concerns are the logistics behind operating a complex geographic network. Distribution companies as they currently exist largely take profits purely from sales volume, unlike wholesalers, retailers, and producers, who all partly rely on mark-ups for revenue. As such, and without any way to price out competition, distribution companies struggle to control market share. Without market share or higher net income, domestic distributors cannot afford the workforce or fixed assets to manage a large, multi-city distribution company. An international distribution company however, may have the assets and capital to succeed in introducing such a program.

Conclusion

The distribution industry, both in Shanghai and greater China, represents a solid opportunity for both international firms looking to expand into China and companies which already have an established foothold in the country. The current way distributors do business is not conducive to creating a higher margin business. Distributors' focus on nightlife retail outlets as prime customers must change in order for a wide-scale, national business to be more effective. Companies seeking to maximize profits through on-trade sales must turn their attention to Chinese retail outlets, local restaurants, and mom and pop stores. Supplying these stores instantly gives distributors access to a much larger section of the market share.

To adequately supply Chinese companies, distributors will require a variety of resources, which ChinaVest has experience in dealing with.

- 1) A strong network of relationships and contacts within the distribution industry and with retailers throughout the country (both western and Chinese)
- 2) Previous experience in the logistics industry - ChinaVest's acquisition and management of TAIT uniquely positions our firm as advisors to potential distributors.
- 3) Access to cold storage trucks and warehouses in a number of cities. Currently most localized distribution companies keep 3-5 days worth of products stored at an on-site warehouse. To ensure consistent distribution ability, a firm will need to increase capacity.
- 4) Buy-Side and Sell-Side quota agreements with wholesalers and retailers alike, as detailed on page 2 of this report. Although exclusivity contracts are unlikely for distributors, partial-exclusivity is not out of the question.
- 5) Consistent buyers in multiple cities. In order for long-distance distribution to be profitable, distributors need to ensure long distance hauls are not one-way. This also requires storage facilities in multiple cities as well.

Beverage distribution has the potential to be a highly profitable business. Currently, we believe the restructuring of the industry, due to scaled-back operations for international firms, provides a unique opportunity for one or more companies to take a sizable portion of the market share. Specialization and consolidation are both possible, and as China's infrastructure improves, even more markets will open up to large distribution companies.