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Asia Pacific Food and Drink INSIGHT

BMI's monthly market intelligence, trend analysis and forecasts for the food & drink industry across the Asia Pacific

REGIONAL FOCUS

San Miguel Shareholders On Rollercoaster Ride

As **BMI** reported has previously reported, Philippines conglomerate **San Miguel Corporation** (SMC) is to bring forward its packaging and domestic beer unit spin-offs in order to accelerate its planned entry into the power industry.

The news shocked many analysts, both due to SMC's recent high profile food and beverage acquisitions and its lack of experience in so-called 'heavy industry'. However, on reflection one should not be surprised. SMC has been in a perpetual state of restructuring in recent years as it looks to shore up its position as South East Asia's leading food and drink firm, while also pursuing diversification into more profitable markets and industries.

SMC, which is generally regarded in the West as a brewing specialist, also boasts interests in liquor, soft drink, food processing, animal feed and packaging. In recent years the company has sought to expand into higher value operating sub-sectors. In 2005, it acquired Australian dairy specialist **National Foods**, as well as one of that country's leading fruit juice manufacturers, **Berri**.

These acquisitions hugely increased SMC's debt level, leaving many shareholders unsettled, although the company has also shown itself to be ruthless in terms of divesting under-performing businesses and improving shareholder value. In early 2007 SMC sold its majority stake in **Coca-Cola Bottlers Philippines Inc**, following conflict with its fellow shareholder, **The Coca-Cola Company**.

The most recent activity to shake the exchanges was the news that SMC might sell a stake in National Foods to Japanese brewer **Kirin**. The fact that this would again reduce the company's debt triggered an increase in its share price. Incidentally, the impact on Kirin's share price – a brewing specialist that is looking to move into dairy – was negative. However, the Kirin interest followed news that SMC was to close its only brewery in its largest beer market in value sales terms – Hong Kong. The company is to move production at the Yuen Long facility to mainland China and will instead rely on imports to fulfil local demand. The measure will result in cost savings in the long term, although profitability will once again take a short-term hit due to the restructuring involved in such a move.

SMC's ambition certainly mean that it is an exciting company in which to invest, although further volatility in its share price seems inevitable.

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San Miguel Corporation In The Asia Pacific Region

	Alcoholic beverage facilities	Non-alcoholic beverage facilities	Food plants/ farms	Other plants*	Total
Thailand	1	1	0	0	2
Vietnam	1	0	8	2	11
Malaysia	0	0	2	4	6
China	2	0	0	3	5
Hong Kong	1	0	0	0	1
Philippines	9	0	32	17	58
Indonesia	1	1	1	1	4
Australia	1	12	8	0	21
New Zealand	0	0	1	0	1
Total	16	14	52	27	109

** Incl. packaging facilities. Source: San Miguel Corporation Annual Report*

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COMPANY PROFILE

Metro Unafraid To Take Risks In Asian Expansion

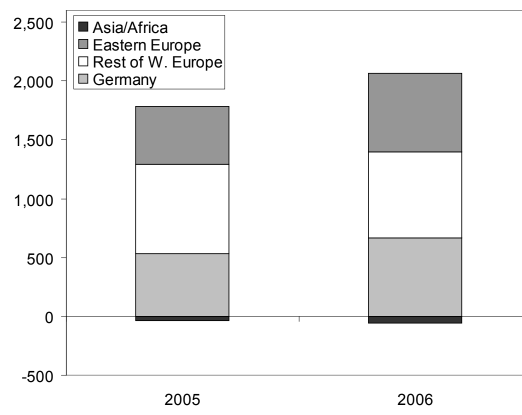
Metro Group is the largest retailer in Germany, its domestic market, and the world's fourth largest grocery retail multinational, behind US major **Wal-Mart**, France's **Carrefour** and UK major **Tesco** (Metro outsells Tesco, but not if its non-food divisions are excluded).

Metro's flagship division, and the one on which this profile will focus due to its presence throughout Asia, is its cash-and-carry division, which operates via both the Metro and Makro brands. It also operates a chain of Real-branded hypermarkets – its largest division in store number terms – Extra-branded supermarkets, consumer electronics stores under the Media Markt and Saturn fascias and the Kaufhof Warenhaus AS department store network.

BMI cites Metro's ability to manage the differing needs of both a multi-format grocery retail network and a number of non-food retail interests as one of its most significant achievements – and achieve it does In 2006, Metro posted revenue growth of 7.5% year-on-year (y-o-y) to EUR59.9bn, while EBIT (earnings before interest and tax) increased by 10% to EUR2.4bn – quite an accomplishment when you consider that the bulk of its sales come from the mature and largely saturated markets of Western Europe, where sales growth above the low single digits is notoriously hard to achieve.

Delayed Gratification In Asia

Metro Group EBIT By Operating Region, 2006 vs 2005 (EURmn)

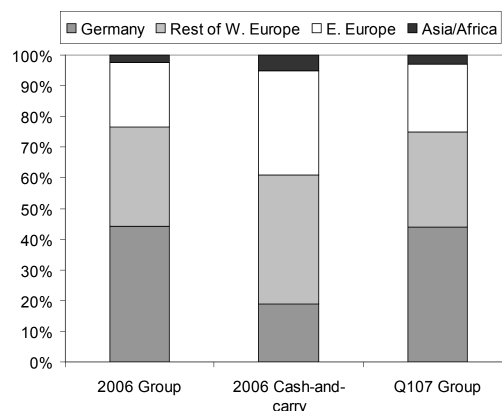


Source: Metro Group Investor Relations

However, in recent years, Metro has been expanding away from its Western European base and into the emerging markets of Eastern Europe and increasingly Asia. In the first quarter of this year Metro's Asia/Africa division accounted for just 3% of group sales and yet with y-o-y growth of 24.9% it was the retailer's highest growth division. With wholesaling representing Metro's only foray into Asia to date, the division's contribution to cash-and-carry sales is obviously higher. However, at just 5% there is still plenty of work to be done if Metro is to turn what currently represents a strong growth opportunity, into a serious long-term sales contributor.

Europe Dominates, But Attention Is Shifting

Metro Group Segment Sales By Region, 2006 And Q107 (%)



Source: Metro Investor Relations

Metro's commitment to Asia is not in doubt. It continues to post a loss in the region from year to year as it continues to plough funds into further store openings and into local training and brand-building schemes. Like its rival multinationals, it is leveraging its competitive advantage – that being its superior economies of scale – to make significant strides into Asia without the need for immediate returns. Unlike its local rivals, Metro and its multinational peers can afford to take the risk of opening a large-scale store network without existing demand, safe in the knowledge that its established, secure and profitable Western European operations can accommodate market failure.

Metro's approach to Asia certainly shows that it is not a risk adverse company. Yes, it has stayed within the cash-and-carry format and enjoyed all the benefits this brings, in terms of less multinational competition and more liberal foreign investment regulations. However, it has also opted to enter some of the region's most challenging markets. China and India, where Metro operates 34 and three stores respectively, are obvious choices for any expansion-oriented multinational, but they still carry a high degree of risk.

Country Profiles

Metro benefited from restrictive foreign direct investment (FDI) rules on consumer retailing in India to introduce the Metro brand to the country ahead of the competition. However, infrastructural challenges and unique provincial regulations have prevented it from expanding at the pace it would have liked and now, if Metro is to remain competitive within the changing business environment, it will have to make an enormous investment in the local market with no likelihood of short-term returns.

This is the approach the company has taken in China, where the same is true in terms of fast-developing competition. China's vast landmass and still somewhat inefficient logistical systems and infrastructure, make the establishment of a large store network challenging and non-cost efficient. Yet the risk of such trials must be borne if a retailer ultimately hopes to gain a substantial chunk of market share.

The situation for Metro in Vietnam is largely the same as that of India. Sector liberalisation will soon result in greater competition and Metro is now expanding fast in the hope of offsetting this challenge – in fact, Vietnam was Metro's highest growth Asian market in 2006. Once again, however, infrastructural challenges, an unskilled labour force and sourcing and supply chain problems have necessitated enormous investment from Metro – investment that Vietnam's low-income population cannot yet repay, regardless of the country's economic growth rate.

Metro's presence in Japan represents a very different sort of risk altogether. Here, high consumer spending and developed infrastructure means retailers could expand at any pace they like – if, and it is a big if, there was any room to do so. Metro's three-outlet-strong chain is unlikely to be developed further. However, in spite of market maturity in Japan, Metro still posted 17% sales growth there in 2006. **BMI** believes that this is because of a core risk slowly beginning to translate into an important opportunity. The death of independent retail in Japan could have spelt the end for Metro, as its customers

Continued on next page...

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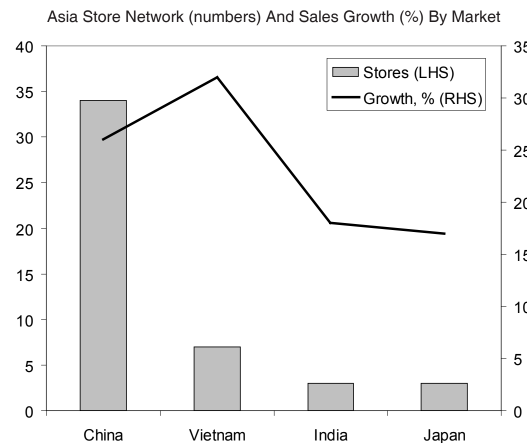
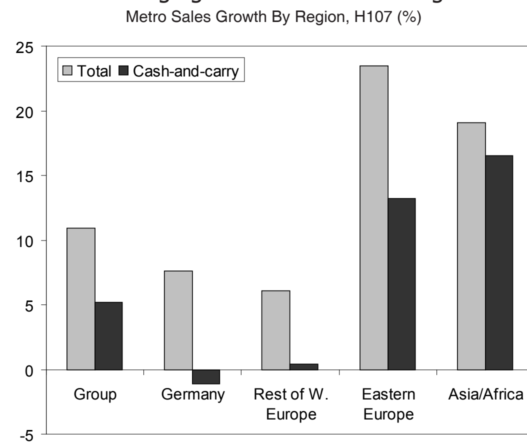
disappeared or were bought out by large-scale rivals with their own distribution network. However, a mild, but notable reversion to traditionalism has given Metro a lifeline – a lifeline that the company may one day need to exploit in the fast-maturing markets of Western Europe.

