

Policy Changes Affecting Foreign Food & Agriculture Companies in China



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The introduction of China's 12th Five-Year Plan (FYP), government interventions to control inflation and policies on food safety and security have created heightened uncertainty for foreign invested enterprises (FIEs) operating in the agricultural, food and beverage sectors in China.

To better understand these issues and provide guidance to companies operating in these sectors, members of APCO's food and consumer products practice in Greater China interviewed senior executives in more than 20 FIEs to understand their concerns and hear their views on how government policies impact their businesses. The executives we spoke with represented a range of sectors: agricultural products sourcing; grain, oilseed and meat processing; beverages; food supplements; and packaged foods.

Their responses and APCO's independent research formed the basis of this report. In the last section, we provide recommendations on how to deal with these issues and manage upcoming risks. >>

EXECUTIVE SUMMARY

China's 12th FYP, as well as new policies regarding food security, inflation and food safety, will shape the development of the agricultural, food and beverage industries in China as summarized below:

12th FYP

- China's National People's Congress (NPC) approved the 12th FYP in March. Covering the years 2011-2015, the 12th FYP sets out to achieve sustainable growth, with a strong emphasis on economic rebalancing, promoting social equality and ensuring that growth is environmentally sustainable.
- Stimulating consumption is an important part of the plan.
- A shift to consumption-led growth will have a profound impact on food manufacturers in the long term as Chinese consumerism rises. In the short term, however, FIEs will face increased costs from social welfare measures, government-mandated increases in minimum wages as well as higher environmental compliance costs.

Food security policies

- The 12th FYP also contains policy initiatives to ensure food security, including advancing the consolidation of agricultural land, stimulating the production of essential crops by increasing the share of incomes to farmers, modernizing agricultural production and promoting the development of bio-agriculture.
- A number of policies outside of the 12th FYP also aim to reinforce China's food security. These comprise tighter controls over foreign investments in agriculture (including a new mergers and acquisition "security review"), the gradual consolidation of agricultural production of essential crops into the hands of Chinese companies, Chinese overseas investments in farmland and agriculture and government interventions in the market via the reserve system. As China's control over genetically modified (GM) technology increases, the use of GM crops to raise production yields could also be further encouraged.
- Policies on food security will create both opportunities and risks for companies planning to invest in the agriculture sector. They will also inflate commodity prices for companies operating upstream.

Policies to control inflation

- Many of the policies to control China's soaring inflation are targeted at controlling food price increases as these are an important component of China's CPI.
- Policies include market interventions in the form of price caps, interventions in the commodity exchange markets and selling products from reserves.
- This government tinkering in the market creates price volatility.
- As an alternative to controlling inflation, the government has also recently attempted to deflect the blame for food price increases on FIEs. Tightly managed social media

campaigns against high-profile FIEs have led to a greater scrutiny of food price increases from consumers. This has eroded FIEs' pricing power.

- As a result, while FIEs in the food sector are facing greater cost pressures on labour, commodity prices, environmental and regulatory compliance, they are now increasingly reluctant or even unable to pass on these cost increases to consumers.