If China, India, Vietnam and Japan suggest a risk-happy approach, nothing highlights it more than Metro's imminent entry into Pakistan. Pakistan has consistently been at the foot of **BMI**'s Retail Business Environment Rankings (*see table on p4*) – a tool that is used to compare Asian markets in terms of their investment potential – since they began in early 2005. Economic and political risks are rife, food spending is low and infrastructure is undeveloped. Nonetheless, there is a thriving independent grocery retail sector and Metro aims to capitalise on the fact that it will stand alongside the Netherlands' **Makro** as the only modern retail brand in the country.



*NB Stores as at March 2007. Sales 2006 year-on-year growth. * All Asia stores belong to the cash-and-carry network. Source: Metro Investor Relations*

Even if market entry is successful, serious risks will remain for Makro in Pakistan. Ploughing funds into the country will inevitably provide a stimulant to the country's grocery retail sector, a stimulant that other multinationals will find it hard to ignore. Metro could eventually find Pakistan going the way of India and Vietnam, in that being a groundbreaker soon turns into a race to stay ahead of the chasing pack.



Source: Metro Group Investor Relations

Strengths

BMI identifies four key strengths of Metro's business strategy for Asia. Number one is the prospects for long-term growth in its chosen markets. To date, the company has avoided the likes of Thailand and South Korea, choosing riskier but much higher potential markets.

Second is Metro's sole commitment to the cash-and-carry format. It may yet chose to diversify and introduce some of its other brands to the region, but for now its wholesale presence restricts true direct competition with its multinational rivals.

Third, is its importance to independent retailers – a group that still accounts for the majority of grocery sales in emerging Asian economies even if their role is seemingly in perpetual decline. Independent retail is still considered important enough for the likes of **Coca-Cola** and **Danone** to devote sales teams to such outlets and while this remains true, Metro, with its superior warehousing and distribution facilities represents the perfect go-between.

Finally, there is Metro's proactive approach to currying government favour and establishing itself as an important contributor to these emerging markets. Agricultural training programmes of the sort Metro seems to favour, offer three main advantages for the retailer. They serve as a means of building the Metro brand and improving its reputation within the community, of improving the quality of product sourcing and of furthering job creation, beyond company direct employment, thus improving its value and importance as an investor.

Asia, and particularly China, is expected to remain a primary focus for Metro, certainly over **BMI**'s own five-year forecast period to 2011, and most likely beyond. We would not expect Metro to turn a profit in the region anytime soon, preferring instead to boost capital expenditure.

A successful foray into Pakistan, and increased competition in India, will only further drain the company's investment pool. However, if Metro continues to achieve double-digit sales growth in the region, its riskier strategy will prove to have been worthwhile – and **BMI** would not be surprised if the Asia/Africa contribution to group sales is in the double digits as soon as 2010.

METRO GROUP'S FIVE-YEAR FINANCIAL RESULTS

	2002	2003	2004	2005	2006
Metro Group					
Sales (EURmn)	51,526	53,595	53,475	55,722	59,882
EBITDA (EURmn)	2,416	2,615	2,844	2,938	3,233
Store network	2,310	2,370	2,110	2,171	2,378
Selling space (‘000m^2)	10,939	11,436	9,941	10,518	11,924
Cash-and-carry division					
Sales (EURmn)	23,972	25,093	26,442	28,087	29,907
EBIDTA (EURmn)	1,078	1,200	1,280	1,377	1,510
Store network	437	475	504	544	584
Selling space (‘000m^2)	3,423	3,725	3,952	4,218	4,507

Source: Metro Investor Relations

INDUSTRY TREND ANALYSIS

Dynamism Leads To Ranking Changes In Q3

The level of change seen in **BMI**'s Retail Business Environment Rankings from quarter-to-quarter is of little wonder given the dynamic nature of the Asia Pacific region – both its developed markets and its emerging economies. Q307 is no different. While both the top and the bottom of the rankings remain unchanged – South Korea remains the region's most attractive retail investment opportunity, while the Philippines and Pakistan remain in 13th and 14th place respectively – all other rankings positions have undergone a complete shake-up.

It is worth noting that while we had anticipated that South Korea would soon fall from the top of the rankings, its ability to retain that position has been due to its long-term political stability and its high per-capita food consumption levels.

BMI's long-term political risk rating takes into account a country's performance over a sustained period of time and is relatively unaffected by short-term threats to stability. As such, while forthcoming presidential elections and an often volatile relationship with the North do pose a threat to South Korea, its well-established democracy is conducive to long-term stability.

An improved per-capita food consumption rating can be explained by the fact that **BMI** rates markets against their regional peers. As such, South Korea – and many of its more developed neighbours in the region – have seen their scores benefit from the continual low consumption levels in emerging economies at a time when food spending levels in developed markets continues to climb. In addition to South Korea, an improved per-capita food consumption score has played a part in an improved rankings position for Singapore, Taiwan and Hong Kong.

Significant fallers this quarter include Australia, China, Malaysia and Vietnam. Australia – despite having benefited from the aforementioned per-capita food consumption trend – has seen its position in the rankings undermined by a reduced score for the mass grocery retail (MGR) sales growth forecast indicator. A key reason for this lower score is the increasing prevalence of discount retailing in the country, which – coupled with sustained low consumer confidence – is reducing sector growth potential. However, like food consumption, MGR sales growth is rated against regional peers and as such Australia's ranking has paid the price for the explosive growth being seen in the region's less developed retail markets.

China has also seen its MGR sales growth forecast score reduced – growth in the market is set to highly impressive but its superior state of development, compared to the likes of India and Vietnam, restrict a higher ranking.

Malaysia continues to suffer from a challenging regulatory environment, although the improved ranking of many of those with which it shared a position in Q2 has done as much to account for its drop down the table.

Vietnam has also paid the price for failing to keep up with its former ranking neighbours, although the country also suffers from a poor long-term economic risk rating – a consequence of significant infrastructural challenges, even though strong economic growth makes the short-term outlook bright.

On a more positive note, significant risers this quarter have included Taiwan, Singapore and Hong Kong. Very high per-capita food consumption levels, which make such markets enormously appealing to retailers, played a part in the improved position for all three markets. However, all three have also benefited from their ability to sustain MGR sales growth in spite of market maturity. This has primarily been achieved via innovation and retailers' ability to persuade consumers to spend more within the confines of existing store numbers. The market entry potential scores for all three markets make them enormously frustrating for expansion oriented retailers, but their attractiveness – in the short term at least – cannot be denied.

ASIA PACIFIC BUSINESS ENVIRONMENT RANKINGS, Q307

	Economics Long-Term Risk	Politics Long-Term Risk	MGR Sales Growth	Market Entry Potential	Barriers To Entry	Per-Capita Consumption	Composite Score	Regional Rank
South Korea	8	9	6	4	7	9	43	1
Taiwan	7	8	5	3	7	10	40	2
India	7	7	10	10	4	1	39	3=
Singapore	8	8	4	1	8	10	39	3=
Australia	8	9	3	1	8	9	38	5
Japan	7	9	1	2	8	10	37	6
China	8	6	7	9	5	1	36	7=
Hong Kong	7	6	3	2	8	10	36	7=
Indonesia	6	6	9	7	4	3	35	9
Vietnam	4	5	10	9	4	1	33	10
Malaysia	7	7	4	6	5	3	32	11=
Thailand	7	6	7	6	3	3	32	11=
Philippines	6	6	3	8	5	2	30	13
Pakistan	6	5	2	7	3	1	24	14

LT Economic Risk: Based on BMI Country Risk Service long-term economic risk rating. LT Political Risk: Based on BMI Country Risk Service long-term political risk rating. MGR Sales: Based on BMI forecasts for 2006-2011 MGR sales. Market Entry Potential: Based on saturation of market. Barriers To Entry: Based on BMI Business Environment Rankings, FDI and industry regulations. Per-Capita Consumer Spending: Based on BMI consumer expenditure figures and BMI population figures. Composite Score: Total of preceding six scores. Regional Rank: Highest composite score = most attractive retail sector environment in the Asia Pacific region; lowest composite score = least attractive. Source: BMI

INDUSTRY NEWS

EU Drops WTO Alcohol Case Against India

Welcoming the Indian government's decision to scrap its additional customs duty on imported wines and spirits, the EU has decided to suspend its WTO panel action over the case. The Indian government made the decision following a European Commission (EC) Trade Barriers Investigation that harshly criticised its alcohol duties system.

According to Brussels, duties in India can be as high as 550% for imported spirits and 264% for wines, which it says amounts to discriminatory measures. The EU made the decision to take this issue to the Geneva-based WTO late last year, further pressing for resolution on the conflict in March by seeking a dispute resolution panel. Given the size of the market, and its huge potential for growth, it is easy to see why access to the Indian alcoholic drinks market is being so hotly contested.

The Indian alcoholic drinks market is currently dominated by domestic producers, due to the historically high levels of tax on imported products. Both the beer and spirits sectors have attracted considerable levels of international investment in recent years. Anglo-South African brewer **SABMiller**, **Heineken**'s regional joint venture **Asia Pacific Breweries** (APB) and the UK's **Diageo** are all present in the country, and are seeking to extend their current market share through further investment. In addition, the world's largest brewer **InBev** is rumoured to be in talks about entering the market, as is US market leader **Anheuser-Busch**, in moves that could significantly dent SABMiller and the **UB Group**'s **United Breweries**' comfortable market leadership positions in the beer sub-sector.

However, the wine sector has thus far been overlooked by most foreign operators, and remains tiny in comparison. Wine is still considered to be a premium drink, and even the local economy brands are the reserve of the middle and upper income consumers. As the Indian economy experiences booming growth, the middle class is rapidly expanding. With their significant spending power, it is this group that will be the real driver fuelling the demand for alcoholic drinks.

BMI is currently forecasting value sales growth of 44.7% to 2011 in the alcoholic drinks sector, when the value of the industry is expected to reach US$14.63bn. Value sales growth will exceed volume sales growth as multinational brewers, with portfolios containing international premium beer brands, spread throughout India.

According to an official EU statement, European spirit and wine makers 'have been badly disadvantaged by Indian measures for many years', and are therefore very pleased with this decision. However, the EU alcoholics drinks representatives were annoyed to see that India chose to raise basic duty on wine from 100% to 150%, which is still within its WTO limit. The EU and the US allow nearly all spirits to enter their markets duty-free, while China, another Asian market with major growth potential, imposes only a 10% tax on foreign liquor.

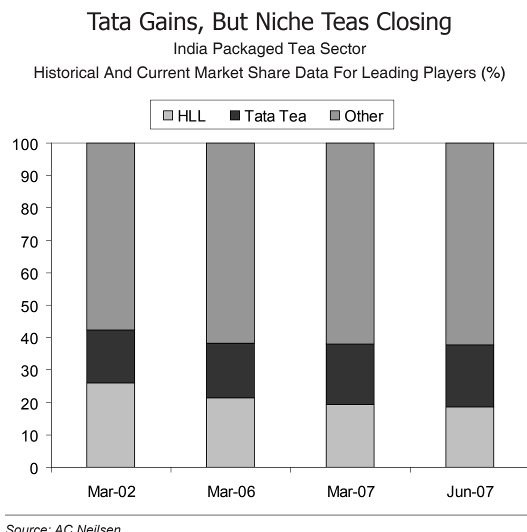
According to an official statement: 'The European Commission will now continue to monitor the situation on the ground to make sure that no new discriminations appear at state level.' However, India is not yet off the hook, as the US has said that it will continue to move forward with a separate WTO complaint.

COMPANY NEWS ALERT

Tata's Tea Focus Pays Dividends

India's **Tata Tea**, the world's second-largest tea manufacturer, has finally taken over the coveted market leadership position in the country's 430mn kg packaged tea segment. Tata, already the overall category leader in India, has long lagged behind rival **Hindustan Lever Limited** (HLL) in the packaged tea segment, but months of market share building paid off in June when Tata confirmed a market share of 19.2%, compared to HLL's 18.6%.

Interestingly, Tata's success follows the sale of its 30% stake in functional waters firm **Glacéau** to global drinks major **The Coca-Cola Company**. The sale surprised many due to Tata's insistence that it wanted to be more than a hot beverage manufacturer, it wanted to be a leading multi-category drinks producer. Nonetheless, in proceeding,Tata received almost double what it initially paid for its stake in August 2006. Early signs suggest that the bulk of funds raised via the Glacéau sale will go towards further expansion in emerging markets – largely via its existing tea and coffee operations, with a coffee joint venture in the high-growth Russian market seemingly a particular priority.



Source: AC Neilsen

However, while capital enlargement leaves Tata better poised to pursue international ambitions, high levels of domestic investment will be needed if it is to retain the position it recently won from HLL. While the loose tea market in India might be stagnant, packaged tea is growing fast in line with the country's economic growth. The segment offers enormous potential profits, particularly as higher-value speciality teas grow in popularity. Yet the emergence of speciality teas has not just served to stimulate consumer interest in the industry, it also threatens to change the competitive landscape.

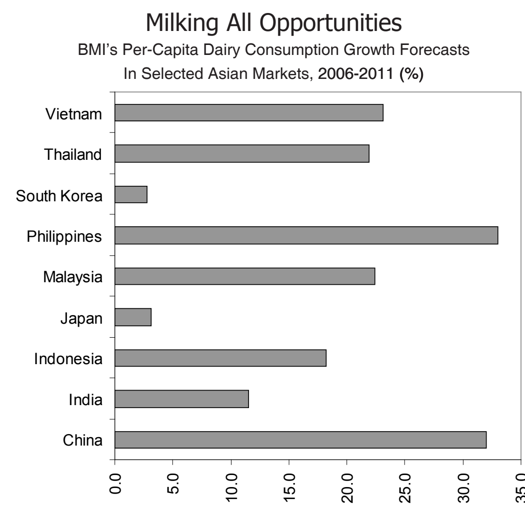
Improbably, in a market dominated by two such financial powerhouses, the combined market share of HLL and Tata is declining as smaller competitors' niche brands hold a strong competitive advantage. Whether Tata will chose to compete via the acquisition of some of these smaller brands, or whether it will pursue further product innovation of its own is uncertain, but the market is far too dynamic for a manufacturer to turn too much of its attention elsewhere.

COMPANY FINANCE ALERT

Campina Forms Niche Dairy Joint Venture

Dutch dairy co-operative **Campina** has entered into a joint venture with **Thai Advanced Food** (TAF) for the production, distribution and marketing of cultured yoghurts and enhanced dairy beverages in the Thai market. The joint venture, which is expected to have an annual turnover of EUR60mn (US$82.7mn), will replace Campina's milk production joint venture with **Thai Dairy Industries** (TDI). The change in strategy, little more than a year after entering into partnership with TDI, indicates a definite shift in focus for the Dutch firm as it looks to enhance revenue growth.

At a time when its multinational dairy rivals are posting impressive annual sales growth, Campina's total group sales increased by just 1.5% y-o-y to EUR3.6bn (US$4.96bn) in 2006. In order to accelerate growth, **BMI** believes that two key strategies must be pursued – diversification beyond the mature markets of Western Europe and greater investment in its broad business strategy of adding value to milk.



Campina has been particularly active in pursuing the first of these objectives in recent years. Despite having typically focused on exporting to markets outside Europe, it has now begun to establish more local production facilities. Within Asia, Campina entered into a joint venture with Vietnam's leading dairy operator **Vinamilk**, while the TDI joint venture was an extension of its Thai interests. Although both activities are steps in the right direction, the high potential Asia Pacific region still only accounts for 4.3% of Campina's total group sales.

The company's latest Thai joint venture is an opportunity both to improve the contribution of Asia to total group sales and to begin diversifying into added-value, higher-margin dairy categories. On partnering TDI, Campina quickly realised that the company's production facilities did not meet its own expectations in terms of opportunities for expansion. The partnership with TAF will both address Campina's concerns over enhanced production, in addition to facilitating its move into healthier, more profitable product areas. The Thai firm not only has strong nutritional credentials, it also has experience in marketing these high-value products to a predominantly low-income local audience.

Thailand is proving to be an interesting battle ground in the war for Asian dairy supremacy. Campina's latest move follows the establishment of a joint venture between France's **Danone** and local player **Dutch Mill Co** for the production of fresh dairy in Thailand in January 2007. Some less expansionary companies are seemingly using the market as a testing ground for its niche and innovative product categories, rather than trying to launch an assault on mass-market product categories in higher-growth but lower-income regional markets.

Campina's patient approach could pay off. The continued emergence of a larger middle class, and a receptive audience for fresh dairy in Thailand, will be followed by growth in middle and upper income groups in markets with greater long-term opportunities, such as China. Having garnered strong distribution and marketing experience in Thailand, Campina should be well positioned to launch its niche goods elsewhere in Asia.

However, the approach is a risky one. Aspirational consumers in key regional markets have shown a strong preference for branding, and this a trait that multinationals already present in these high opportunity markets have worked hard to exploit. In attempting to follow demand rather than drive it, Campina could well find its brand lacking the support it needs to thrive.

COMPANY FINANCE ALERT

FamilyMart Taking Backward Step To Growth

Siam FamilyMart, the Thai subsidiary of the Japanese convenience retail major, has confirmed that it will close 100 convenience stores this year, while remodelling 25 outlets and opening 60 new stores as it experiments with a new approach to achieving growth. The retailer, which lags behind both **CP 7-Eleven** and **Tesco Lotus**'s Express concept in terms of convenience sales, will end the year with some 500 stores and **BMI** believes that its new strategy is far better suited to broader industry growth trends.

In addition to dealing with strong competition, FamilyMart has also contended with a number of internal logistical problems in Thailand in recent years. In March 2007, as **BMI** reported, the company cited five key problems with its business – that of competition, IT weaknesses, human resource problems, poor product mix and the limitations of franchising.

Some THB400mn (US$13.4mn) has been allocated towards addressing these problems this year, while the company is also juggling the challenge of further expansion – which is a vital consideration if FamilyMart is to keep pace with its rivals. The company has invested in IT upgrades, while also seeking to improve its management and supervisor training structure. It has also sought to open more company-managed outlets, recognising that while franchising allowed for faster expansion, it does not allow for all-important control over branding and stock issues.

However, the biggest challenge that the company faces is rectifying its product mix, and this could in turn be the key to improving its competitive position. FamilyMart's approach to achieving sales growth in Thailand in recent years has been to open more stores. However, this strategy has gone against what **BMI** figures and forecasts show to be the country's convenience retail growth trends. Sales growth for the convenience format does remain strong, and looks set to continue in that vein. However, an expansion in terms

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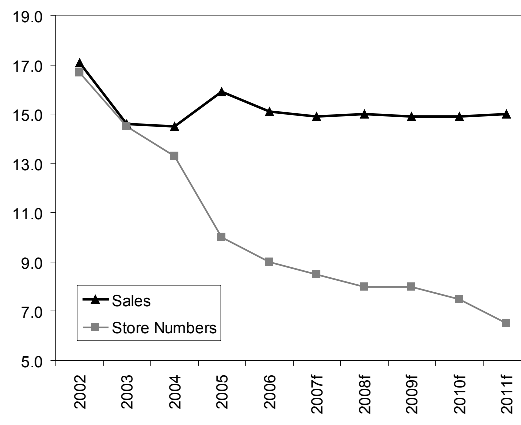
of store numbers is expected to drop off considerably, indicating that something else is driving this growth – that something else being an improved in-store product mix.

CP 7-Eleven and Tesco Lotus Express have been at the forefront of driving this trend and FamilyMart must now follow suit. The adage that non-food items contribute more to sales and profitability than food items, due to the former's superior margins, does not apply to the convenience format. Here, stores lack the size and inclination to stock or sell goods that would be expensive enough to make this true, and as such high-value food items must be a priority.