Food safety policies

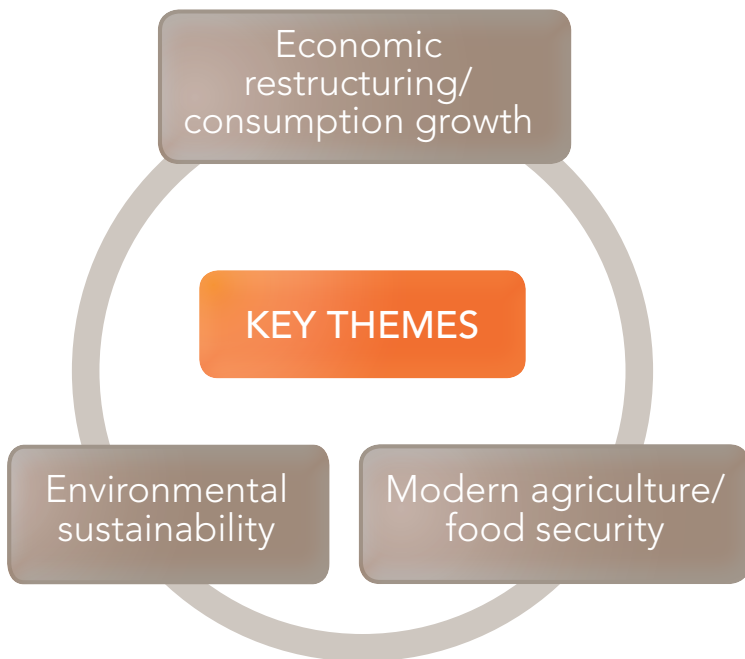
- Despite the implementation of the Food Safety Law in 2009 and significant efforts to revise food safety standards, food-safety incidents are regularly occurring.
- According to recent government surveys, more than 70 percent of the population remains highly concerned about food safety, and more than half view government failure as the key reason behind unsafe food.
- As a result, food safety remains high on the government's agenda and government agencies have put forward ambitious work plans to address the issue.
- Sustained regulatory activity is therefore to be expected in 2011, with a continued focus on redrafting and streamlining standards, particularly on food additives and ingredients but also on new under-regulated areas such as food packaging.
- Regulation on nutrition, health food and health claims is also emerging, driven by concerns over food safety but also a rising incidence of chronic diseases.
- The government will continue closely monitoring safety in the dairy sector and extend its oversight to the meat, edible oil and alcohol sectors.

KEY POLICY ISSUES

I. 12TH FIVE-YEAR PLAN

The government unveiled the country's 12th FYP for National Economic and Social Development (2011-2015) in March's National People's Congress annual session. The 12th FYP emphasizes the quality, rather than the quantity, of growth and strives to ensure that more Chinese citizens benefit from the country's unprecedented development. If that key objective is ultimately successful, China's consumption potential should be unleashed in the next five years as more citizens move into the middle class. This will create growth opportunities for companies in the food and consumer products sector. But these opportunities will also come at a cost for FIEs operating in China, as policies to increase spending focus on accelerating income redistribution and growth.

Key policy themes in the 12th FYP likely to affect the operations and investment plans of FIEs in the food and agriculture sector are summarized below.



Stimulating consumption growth

While China's growth has been strong over the past few years, it has also been imbalanced, with coastal regions and urban areas developing faster and income disparities rising rapidly. These income and development gaps are now threatening China's social stability.

Income growth constraints have also severely impacted China's domestic consumption growth. While retail sales have been increasing in absolute terms, China's share of household consumption in GDP fell by 11 percentage points between 2000 and 2008, reaching 35.6 percent in

Percentage of household consumption in GDP



Source: Dragonomics data from Gavikal

2010, its lowest level since 2003. China's real consumption potential has not yet been unleashed, and China's growth is still heavily reliant on investment.

The 12th FYP aims to address these economic and social imbalances and create a more sustainable growth pattern by fundamentally restructuring the economy and stimulating consumption growth. Premier Wen Jiabao's 2011 government work report called expanding domestic demand "a long-term strategic principle." The unofficial target is for consumption to reach 40 percent of GDP by 2015.

Income and wage growth

To stimulate consumption, the 12th FYP aims to increase household disposable income by an annual rate of 7 percent, the same as the projected GDP growth rate over the next five years. This will help create a larger urban middle class with more spending power.

Raising minimum wages and creating more urban jobs should help meet that objective. According to Premier Wen's new "road to happiness," minimum wages should rise by a minimum of 13 percent per year over the next five years (the figure has been lowered from the previously announced target of a 20-percent increase per year), and the minimum wage of most areas should be at least 40 percent of the local average wages. The government has also announced that rural incomes would also be raised by increasing the share of revenue that goes to farmers for commodities.

Development of the service industry

To create more urban jobs, the plan is to move away from manufacturing industries focused on export-led growth to

service industries focused on inward-led growth, including wholesale and retail, financial services, and leisure and hospitality. Analysts note that since output from the service industry creates more jobs than manufacturing, this shift in emphasis can allow China to drive up employment rates without decelerating growth.