Consequently, FamilyMart will boost its ratio of food to non-food products from the current 45% to 70%, with fresh and healthy pre-prepared foods counting for the bulk of the increase. Remodelled and new stores will be among the first to stock FamilyMart's new product mix and, as the retailer's 100 closed outlets begin to reopen, they too will operate under the new system.



f = BMI forecast. Source: BMI, National Statistics Office

Since its major convenience rivals have been quicker to adapt to Thailand's subtly changing convenience trends and have therefore been able to expand rapidly while juggling minor restructuring, FamilyMart should not expect its new strategy to translate into any significant market share gains.

However, with convenience retail sales in the country continuing to grow at a double-digit rate annually, and with the company now working in better alignment with existing industry growth trends, **BMI** would certainly expect FamilyMart's stagnant sales soon to start showing growth.

VIETNAM

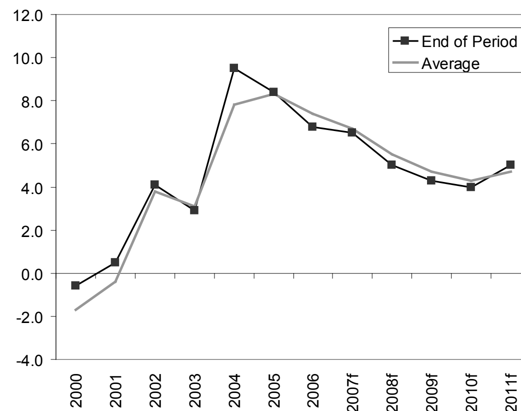
INDUSTRY TREND ANALYSIS

WTO Entry Failing To Offset Rising Food Prices

Six months after securing WTO membership, Vietnamese consumers are finding that food prices in the country are moving in the opposite direction to that which had been anticipated. Improved competition and export opportunities for domestic producers were expected to result in falling food prices, but the country's consumer price index (CPI) – 42.8% of which is made up of foodstuffs – rose by 8.4% y-o-y in July.

Government officials have been quick to distance the two occurrences, highlighting a range of other trends that have affected food prices. Two such trends in evidence throughout South East Asia are the avian influenza epidemic and the increasing prevalence of bovine diseases. Both have reduced food stocks, thus pushing up prices, while the price more affluent consumers are willing to pay for high-quality, perceived-safe meat and poultry has also driven up average costs.

Global food and agricultural trends have also touched the country. A massive increase in the global price of key agricultural commodities has been felt right across the food chain, raising the price of imported basic foodstuffs and increasing the raw ingredient costs for processed foods and beverages. EvenVietnamese-grown basic foodstuffs have been affected by this trend. Producers can now get a much higher price on the global export market than they could even a year ago, and as a result domestic buyers are having to pay higher prices to keep stocks in the country.



f = BMI forecast. Source: IMF, BMI

While these trends have had a significant effect on the CPI, when broken down the effect on food is even more pronounced. The cost of food and food and drink services has risen by 11.13% y-o-y, while the price of rice and other grains has increased by some 15%. The strength of the Vietnamese economy – and the impact that sustained growth has had on middle- and upper-income spending – mean that these price increases can largely be cushioned by such consumer groups. Wealthier Vietnamese citizens are feeling their disposable incomes pinched, but actual food affordability is not yet a problem.

The real risk is to Vietnam's poor rural majority, who to date have been largely unaffected by the country's economic development. The poorest 20% of Vietnam's population have a per-capita expenditure level of just US$275 a year, according to **BMI** figures. While many of these are rural workers who could actually benefit from the increased price of their crops in the global marketplace, the government will need to ensure that rural communities do feel the benefits of improved crop prices and do not just see the downside of rising food prices.

This brings us back to the conflict at the heart of Vietnamese agriculture. Any policy the government takes to reduce food prices, such as reducing export quotas and so boosting domestic supply, will have an adverse effect on those citizens that most need the government's help.

COMPANY FINANCE ALERT

Pepsi Plans To Learn From Coca-Cola's Struggles

Pepsi-Cola Products Philippines Inc (PCPPI), the licence holder for the production, marketing and distribution of **PepsiCo** brands in the Philippines, has announced a planned share offering. It is to release 1.14bn shares, equivalent to 20% of its capital, in the hope of raising PHP6.9bn (US$153.9mn), most of which will be invested in expansion and product development. Even prior to the proposed share offering, PCPPI had announced plans dramatically to ramp up its capital expenditure level in 2007 as it seeks to exploit what has been a rare period of weakness for its main rival **Coca-Cola Bottlers Philippines Inc** (CCBPI).

Having invested PHP939mn (US$20.9mn) in 2006, PCPPI – 33% owned by US parent PepsiCo – will invest PHP2.1bn (US$46.8mn) in 2007. Chief among its plans are product launches, particularly in the high-growth non-carbonates segment, and the installation of new production and bottling lines, which will support improved non-carbonate output. Pending a successful share offering, **BMI** expects PCPPI's capital expenditure in 2008 to be even higher.

To date, the year has been mixed for PCPPI. Net income for the first nine months of FY07, ending in June, was down 21% to PHP501mn (US$11.2mn), due to higher operating and raw material costs. However sales rose 17% to PHP7.6bn (US$169.5mn). PCPPI can attribute this sales growth both to the Philippines' continued economic performance, which has boosted consumer spending on non-essential food and beverage products, and CCBPI's recent blip. PCPPI is keener than ever to exploit both potential drivers.

BMI expects economic growth to remain a long-term fillip for the likes of PCPPI. We expect GDP growth to remain at around 5.5% to 2011. The failures of Coca-Cola, however, are a short-term opportunity. The company recently split with partner **San Miguel Corporation**, leaving CCPBI a 100%-owned **Coca-Cola Company** entity. Coca-Cola blamed the split on SMC's distribution failings, while SMC blamed Coca-Cola's failure to support its own brands and to move with the times in terms of consumer demand for non-carbonated soft drinks. With a market share of over 70%, such a tussle is unlikely to affect Coca-Cola's dominance in the Philippines and yet eagle-eyed PepsiCo's renewed non-carbonates push suggests that the local soft drinks sector remains as competitive and dynamic as ever.

INDUSTRY TREND ANALYSIS

Building An Audience For Convenience

With per-capita food consumption of just US$268.5mn in 2006 and unemployment stubbornly around 8%, the Philippines does not appear to be an ideal location for an advanced convenience retail chain. Of course, all emerging Asian economies have some off-putting macroeconomic indicators, and yet multinational retailers prefer to offset the accordant risk against the long-term prospects associated with early market entry – but, the convenience sector is unique, requiring specific market conditions to thrive, which is what makes **Philippine Seven Corporation** so interesting.

Via its 260-outlet-strong store network, the retailer is targeting only the country's affluent middle classes – a rarity, albeit a decreasing one, outside Metro Manila. The absence of any real competition for Philippine Seven until the last couple of years, when the likes of **Robinson**'s MiniStop have proliferated, highlights the difficulties of operating in this segment. The market leaders have preferred to stick to the established and profitable supermarket format, limiting their more innovative ventures to the fledgling hypermarket sector.

Philippine Seven's latest financial results underline the difficulties. In Q107 the retailer's sales rose 6.3% y-o-y to PHP1,163mn (US$25.8mn) as customer spending and numbers expanded in line with economic growth. However, the net loss was PHP22mn (US$0.49mn), against PHP19mn (US$0.42mn) in Q106, due to the pricing strategy the company uses to attract customers to convenience in this price sensitive market.

The business environment has inevitably impeded Philippine Seven's business strategy. It is limited in location choices, restricting its expansion rate, while it cannot adopt the high-margin product mix it uses elsewhere. However, **BMI** believes the chain's future is bright. Despite a strong agricultural sector, the pace of urbanisation in the Philippines has been rapid. An estimated 63% of the population were classed as urban in 2006, according to **BMI** estimates, and it is this group the retailer is targeting. Likewise, it operates in one of the fastest-growth modern retail channels. We expect convenience retail sales to grow by 61.5% to 2011, albeit from a low starting point, compared to broader MGR sales growth of just 29.3%.

Balancing sales growth and profitability will be a key challenge, but an even greater challenge may well be on the horizon. Rumours linking one of the major multinationals, including the UK's **Tesco**, to the Philippines will not die down. Although such a firm would most likely enter the market via the profitable hypermarket channel, **BMI** would expect it rapidly to seek a multi-format network. While helping to introduce dynamism to the convenience retail sector, the superior capacity of such firms to cushion low prices and low margins internally, would further turn up the heat on Philippine Seven.

KEY PLAYERS IN THE PHILIPPINES MASS GROCERY RETAIL SECTOR, 2006

	Sales US$mn	Fascia	Format	Year est.
SM Group	1,528.9*	SM Supermarkets, Super SM	Supermarkets, hypermarkets	1958
Suy Sing Commercial Corp	450e	Rustan's Supermarket, Uniwide Sales†, Shopwise	Supermarkets, hypermarkets	1970
Pilipinas Makro Inc	220e	Makro	Cash & Carry	1995
Philippine Seven Corp	102.7	7-Eleven	Convenience stores	1982
Robinsons Retail Group	100e	Robinsons Supermarkets, Mini Stop	Supermarkets, convenience stores	na
Grand Union Supermarket Inc	65e	South Supermarkets	Supermarkets	na

** Incl. department store business. † Leased to Suy Sing in Feb. 2006. e = estimate. na = not available. Source: BMI, Trade press, Company investor relations material*

COMPANY FINANCE ALERT

Nestlé Turns To Trimmer Noodles

Swiss food giant **Nestlé** has confirmed that it will invest MYR100mn (US$29mn) in upgrading facilities at its Malaysian subsidiary's Shah Alam production plant. Half of the investment will go towards the production of lower-fat, lower-salt noodles in line with the global health and wellbeing trend, which has not escaped Malaysia in spite of the market's majority low income levels. The other half will go towards a more general upgrade at the Shah Alam site, once again highlighting the growing regional importance of Malaysia to Nestlé.

Nestlé, with its flagship MAGGI noodle brand, is Malaysia's leading instant noodle manufacturer. Despite having enjoyed success with the brand, the instant noodle category, due to its maturity and competitive nature is actually a fairly low-margin, low-growth food sub-sector. In 2006, **BMI** estimates that volume sales of noodles increased by a modest 3%, while value sales rose by between 4% and 5%. While Nestlé can boast a diverse high value product range in Malaysia, it is also keen to premiumise its noodle offering, due to the product's importance in the Malaysian diet and the opportunities available for innovation, particularly within currently popular channels such as health.