Urbanization

Another key element in the plan is to encourage rapid urbanization, on the basis that urban dwellers spend more than their rural counterparts (up to three times more, according to some studies).

Income redistribution and social safety nets

The 12th FYP also promotes income redistribution. This will be done via personal income tax reform (raising income tax brackets so low-to-middle incomes are taxed less) and the expansion of government-funded social welfare initiatives. The government announced at the NPC its intent to increase health care spending by 25 percent more than originally planned, build 36 million affordable homes at a cost of nearly USD 200 billion and ensure China's pension system covers all rural citizens by 2015.

The table below summarizes key policy initiatives:

QUICK FACTS:

China is the world's second-largest economy.

China ranks 99 globally in terms of GDP per capita, right behind Albania.

Wages and household income have been growing at a slower rate than GDP, particularly in rural areas.

Urban household income is one-tenth of that of the United States.

China's Gini coefficient in 2010 was 0.47, placing China in the top ten most inequitable countries in the world.

China's household savings rate is 38 percent, one of the highest in the world.

Target	Key policies	Specific policy measures	Impact on consumption
Consumption growth	Urbanization	From 47 percent in 2010 to 52 percent in 2015 and almost 70 percent in 2030	Multiplier effect (urban households spend more)
	Social safety nets	<ul style="list-style-type: none"> •357 million people enrolled in urban basic pension program by 2015 (up from 223 million in 2010) •3 percent increase in basic health insurance coverage •Construction of 36 million units of affordable housing (2011-2015) 	Reduced savings rate
Inclusive growth	Job creation	Create 45 million jobs in the service industry and SMEs	Income creation
	Adjustments to income distribution	<ul style="list-style-type: none"> •Minimum wage hikes of 13 percent per year for next 5 years (informal target) •Higher share of income to farmers (minimum prices for agricultural products) 	Development of larger middle class with higher purchasing power
	Development of western/ central regions	<ul style="list-style-type: none"> •Financial and fiscal incentives for companies to relocate inland •Integration of logistics networks 	Broadening of China's consumption base

If these initiatives are ultimately successful, analysts say China's consumption rate could increase from its current low of 35.6 percent to around 40 percent of GDP by 2015. While 40 percent is still a low number (by comparison, the United States' consumption rate is currently 71 percent, Brazil is 63 percent and India is 54 percent), it could put China on the right track toward rebalancing its economy, as well as reducing China's dependency on exports.

Promoting food security and agriculture modernization

The 12th FYP also continues the government's core objective to ensure that China's massive populace has enough to eat. This is no easy feat: China has 20 percent of the world's population but only 7 percent of the world's arable land and 7 percent of freshwater resources.

The Chinese government has long tried to address this issue through policies that promote self-sufficiency in food production. Food security is considered a necessity for maintaining social stability while self-sufficiency policies are promoted as way to avert foreign dependency.

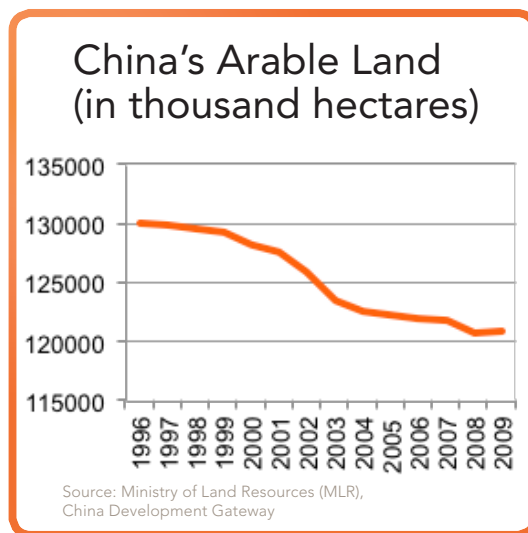
As a result, the Chinese government has set a 95-percent self-sufficiency target for wheat, rice and corn. This self-sufficiency target has proven difficult to attain for a number of reasons, particularly the continued loss of arable land; a heavy reliance on vulnerable wheat crops; land fragmentation and inefficient farming; and changing dietary habits resulting in a growing demand for grains.