The new Shah Alam production line will use instant dry technology, which removes the need to fry noodles and reduces their fat content by between 60% and 80%. Output from the line will cater for the Malaysian market, as well as the neighbouring export markets of Singapore, Thailand, Indonesia and the Philippines. These healthier noodles will obviously carry a higher price tag than their standard counterparts. However, Nestlé is confident that an audience for such high value produce exists – on a wide scale in Singapore, to a more moderate extent in both Malaysia and Thailand, and to a limited extent in the fiercely price sensitive markets of Indonesia and the Philippines.

Nestlé's noodle investment highlights the company's innovative credentials, as well as emphasising the growing value of the Malaysian market, thanks to sustained income growth among middle- and-upper-income groups. However, the second part of the company's investment is arguably the more interesting – a general facility upgrade in line with the country's increasing importance as a regional export hub.

As higher-growth regional opportunities have emerged, Nestlé has remained heavily committed to Malaysia, primarily due to the country's status as a centre of excellence in halal production. The Swiss firm has identified this as an important regional – and indeed global – food trend and while this remains the case Nestlé's interest in Malaysia can be expected to continue unabated.

INDONESIA

COMPANY FINANCE ALERT

Ramayana Lines Up Retailindo Offer

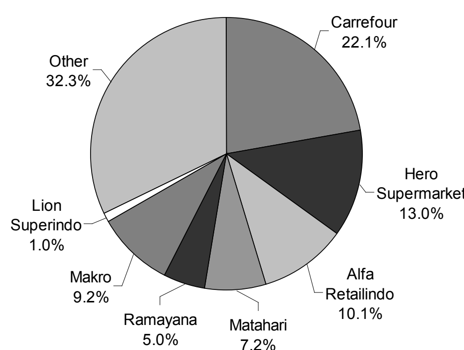
Indonesian department store specialist **Ramayana Lestari Sentosa** has revealed that it is planning to acquire a 55% stake in Indonesian grocery retail specialist **PT Alfa Retailindo**. Ramayana is planning to offer IDR1,600 (US$0.18) per share in order to acquire the stake – which is equivalent to 257.4mn shares – from a local firm, **PT Sigmantara Alfindo**.

Ramayana's IDR411.84bn (US$45.9mn) offer is an attempt by the company to improve its competitive position in Indonesia's high-growth and fast-consolidating grocery retail industry, and to bring its food retail focus in line with that of its department store business.

The acquisition of a majority stake in Alfa Retailindo will increase Ramayana's grocery retail market share from an estimated 5% to around 15%, thus making it the country's second-largest MGR, behind France's **Carrefour**. Retailindo – which is 40%-owned by Singapore's **Prime Horizon**, with the remaining 5% held by private shareholders – will give Ramayana access to a highly diverse store network, both in terms of formats and geography.

Plenty To Play For

Indonesia MGR Market Share Breakdown, 2006 Estimates



Source: BMI, Trade press, Company investor relations material

The retailer operates both supermarkets and convenience stores and has been working on developing a discount offering to cater for Indonesia's majority low income population. Another of its key strengths is its presence in the country's emerging suburbs, areas where rival retailers have yet to tread.

However, as much as this aspect may appeal to Ramayana, the crucial advantage of acquiring Retailindo will be the generation of instant scale. This will dramatically improve Ramayana's ability to negotiate with suppliers and its capacity to offer low prices, which is vital when competing with discount-oriented multinationals such as Carrefour – and potentially one day, if the rumours are to be believed, the UK's **Tesco** and US giant **Wal-Mart**.

Integral to Ramayana's making a success of Retailindo will be an acknowledgement that the hard work starts here. MGRs in Indonesia are experiencing strong growth and yet in some cases this has been less to do with the MGRs' efforts than the simple increase in customer numbers.

Independent, non-organised retail in the country is in decline, with **BMI** forecasting that sales through independent outlets will decline from 78% of total grocery sales in 2006 to some 60% by 2016. This will provide plenty of opportunities for all, and yet retailers cannot afford to be complacent, particularly when some of the market leaders, namely Carrefour and **Matahari**, are being so ambitious in their attempts to expand.

INDUSTRY TREND ANALYSIS

Premiumisation And Innovation Still Strong

The first half of this year saw the strengthening of the partnership between US organic major **Hain Celestial** and Singaporean food and beverage firm **Yeo Hiap Seng** (YHS). The April 2007 share swap deal, which saw both companies increase their shareholding in each other in pursuit of greater distribution opportunities typifies what **BMI** believes are two recurring themes in the Singaporean food and beverage market – Singaporean manufacturers targeting improved growth opportunities internationally and the ongoing premiumisation of the domestic market. In our latest *Singapore Food & Drink Report*, for Q207, we further examine the growing prevalence of these trends and how manufacturers are looking to exploit them.

Faced with a mature and saturated domestic market, it is little wonder that Singaporean food and drink manufacturers have been looking elsewhere for growth opportunities in recent years. This is not a new trend and the likes of leading brewer **Asia Pacific Breweries** and leading soft drinks manufacturer **Fraser & Neave** are now being followed by smaller local players, such as **Petra Foods**, who want to use their experience of the developed Singaporean market to secure a regional, or even global presence. In looking to the US, in partnership with Hain Celestial, YHS is of course looking to an equally developed market, but one whose vastness represents far greater possibilities.

An equally prevalent, but more recently-emerging trend, is the changing nature of premiumisation in the city-state. The local market has matured to an extent that Singaporean manufacturers are having to find increasingly innovative ways to add value to their already added-value goods – the introduction of western-style products and international brands is no longer enough. One sector to benefit enormously from this – and indeed the very sector Hain Celestial is hoping to target in Singapore – is the fledgling organic foods industry.

To the end of our forecast period in 2011, **BMI** is expecting sales of organic foods in Singapore to increase by 33.3% to US$8.8mn. This will occur at a time when per-capita consumption of basic food products is more or less stagnant. In the Q207 report **BMI** has for the first time incorporated per-capita consumption forecasts for the country's primary foodstuffs and it is largely as one would expect for a developed market. Per-capita consumption of pork is set to increase by just 3.0% to 2011, while per-capita vegetable consumption will rise by 2.3%. Meanwhile, per-capita fish and poultry consumption will drop by 0.4% and 3.8% respectively to 2011. Yet, while volumes remain stagnant, value consumption will continue to grow, thanks to trends such as the organic food boom and investment of the nature of Hain Celestial's.

If more encouragement were needed than the aforementioned growth drivers, local manufacturers can also take comfort in the fact that their market is so small, and long-term growth opportunites so limited, that serious international competition in these emerging channels is set to remain extremely limited. Even where interest is forthcoming, local partnerships are likely to be sought, and this can only benefit the local industry.

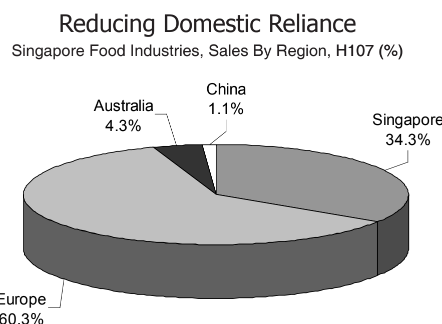
COMPANY FINANCE ALERT

SFI Confident On Back Of Strong First Half

Singapore Food Industries (SFI), which is one of the country's leading convenience, frozen and chilled food manufacturers, has announced a strong first-half financial performance. This underlines once again the strengths of its expansionary cross-market, cross-category growth strategy. At a time when leading multinationals are shedding interests in non-core product categories and non-core markets in a bid to boost efficiency, the company's success highlights the competitive advantages of a smaller, more nimble operation.

Reducing Domestic Reliance

Singapore Food Industries, Sales By Region, H107 (%)



Source: Singapore Food Industries Investor Relations

In the first half of this year the company's turnover climbed by 11.5% y-o-y to reach some SGD331.4mn (US$219mn), while profit before tax (PBT) rose by 13.9% to SGD23.3mn (US$15.4mn). SFI's food preparation, manufacturing and processing division – its largest by some distance – continued to perform strongly, posting growth of 17.8% and 21.4% in revenue and PBT terms, respectively. However, it is the company's geographical performance that tells the most interesting story.

As recently as 2001, international operations contributed just 10% to SFI's turnover. At the end of the first half of the year this figure stood at 66%. Initially, SFI pursued entry into markets that broadly matched the profile of its domestic market. Established high-income, high-consumption markets, such as the UK, Ireland and Australia, have been notable successes for the company and only now is it turning to emerging markets in search of truly explosive long-term growth opportunities.

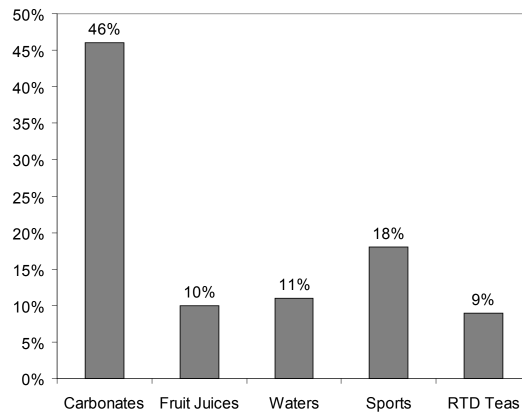
This change of strategy has not brought immediate results for SFI. In the first half, sales in China dropped by 20.2%, while the division is continuing to operate at a loss. However, **BMI** believes that such early indicators are inevitable for a firm of SFI's scale – it cannot afford to enter China on the sort of scale that allows for more immediate returns and as such a more patient approach is required. The Singaporean firm's chosen approach seems equal to the task.

Aware that it cannot compete with consumer goods giants, such as **Nestlé** and **Unilever** globally, SFI has always sought competitive differentiation. In the case of developed markets, this has meant targeting niche, premium categories – its leading New Covent Garden soup range being one such example. In the case of emerging Asian markets this has meant spotting a market entry opportunity, meat processing in the case of China and seafood in the case of South East Asia, and targeting it relentlessly, undeterred by more brand-friendly, but also more competitive consumer divisions.

COMPANY FINANCE ALERT

CCA To Cut Losses As It Opts For LG

Australian soft drinks major **Coca-Cola Amatil** (CCA) has announced South Korean consumer goods manufacturer **LG Household & Health Care** as the preferred buyer for its South Korean drinks business. CCA is expecting to receive between AUD500mn and AUD545mn (US$431-469mn) for the unit, a loss of AUD25-50mn (US$21.5-43mn). The fact that CCA is willing to sell well below its initial AUD700mn (US$602.7mn) asking price highlights the barriers the firm has run into in South Korea, but will LG fare any better?



RTD = Ready-to-drink. Source: Coca-Cola Amatil

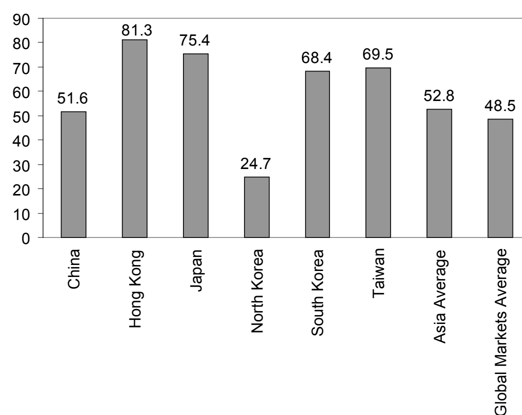
CCA's most recent results in South Korea were hit by an expensive product recall – the consequence of an employee extortion attempt – which seriously affected volumes. However, the company is now on the path to recovery and as such a more realistic reason for the sale is the difficulties it has had in adapting to the declining sales of carbonates in South Korea. **The Coca-Cola Company** has had varying degrees of success in managing this trend worldwide, but in South Korea carbonates is the only category in which it enjoys anything like a dominant market share and as such the challenge has been even more pronounced.

Yet why will LG, a household cleaning and personal care products specialist, make a better job of this transition from carbonates to healthier drinks than CCA could, given the brands and support at its disposable? **BMI** believes a determining factor could be the size and scope of LG's existing distribution network, which may open up new sales channels for CCA's soft drinks. Also, although the synergies are not glaringly obvious, LG's health credentials may prove compatible with the beverage sector. At a time when health and wellness trends are governing consumption across all product categories, which is better to have at the forefront of innovative research and development? A carbonated beverage specialist, or a health and nutritional specialist, irrespective of its product experience?

INDUSTRY NEWS

Collusion Prevalence Damaging Business Environment?

South Korea's Fair Trade Commission (FTC) has confirmed that it has fined three local sugar producers a combined total of KRW51.1bn (US$55.9mn) after they were found to have been colluding over production quotas and prices of sugar since the import sector was liberalised in 1991. Leading conglomerate **CJ Corp**, previously charged with colluding over flour and detergent prices, was hit with the bulk of the fine – KRW22.7bn (US$24.8mn), with **Samyang Corp** and **TS Corp** the other offenders, with fines of KRW18.0bn (US$19.7mn) and KRW10.4bn (US$11.4mn) respectively.



NB High score depicts more favourable business environment. Source: BMI

The fines form part of a combined KRW329bn (US$360.1mn) total imposed by the FTC in the first six months of 2007 – a phenomenal increase on the KRW111bn (US$121.5mn) imposed throughout the whole of 2006. Yet it is improbable that the prevalence of collusion is dramatically on the up. Instead **BMI** believes that the authorities are taking a harder line on such practices in order to promote the transparency and fairness of South Korea's business environment to foreign investors – which is a vital concern at a time when other regional markets are proving more attractive alternatives.

South Korea's food and beverage industry has been a major success story. Both local manufacturers and multinationals have profited from the market, riding the wave of economic growth to bring western style products to the mass-market before gradually trading consumers up to higher-value equivalents. The pace of growth has seen the industry increasingly resemble that of a developed market when set against many of its emerging regional peers. Such a degree of establishment inevitably impedes growth potential, resulting in leading market players turning their attention elsewhere in search of longer-term opportunities.

However, many have retained a strong degree of commitment to South Korea because of some of its key advantages – increasingly affluent consumers, an educated workforce and a liberal and open business environment. As such, bad publicity related to any of these remaining advantages is enormously unwelcome in the eyes of officials.

Yet foreign investment is not the only thing to suffer from the apparent prevalence of collusion. The OECD estimates that the cost of price-fixing for consumers is 15-20% of sales. With CJ Corp, TS Corp and Samyang thought to have earned some KRW2.6trn (US$2.85bn) from their efforts between 2001 and 2006, the direct cost to consumers could be as much as KRW520bn (US$569.1mn). Viewed in this manner, is the level of the fine really a significant enough deterrent not to warrant the risks?

INDUSTRY TREND ANALYSIS

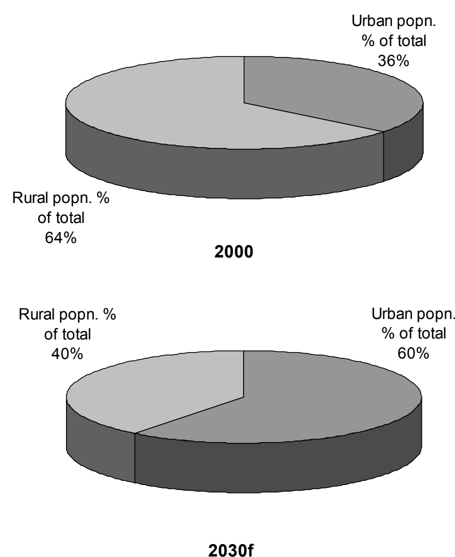
China's Challenges In The Face Of Growing Urbanisation

China is one of the most important agricultural producers in the world, ranked first globally when it comes to farm output. It produces a wide variety of primary products, including rice, wheat, tea and cotton, as well as pork and fish. Agriculture is equally important to China's economy, employing nearly half of its workforce.

In recent decades the government has placed great importance on improving the agricultural sector, and consequently production has risen sharply, along with the level and quality of food consumption among the general population. However, despite the tremendous gains made in expanding and improving the sector, as the country's economy booms more peasants are migrating to cities in search of new opportunities, further feeding the urbanisation trend. As urbanisation increases, many ask what effect this will have on the agricultural sector, and more broadly, if it will be able to meet the food needs of its constantly expanding population.

City Bound, But At What Cost?

China's Urban Rural Division



f = forecast. Source: UN Population Division

When major agricultural reforms began in 1978, China was one of the poorest countries in the world, with some 60% of its citizens living below the poverty line. Under the Family Production Responsibility System, communes were dismantled, with agricultural responsibility given back to individual households. Parallel to these reforms, major irrigation projects were undertaken, helping to improve yields. Over the years the poverty level declined dramatically as agricultural output increased, with rural industries absorbing a large part of the labour force. However, at the same time the country has begun making the transition from a rural to an urban society, becoming heavily industrialised, and has also, very importantly, shifted over to a market-based economy. As the economic situation has improved, the government too has shifted its focus from increasing productivity to supporting rural communities, and most recently, to environmental concerns.

Today, China's vast agricultural industry has attracted a host of investment from multinational manufacturers keen to exploit the opportunity that the country's immense population and economic growth represents, via the establishment of a strong local production system. These investment-led agricultural improvements have been backed by government initiatives to boost agricultural efficiency. Such government measures are vital, not only in terms of attracting investment, but also in order to improve living standards among the country's majority rural population, therefore boosting the economic contribution of these sections of society.

While the meat, poultry and fish sectors have experienced strong growth over the review period, the greatest growth has been in the dairy sector. Although traditionally not compatible with local taste preferences and consumption habits, huge levels of multinational investment from the likes of **Danone** and **Fonterra** have boosted output enormously. The challenge for the government is going to be to ensure that multinational investment is forthcoming, and that it filters into all agricultural sub-sectors.

FDI is of great importance, but equally crucial is ensuring that the agricultural industry improves in line with the ever-growing demands of the population. The government cannot afford to have an inefficient allocation of resources flowing into attractive profitable sub-sectors, such as dairy, to the detriment of key commodities, such as rice and wheat. Once greater internal stability and food security is achieved, China can take steps to boost the value of its agricultural output.

There are other pressing concerns. For example, the seizure of farmland is a growing problem, with a recent study by Michigan State University and Renmin University showing that government land grabs have increased 15-fold in the past 10 years. As the state requisitions farmland to sell at a higher price to build factories or high-tech zones, rural discontent is growing.

Furthermore, as the income gap between the cities and countryside grows ever wider, increasing numbers of villagers are moving to China's constantly expanding cities in search of higher-paying work. According to some estimates, one-quarter of the rural population, or around 200mn people, could migrate to the cities in search of work. This is a momentous demographic shift, with rural residents moving to the cities while the cities themselves encroach onto agricultural lands. In fact, a side effect of China's astounding economic growth has been that large areas which used be agricultural land are now cities, or form part of the extending urban sprawl. As these two forces feed off each other, it is difficult to see exactly where this will end. However, this development will clearly have a tremendous impact on China's agricultural sector and its ability to feed its citizens. With rural poverty and discontent growing, Chinese authorities must be careful to pursue a fine balancing act between economic and agricultural development.

INDUSTRY TREND ANALYSIS

US Questions China's Meat Import Rules

US beef exporters, leading processors **Swift & Company** and **Cargill** chief among them, have voiced concern over the treatment of US exports by China and Hong Kong. As US disputes with the important Asian export markets of Japan and South Korea rumble on, the US has turned its attention to China, an important high-growth market from which export officials argue their produce is being unfairly blocked.

Continued on next page...