Policies in the 12th FYP

To meet these challenges, the 12th FYP includes a target to reclaim land, modernize agriculture and attain an extra grain production capacity of 10 million tons per year over the next five years.

Key measures in the plan are summarized below:

- Protecting arable land:** The government is set to strictly protect arable land, with a goal of 120 million hectares maintained by 2020. The Ministry of Land and Resources (MLR) pledges to intensify monitoring through punishment for officials responsible for illegal farmland seizures for industrial and residential use. The government also plans to invest more than RMB 100 billion (USD 15 billion) over the next five years to improve 4 million hectares of land and replenish an additional 670,000 hectares of arable land in major grain producing areas, including Hebei, Jilin, Heilongjiang, Jiangsu, Anhui, Jiangxi, Shandong, Hubei, Inner Mongolia and Guangxi provinces.



- Promoting land consolidation:** Chinese farmers have an average planting area of 0.6 hectares (compared with 169 hectares in the United States). Encouraging land consolidation is a key component in the government's plan to modernize the sector and increase production leads. In recent years, consolidation has made slow progress against a backdrop of unclear policies over land rights. Unless this issue is addressed, and given the Ministry of Agriculture's reluctance to push the consolidation agenda aggressively, it is unlikely that land consolidation will accelerate dramatically. As several executives emphasized during our research, land consolidation will occur naturally as a result of migration and of land being left fallow. This will be a slow process.
- Promoting modern agriculture:** A heavy focus of the 12th FYP is to develop more efficient, large-scale and modern agriculture. The development of bio-agriculture, modern agricultural technology, a modern seed industry and a more efficient and integrated agricultural logistics system are also emphasized. Heavy investments should be made on research projects and pilot initiatives to accelerate the development of scientific innovation in agriculture. Bio-agriculture is part of one of seven "Strategic Emerging Industries" identified in the Plan as essential for China's long-term growth. This could provide investment opportunities for FIEs, but ultimately the aim is to develop home-grown technology so a tight IP protection strategy is required before entering the sector.
- Developing farmers' incomes:** Increasing the share of revenue that goes to farmers and improving farming incentives should help encourage farmers to grow crops in short supply. But this will also increase commodity costs

for FIEs operating upstream as well as remove incentives to consolidate land.

In addition to the 12th FYP, the State Council recently allocated an additional RMB 5 billion (USD 760 million) to help farmers battle the on-going draught that has been affecting some of China's wheat-producing provinces. The money will be allocated for irrigation equipment, fertilizer and to construct emergency wells.

Policies on food security outside of the 12th FYP

The Chinese government is also rolling out other initiatives to ensure higher levels of food security. These include:

- Reserve policy:** This traditional Chinese approach for ensuring food security focuses on building reserves of essential grains. China uses reserves to buffer the effects of short crops and volatile grain prices on global markets and also to stabilize prices when inflation rises. According to estimates, China's grain reserves in December 2010 were around 40 percent of annual its food consumption, more

than double the 17-percent safety level recommended by the UN Food and Agriculture Organization.

- **Increased crop imports:** After the United States, China is the second-largest food importer in the world. MOFCOM recently confirmed that government would further strengthen imports of certain agriculture products. There are two reasons for that. First, changing dietary habits resulting from improved living standards have led to an increase in demand for meat, thereby forcing China to import more soybean, corn, and fishmeal for animal feed. Second, drought and variations in crop production at times require that China imports significant amounts of crops. In 2010, for the first time, China procured significant amounts of maize in international markets. Another factor is the view of minority factions within government who argue that China should refocus on growing more value-added crops and importing more basic commodity crops.
- **Control over imports of key commodities:** China maintains import quotas for essential food staples such as wheat, corn and rice. These quotas are controlled by the central government and not easily accessible to the private sector. When China has needed to import commodities, only large state-owned traders have been allowed to use the preferential quotas.
- **Growing control over agricultural production and protectionism:** The Chinese government has in place a set of measures aimed at consolidating the production and processing of essential agricultural commodities in the hands of Chinese entities. Controls also apply to seeds. This is to ensure that these industries continue developing according to government plans and not as a function of foreign investment decisions. It also enables government to control output and prices when required. Per MOFCOM's

2007 Foreign Investment Catalogue, FIE investments are restricted in a growing number of agricultural activities, such as seed development and cottonseed processing, rapeseed and soybean processing. To the dismay of some of the foreign companies we've interviewed, domestic companies continue to expand in these areas.

- **Export restrictions:** The government has cancelled VAT rebates for a number of commodities to ensure that production remains in China.
- **M&A "security reviews":** In February 2011, MOFCOM released a Notice on the Security Review of Foreign M&A of Domestic Enterprises. According to the notice, "Key Agricultural Products" are one of the seven sectors that relate to China's national security interests and for which foreign M&As are subject to a security review.
- **Overseas investment in agriculture:** While China restricts investments in agriculture in its own country, it also actively seeks to invest overseas, buying or leasing farmland as well as signing farming contracts in Southeast Asia, South America, and Africa to harvest palm oil, eucalyptus, teak, corn, cassava, sugar cane and other crops. According to estimates, China has signed 30 agricultural co-operation deals covering more than 2 million hectares since 2007. A recent example is the contract signed last December by Chinese state-owned company CAMC and companies under Venezuela's Ministry of Agriculture and Land for the construction of industrial parks, rural infrastructure and irrigation systems and crop planting. In addition to investments in farmland, Chinese companies are encouraged to carry out an aggressive outbound investment strategy and to raise necessary funds through IPOs. A few examples of recent deals are given below:

Date	Buyer	Target			Deal Size	
		Target Name	Description	Country	Value (US\$ million)	% Acquired
Feb 2011	COFCO	Château de Viaud	Wine	France	N/A	100
Jan 2011	Beidahuang	Rio Negro Govt	Farmland	Argentina	20	N/A
Dec 2010	China National Chemical Corp	Makhteshim-Agan Industries	Agrochemical Corporation	Israel	1,440	60
Jun 2010	Sino Forest	MFV Limited	Pine Plantation	New Zealand	N/A	100
Jul 2010	Bright Food	Synlait Milk	Dairy Farms	New Zealand	58	51
Jul 2010	Complant Int'l Sugar Industry	Govt of Jamaica	Sugar Producers	Jamaica	9	N/A
Jul 2010	Agfeed	M2P2	Hog Producer	United States	16	100
Jul 2009	ZTE Agribusiness	Govt of Congo	Oil Palm Plantation	Congo	N/A	N/A
Jul 2009	COFCO	Smithfield Foods	Pork Producer	United States	N/A	5

Source: Capital 8

- GMO development:** China continues to restrict the use of GM seeds in most crops destined for edible usage for at least two reasons. First, the government remains sensitive to negative perceptions consumers may have regarding GMO and food safety. Second, due to heightened concerns that foreign companies might have too much control over domestic food supplies, the Chinese government is reluctant to move forward with GM agriculture until domestic enterprises have mastered the technology.

Promoting environmental sustainability

As part of its objective to create a more sustainable growth in the long term, the 12th FYP also promotes environmental protection. The focus is on reducing energy consumption and emissions. The plan includes 10 environmental targets, six of which are new as compared to the previous plan. For instance, the plan now includes a carbon intensity reduction target of 17 percent based on 2010 levels, which would reduce 8.9 billion tons CO2 by 2020.

The table below summarizes targets of relevance to food and agriculture companies:

While some of the above targets have been lowered as compared to the 11th FYP, there are a larger number of compulsory targets. Moreover, the government has pledged to step up enforcement of these targets. Consequently, new investments will come under closer scrutiny.

Additionally, there is government discussion of an environmental tax on some disposable goods and more stringent regulations on the recycling of waste packaging.

II. FOOD INFLATION

Inflation in April reached 5.3 percent, its highest level since July 2008. Food prices in China increased 10.3 percent in February 2010 year-on-year. The country's poorest citizens reportedly spend nearly half their income on food, and middle income residents spend close to 40 percent. By comparison, the average U.S. resident spends 16 percent of income on food.