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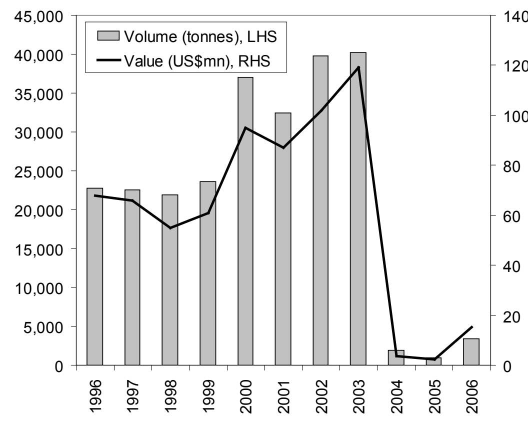
Both China and Hong Kong blocked US beef imports in late 2003, after BSE was detected in a US cow. Trade resumed in early 2004, but has since been subject to strict regulatory requirements – requirements on which the US and its trading partners cannot agree. Hong Kong will only import boneless beef, but its definition bans shipments containing even tiny amounts of bone shards, shipments that would pass as boneless in the US. Mainland China, meanwhile, has a zero tolerance policy on the use of pathogens in both meat and poultry, which the US claims has no scientific basis and is simply an excuse to block undesirable imports.



* Includes variety meats. Source: US Meat Export Federation

Fuelling the dispute is the fact that US meat exports to China soared between 1996 and 2003 as China's economic emergence created a larger audience for good quality imported meats. Today, however, China is more than a strong export opportunity, and meat processors themselves have flocked to the country, establishing domestic production units and reducing it's export dependency. Yet in spite of the growth in domestic output, upper income consumers remain attracted to high value imports, ironically because of perceived higher safety standards. As such, the Chinese beef import market remains an important one.

While an inability to capitalise on this opportunity is irking US exporters, their frustration is exacerbated by China's failure to apply its stringent import rules to its domestic food production industry – a failure that implies the tight regulations have more to do with agricultural protectionism than genuine fears over food safety. Indeed it is hard to argue against such a claim, given the repeated food safety scandals that have blighted China in recent months. Of course, China itself could argue that, with the cost of rectifying its food safety issues estimated at around US$100bn, it must start somewhere manageable, so why not with imports?

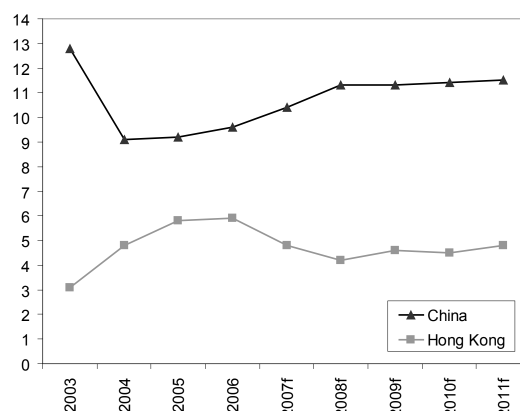
The US looks set to persist with its complaints to the WTO that Beijing is flouting open trading laws. In fact, this appears to be the only viable course of action. With Chinese food exports already failing to gain a strong foothold in the US due to their repeated failure to meet the US's own import standards, the latter can offer little in the way retaliatory restrictions.

HONG KONG

COMPANY FINANCE ALERT

Hong Kong Remains Important Despite Closure

AEON Stores (Hong Kong) Co, a subsidiary of Japanese retail giant **AEON** and the operator of the parent's stores in Hong Kong and mainland China, has confirmed the closure of one of its 20 Hong Kong stores. However, on announcing the news AEON moved fast to reassure observers it was committed to the Hong Kong market and that the closure would be followed by new and diverse openings.



f = forecast. Source: BMI, Census & Statistics Department, National Bureau of Statistics

The company has failed to give a reason for the closure of its Tseung Kwan O general merchandise store, but **BMI** would venture that the outlet does not offer sufficient growth potential to warrant the sort of investment that is required to achieve sustained like-for-like sales growth in the competitive local market. Instead, AEON is to direct its capital towards new store openings under the Jusco supermarket and Jusco $10 Plaza banners – formats it believes best meet the needs of Hong Kong. A third Jusco supermarket is to open in Tokwawan in H207, with stores of this nature providing a diverse product mix but within the confines of a supermarket-size outlet that matches the territory's geographic limitations. Sites for further $10 Plaza stores are also being sought, with these matching consumer demands for product diversity but within a sensitive pricing environment.

AEON has hinted that it could unveil new store concepts in Hong Kong in a bid to stimulate growth. Hong Kong's MGR market is growing at around 5% annually in sales terms, and **BMI** expects this growth level to remain relatively constant to 2011. In such a crowded and mature market, this growth is inevitably being driven by the continued improvement of the existing store offering. If AEON is to capitalise on this driver and keep up with general sector growth – its sales increased by 5% y-o-y to HKD2.9bn (US$371mn) in 2006 – it must ensure that it is at the forefront of such improvements. New store concepts will play an important role in this and **BMI** expects AEON to consider something like a fresh food retail offering, or perhaps an up-market convenience model in a bid to harness consumer interest.

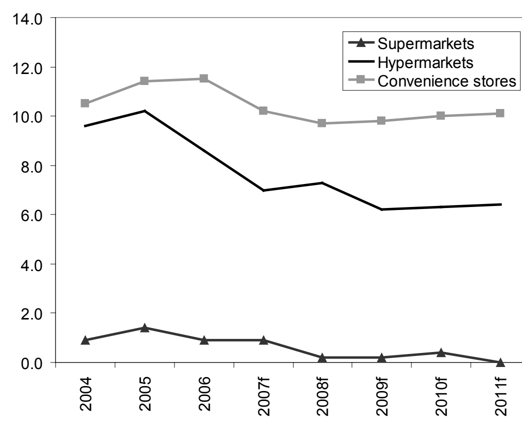
Of course, the level of investment available for Hong Kong will be threatened by AEON's interest in mainland China, where growth opportunities are far higher, but where AEON lacks true scale at this time. However, for the time being, Hong Kong is an important profit centre and testing ground for retailers like AEON, and its interest is expected to remain strong.

COMPANY NEWS ALERT

Carrefour Considers New Course For Taiwan

French retail giant **Carrefour**, Taiwan's leading hypermarket operator, has confirmed that it is considering a change of direction for its Taiwanese business, as it looks to offset renewed competition from hypermarket rival **Far Eastern Géant**, not to mention the threat of a thriving convenience retail sector. However, as **BMI** examines here, the strategy under consideration may not ultimately be in the French firm's best interests.

Carrefour entered Taiwan in 1989 and now has a network of 48 hypermarkets, the most recent opening in late July. Given the geographic limitations of the island, Carrefour's achievement has been impressive. It dwarfs its nearest hypermarket competitor, **RT Mart**, in terms of network size and has achieved this both organically and via mergers and acquisitions, most notably the recent Czech and Slovak store swap deal with multinational rival **Tesco**. However, as is inevitable in a crowded and mature market, Carrefour has seen growth in Taiwan slow in recent years. In 2006 sales rose by 4.9% y-o-y, to EUR1.39bn (US$1.9bn) – arguably a reasonable figure given the saturation of the Taiwanese market – and yet this was largely due to a late-year recovery after sales in both the second and third quarters of the year slumped.



f = forecast. Source: BMI

In response to this trend, Carrefour is ruminating over whether to introduce a smaller, community-oriented format to its network. At first glance, such diversification is a sensible move. **BMI** expects the convenience format to show the strongest annual sales growth over the forecast period, helped by its small size and ability to expand into otherwise crowded areas – and the general sector dynamism that intense competition creates.

However, competition levels also have a serious downside. Carrefour's convenience retail experience is extremely limited. With the exception of franchised convenience operations in a small number of its Western European markets, Carrefour has traditionally preferred to pursue diversification via hard discounting. This lack of experience could be seriously exposed in a convenience sector as competitive as that of Taiwan's. **Uni-President Chain Store Corp** currently rules the sector as the 7-Eleven licence holder, while Japan's **FamilyMart** and **Circle K** are also present through partnerships with local operators. Fierce price wars and constant investment in innovative store and product development initiatives are already routine. While Carrefour's immense global scale could support such participation, the company is unlikely ever really to be able to establish itself as a convenience brand.

The upside of Carrefour's position is the dominance that it already enjoys over hypermarket sales in Taiwan. The retailer cannot afford to lose focus here and is targeting four new stores before the end of 2009 in order to capitalise on sector sales growth that **BMI** expects to stay strong. However, with the pace of change in the hypermarket sector far slower than that of convenience, Carrefour can justify complementing its dominant, core operation, with something of a non-core experiment.

The best course of action for the retailer, were it to attempt a convenience foray, would be to seek differentiation as far as is possible. Rather than looking to become yet another convenience outlet attempting to meet changing consumer demands for fresh and healthy produce within the convenience concept, Carrefour could position itself as a fresh food specialist, which just also happens to boast some key convenience credentials.

If such a path were taken it would represent a similar step to that of Tesco in the US – another case of a retailer, new to a market or model, looking to take on the convenience big guns by distancing itself from the traditional convenience model.

JAPAN

COMPANY FINANCE ALERT

Kirin And Rivals Go Upmarket

Japanese brewing major **Kirin Breweries** has launched Nippon Premium, its first new product launch in Japan's premium beer sector for 14 years. The move is more or less in line with Kirin's domestic strategy of recent years, which has focused on new product launches and marketing campaigns as opposed to production or distribution investments. However, the sector into which Kirin has chosen to expand highlights a marked shift in direction, as the brewer, and indeed its rivals, explore every last avenue of growth in this profitable, yet saturated, market.

To the end of our forecast period in 2011, **BMI** is forecasting that Japanese beer sales in volume terms will increase by just 2.6%. This moderate growth, which is occurring in the face of a population decline, will be the result of a continued shift away from traditional local spirits, towards trendier alcoholic drinks such as beer.

However, Kirin and its closest rival, **Asahi Breweries**, are actually outperforming this growth, in value sales terms at least. In the first quarter of this year Kirin's sales increased by 8% y-o-y to JPY378bn (US$3.09bn), and sales for the first half of the year are expected to reach some JPY837bn (US$6.84bn) – a 7% y-o-y increase on 2006 levels. Of course, Kirin's cause is being helped by expansion into higher growth global markets, but its domestic

Continued on next page...