Inflation of food prices has generated widespread dissatisfaction. According to the Chinese Academy of Social Sciences' 2011 Blue Book of China's Society, high commodity prices were the main concern of urban residents in 2010 and was also a leading cause of dissatisfaction with rural residents. A survey conducted by the People's Bank of China (PBOC)¹ also showed that satisfaction with price levels had sunk to an 11-year low in Q4 of 2010.

These two studies have captured the government's attention, and managing inflation now tops the government's agenda.

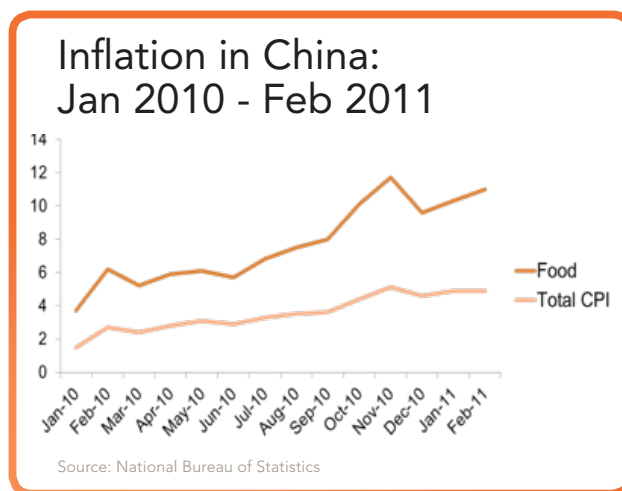
PBOC has raised interest rates four times since October and has increased reserve ratios to curb lending. But these measures have been relatively ineffective in terms

11th Five-Year Plan			12th Five-Year Plan		
Category	Target (based on 2005 level)	Actual	Target (based on 2010 level)	Category	Target (based on 2010 level)
Reduction of energy use per unit of GDP	20%	19.1%	16%	Percentage of non-fossil fuel from primary energy consumption	11.4%
Reduction of water use per unit of value-added industrial output	30%	31.3% ¹	30%	Reduction of carbon emission per unit of GDP	17%
Reduction of chemical oxygen demand (COD)	10%	12.45%	8%	Reduction of nitrogen from ammonia	10%
Reduction of sulfur dioxide (SO ₂)	10%	14.29%	8%	Reduction of nitrogen oxides	10% ²

¹figure by the end of September 2010; ²for key industries and regions

1. A survey conducted by the People's Bank of China (PBOC) among 20,000 people in 50 cities across in Q4-2010. Price Satisfaction Index fell to 13.8 percent, the lowest since 1999. Some 73.9 percent of respondents said current prices are "too high," up 15.6 percentage points from the third quarter, while 61.4 percent said they expect prices to continue to rise.

of lowering the prices of basic necessities, partly because policy-makers continue to control the RMB's appreciation against the dollar. As such, because food items play such an important role in the CPI basket, the government is now increasingly intervening in the food markets to control inflation. Essential measures from the government to control food prices are described below.



accused foreign manufacturers of infant formula for exploiting consumer concerns over food security to make profits in excess of 40 percent. Later that month, NDRC ordered local authorities to fine more than 10 Carrefour stores and three Wal-Mart outlets for price fraud and overcharging consumers. The fraud was probably not intentional, and the response from government, media and consumers was certainly not commensurate to the incident, indicating a hyper sensitivity to food price increases on all sides.

Market interventionism

The Chinese government has been implementing price controls on essential commodities such as flour or edible oil. Recently, Unilever was fined just for public discussion of potential price hikes (see case study). Government has also been intervening in the commodity exchange markets with the State Council threatening to close trading in certain commodities (particularly sugar and cotton) if there is excessive price speculation. The Shanghai, Dalian and Zhengzhou futures markets have all been raising trading margins to force traders to back their positions with more cash. Finally, the government has been releasing products from reserves to increase food supply.

Government interventions in the markets to control food prices have been marginally successful, but at times also counter-productive, as they tend to fuel price speculation. Nonetheless, the trend toward intervention is here to stay, and this will increase price volatility. Moreover, there is a concern that the government could use the new "National Security Review" to block foreign acquisitions which could result in market concentrations and have an effect on prices.

Supply side measures

To boost the country's food supply and bring down food prices, the Chinese government has announced that it will increase food imports. While self-sufficiency will remain the key objective for the supply of essential crops such as maize, wheat and rice, we could see more Chinese intervention in international markets to close supply gaps. China is also likely to import greater amounts of more value-added crops in order to free acreage for essential crops.

Other supply-side measures include guiding production decisions by providing subsidies and incentives to farmers for certain crops.

Deflecting the blame on FIE's

The government has also blamed increasing food prices on foreign food manufacturers and retailers. On January 12, 2011, a high-ranking official at the Ministry of Agriculture (MOA)

This hyper-sensitivity of consumers and government to food price increases has eroded the pricing power of brands and made it even more necessary for companies in the sector to innovate, create price differentiators and control operating costs.

III. FOOD SAFETY

Nearly two years have passed since the government enacted 2009's Food Safety Law (FSL), which was created to ensure greater levels of food safety after China's melamine crisis. While various government agencies, particularly the Ministry of Health (MOH) and the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ), have undertaken a substantial amount of work to meet FSL stipulations, food-safety crises continue to occur with regularity.

These food crises are not passing unnoticed. As Chinese print and online media get bolder in their reporting, and as Chinese netizens use social media as a tool to comment on government practices, Chinese consumers are voicing their concerns and calling for reforms in this sector. According to a recent survey by Tsinghua Media Survey Lab and Insight China, nearly 70 percent of the Chinese population remains very concerned about food safety and more than half view government failure as the key reason behind unsafe food. As a result, food safety is still very much on the government's agenda.

Why is food safety still a problem?

Some of the key reasons why food-safety issues remain nearly two years after passage of the FSL include:

- **Industry fragmentation:** The industry remains very fragmented, yet the government still continues to emphasize supervision rather than prevention and producer education.
- **Regulatory fragmentation:** While MOH has been formally empowered to coordinate on food safety issues, it continues to rely on a number of ministries and

agencies to regulate and supervise food safety. This disjointed approach creates loopholes as well as a lack of responsibility when there is regulatory overlap.

- **Lack of government capacity to monitor food safety:** Despite a heavy emphasis placed on monitoring, agencies in charge of supervision lack the expertise, funds and administrative capacity to carry out checks. Even AQSIO's planned personnel increases will be insufficient to address the problem.
- **Safety requirements that remain difficult to comply with:** In its attempt to build a safer system, the Chinese government has created a set of testing requirements that are so stringent (e.g., some authorized levels of pesticide residues) that the only viable option for food companies is noncompliance, elevating safety risks.
- **Farmers' livelihood issues:** The price given to farmers for agricultural products is often insufficient to cover production costs. This creates incentives to take shortcuts in order to lower costs, such as adding melamine to milk.
- **The FSL does not apply to the entire supply chain:** Areas such as food packaging remain under-regulated and unsupervised.

CASE STUDY: UNILEVER

In February 2011, Premier Wen Jiabao declares in an online chat session that he will not allow prices to rise unchecked.

In March, Unilever's spokesperson announces that the price of some products could be raised by as much as 15 percent as a result of rising materials costs.

The news sparks panic buying of shampoos and detergents.

In an unprecedented move, on May 6, 2011, China's National Development and Reform Commission (NDRC) imposes a fine of USD 308,000 on Unilever after the company announces that it intends to raise the prices of toiletries.

NDRC blames Unilever for "illegally disseminating news of price hikes" and "disrupting market prices." They further declare that "severe punishment was (...) to break ugly habits and build new rules" and warn other firms to "absorb the lesson."

Unilever also had to announce that it would suspend plans to increase prices in order to comply with NDRC requirements.