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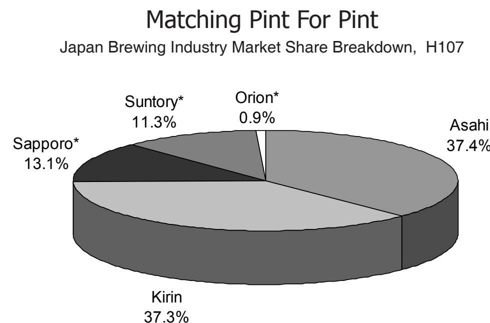
change of tack will also have an impact, certainly in the second half of the year.

Japanese brewing has, in the past three to four years, been governed by a shift towards economy, low-malt beer brands – *happoshu* or 'third beers' as they are termed. These beers are typically made with lower quality produce and escape certain taxes due to their ingredient break-down, allowing for lower price tags. Such beers have proved immensely popular among price conscious Japanese consumers, particularly given the impact that a slight economic slowdown had on consumer confidence in the country. This trend enabled brewers to shift volumes in large enough quantities to offset lower value sales.



* H107 estimate is based on Q107 market share. Source: Brewers Association of Japan, BMI

Now, however, sales of economy beers seem to have passed their peak and lower volume sales are forcing brewers to find alternative means of creating value. Premium beers, which are made with high quality, local ingredients and typically carry a price tag around JPY40 (US$0.33) higher than standard beers, are proving to be an effective means of achieving this. Consumers might drink fewer of these beers, but once again a balance has been reached, this time with higher value offsetting lower volume.

Local brewers predict that the market share of premium beers in Japan could increase from 5% in 2004, to as much as 11% in 2007, yet interestingly – as has so often been the case in the past – no one brewer looks set to benefit more than others from this trend. The launch of Nippon Premium coincided with Asahi rolling out its new all-malt Prime Time brand and **Sapporo** unveiling a new high-end product for the Yebisu range. As such, the new brand is unlikely to translate into market share gains for Kirin and it is likely to stay nose-to-nose with Asahi for the foreseeable future.

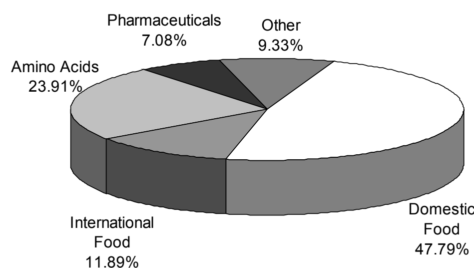
The same was true when third beers and happoshu brands began to proliferate – one brewer's blow was matched with an equally strong punch from one of its rivals. Yet, while such launches and investments might not translate into improved market share, companies opting out of competition would certainly suffer significant market share losses.

COMPANY FINANCE ALERT

Ajinomoto Striking Regional Balance

Japanese seasonings and amino acid specialist **Ajinomoto Corp** has announced mixed financial results for the first quarter of the 2008 financial year, which ends on March 31 2008, once again highlighting the importance of international markets to established Japanese firms.

Domestic food sales for the three-month period ending June 30 2007 climbed by 0.9% to a total of JPY151.7bn (US$1.27bn) – a feat that is to be applauded considering the saturated state of the Japanese market – yet operating income declined by 44.7% to JPY2.1bn (US$17.6mn). A sterling international performance for the food sector saw sales increase by 33.1% to JPY37.4bn (US$313.6mn), while operating income rose by an enormous 70.3% to JPY4.6bn (US$38.6mn).



Source: Ajinomoto Investor Relations

With Ajinomoto's combined domestic and international food division contributing almost 60% to total quarterly revenue, the sector does serve as the best indicator of financial performance. However, the results for the company's amino acids and pharmaceuticals divisions were also noteworthy ,with sales rising by 11% and income falling 28.6% in the case of the former and sales climbing by 25.7%, fuelling income growth of an incredible 167%, in the case of the latter. Overall group sales for the quarter rose by 8%, while net income increased by a solid 37.3%, to reach JPY14.1bn (US$118.2mn).

As in the 2007 financial year, Ajinomoto has been benefiting from both its geographic and product diversity. Rising raw material and production costs have meant eventual price hikes in Japan – which are a real turn off for consumers in this wealthy, yet inherently price conscious market. A desire to cushion these hikes as far as possible has led to a loss of profitability in the country. However, Ajinomoto's local heritage and its emphasis on traditional Japanese seasonings, at a time when these are experiencing a resurgence of popularity, have ensured that its sales continue to increase, albeit moderately.

Internationally, the opposite has been true. While sales growth has certainly been strong, it has been the company's success in promoting its Japanese seasonings and instant noodles as premium goods throughout the rest of Asia and in some European and Latin American markets that has led to an explosion in profitability.

Premium Diversifying

A final interesting element of Ajinomoto's strategy, which stands it in good stead for the remainder of this financial year, is its commitment to diversifying at the ultra-premium end of the market. Its recent JPY82.5bn (US$691.8mn) buyout of healthy beverages producer **Calpis Co** is just one such example of this.

In targeting categories that not only appeal to consumer demand for healthy goods but also promote added health benefits – thus providing a handy overlap with its pharmaceuticals unit – Ajinomoto is addressing the dual needs of both its domestic and international operations. Companies such as Calpis not only provide rare domestic growth opportunities for Ajinomoto, they also, in the long term, allow for strong sales and profitability growth in emerging international markets.

COMPANY FINANCE ALERT

Wesfarmers Lands Coles But Hard Work Starts Here

After months of speculation Australian diversified conglomerate **Wesfarmers** has landed struggling local retail group **Coles** in a deal that is estimated to be worth AUD21.9bn (US$18.77bn). The acquisition – which is the largest in Australia's corporate history – is expected to be finalised in October and was initially fiercely contested by retailers and private equity firms alike. However, as Coles' price tag and yet more disappointing financial results began to place barriers in the way of interested parties, Wesfarmers – which was already a 12.8% shareholder in the group – emerged as the only probable buyer.

However, the congolmerate, whose interests include energy and chemical operations, in addition to its flagship Bunnings home improvement and Houseworks homewares retail divisions, will have little time to reflect on how it has come to be Australia's leading diversified retail group. Instead, **BMI** believes that the real hard work for Wesfarmers will start here.

Firstly, there is the issue of the suitability of the transaction. The offer that the Coles' board proposed that its shareholders accept has ended up matching the earlier AUD17.25 (US$14.79)-per-share Wesfarmers offer that had been rejected on the grounds that it was too low. The fact that Coles has now reconsidered such a valuation is a consequence of the fact that the company's options, particularly if it wanted to keep the group together and in Australian hands, had simply run out. 'No other option' is hardly great grounds on which to launch a new enterprise.

Secondly, there is the question of convincing sceptical Wesfarmers shareholders that the perpetually underperforming Coles group is worth such a price tag. The specifics of the takeover will see Wesfarmers pay AUD4 (US$3.43) in cash, in addition to 0.284 of its own shares, in exchange for each Coles share, valuing the latter at AUD17.25. However, shareholder unrest saw the value of Wesfarmers shares plummet by 6.8% in the days following the takeover announcement. This saw the value of the deal fall by AUD2.3bn (US$1.97bn), to AUD19.6bn (US$16.8bn), or AUD16.36 (US$14.03) per Coles share.

The takeover includes a clause whereby either firm can withdraw if the value of Wesfarmers shares falls by 10% of its level on the day of the agreement – July 2 2007. Yet Wesfarmers, keen to prevent the saga from running on, has moved quickly to quell shareholder unease.

Wesfarmers has confirmed that the Australian Competition Commission should approve the deal, thereby allowing the takeover to run smoothly. The conglomerate has also sought to publicise the synergies between its own retail operations and those of Coles, proposing that Wesfarmers' Bunnings and Houseworks stores could be positioned next to Coles' OfficeWorks or its Target clothing stores, in order to create a one-stop shopping concept.

STRATEGIC SNAPSHOT – COLES GROUP

Potential

- Under a new owner Coles has a chance to shake off past restructuring inefficiencies
- As the market number two, Coles enjoys considerable market share in spite of its recent struggles
- A multi-format operation has enabled it to offset slightly its grocery retail struggles via the improved performance of its clothing and office supply network

Risks

- Woolworths has now edged ahead to such an extent that it has more power over market prices and promotional activity
- The emergence of hard discount rival Aldi further threatens Coles during its period of weakness
- The resurgence of the independent grocery sector threatens to undermine retailers that are ubiquitous in nature
- A long, drawn out sales process could result in Coles losing even more market share before any investment is made in rebuilding the company

Key Figures

- H107 sales: AUD17,768mn – a decline of 6.5%
- H107 like-for-like sales growth: 2.4%
- H107 continuing operations EBIT: AUD737.5mn
- 2006 sales: AUD39,698mn – growth of 3.3%
- 2006 net profit: AUD787.3mn – growth of 13.9%

Grocery Issue Crucial

However, we believe that OfficeWorks and Target are not the problem, it is Coles' all-important grocery operations, which currently contribute over 80% to total group revenue, that are a cause for concern. Despite receiving significant investment, same-store sales growth in the food and liquor division stood at just 0.8% y-o-y in the third quarter of this financial year (which ended in June 2007), while same-store sales in the Coles Express convenience and Kmart discount divisions fell by 6.2% and 3.2%, respectively, over the same period.

Short of saying 'I think things can be done to improve the business', Wesfarmers chief executive Richard Goyder has failed to build shareholders' confidence over the future of Coles' grocery business, as it continues to lose market share to market number one **Woolworths**. Perhaps aware of the lack of a comprehensive business strategy and the importance of the grocery division in harnessing the support of shareholder, Goyder did confirm that, while keeping the Coles group together was preferable, Wesfarmers would consider an offer substantially in excess of the current valuation for any particular division.

However, such a tempter is unlikely to stimulate much interest from within Australia. Competition concerns would forbid Woolworths from bidding for Coles' grocery interests, while Wesfarmers is unlikely to let go its non-food businesses, those in which Woolworths would be interested. Private equity interest is likely to be slim, with a broken-down group offering fewer opportunities for immediate returns.

Consequently, if Wesfarmers were to find a buyer for Coles' grocery operations, it would most likely be an international multinational. **BMI** would expect the likes of US-based **Wal-Mart** and the UK's **Tesco** to follow Wesfarmers' quandary closely, since despite its assertions that it would hold out for a high price, pressure by shareholders might mean that Coles' grocery division ends up going for a song.

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