Key current food-safety policy initiatives

Although the 12th FYP does not include policies geared toward ensuring higher levels of food safety, we anticipate new efforts to tighten the regulatory environment and intensify the supervision of additives and dairy products. Most of the themes that were important in 2010 will remain so in 2011. These include:

- **Strengthen the responsibility of food producers and government officials:** In December 2010, the NPC Standing Committee amended the PRC Criminal Law to expand the definition of food-safety crimes and increase penalties for public officials convicted of negligence or abusing power when supervising and managing food safety. This, together with ensuring a tighter monitoring of food-safety risks, remains a key target of the State Council Food Safety Commission's 2011 work plan.
- **Raise consumer awareness:** The FSL encourages consumers to report safety incidents and seek compensation. Social media has empowered consumers to exercise leverage on companies, and 2010 was marked by a number of social media campaigns against brands or companies, some legitimate, but others driven by compensation objectives. MOH's 2011 work plan includes consumer education campaigns to strengthen consumers' awareness about their rights. This should increase the threat of negative social media campaigns for companies in the FMCG sector since FIEs tend to be preferred targets for social media attacks.
- **Revision of food safety standards for ingredients and packaging:** 163 food safety standards were released in 2010, with a strong focus on food ingredients and additives. For 2011, the revision and consolidation of food standards will continue with an extended focus on food packaging. For instance, discussions on the safety of BPA have started to emerge. The government also plans to establish a national food-safety assessment institution this year.
- **Supervision of ingredients and additives:** Like 2010, the government will continue its plan to regulate food additives throughout 2011. The Revised National Standards for Uses of Food Additives will become effective this year, and the government will continue to crack down on the illegal use of non-edible additives. MOH will also optimize the "black list" system for the use of non-edible food substances illegally used in food.
- **Strengthened supervision of the dairy, meat, edible oil and alcohol industries:** In 2010, the use of melamine in milk was formally banned, and MOH published 68 dairy product safety standards and reviewed national standards on infant formula. The supervision of the dairy industry is still a top priority in 2011 as new safety issues have emerged. MOA said its inspectors will carry out 6,450 random checks on dairy products this year. MOH has announced that similar measures will be adopted in the meat, edible oil and alcohol industries.

- **Strengthened supervision over health food and health claims:** MOH is following in the steps of the European Food Safety Agency (EFSA) and reviewing health claims. In March 2010, SFDA strengthened the administration of health food product registration. A work plan to strengthen the supervision over labelling of health food, and health food advertising was also released for comments in 2010. CDC is also working on a plan to create a new categorization and further regulate health food, and we expect MOH to release the Administrative Rules on Health Food Administration and on Novel Food registration this year. We anticipate that the results of EFSA's current review of health claims will influence decisions made by Chinese regulators.
- **Greater focus on healthiness and nutrition:** Government concern over healthiness is increasing against the backdrop of rising obesity and chronic diseases. According to a study published in the New England Journal of Medicine in March, 92 million Chinese suffer from diabetes, which is much higher than previous estimates. Additionally, a heavily debated topic at the recent World Cancer Congress held in China in August 2010 was that 30 percent to 40 percent of cancers could be prevented by good nutrition, physical activity and avoidance of obesity. In the context of health care reform, where MOH emphasizes prevention as a means to control rising health care costs, it seems likely that MOH will aim to prevent the rise of obesity and related chronic diseases by promoting healthier nutrition. Recent regulatory activity points toward this direction. A working committee focused on drafting a national nutrition plan and nutrition standards was created in 2010. A draft Standard for Nutrition Labelling of Pre-packaged Foods was circulated for comments in April 2010 and should be released in 2011. CDC is currently developing a draft nutrient profiling (NP) scoring system, aimed at educating consumers and helping them eat a more balanced diet. Discussions around trans fat have started, and we could easily see debates on advertising to children and nutrition labelling, as occurring elsewhere in the world, emerge in China in 2011.

The FSL has a long way to go before it makes substantial progress toward addressing China's food-safety issues. The tighter regulatory environment has somewhat levelled the playing field and this has benefited FIEs who tend to have a better track record at ensuring food safety. Also, FIEs feel that they've been given more opportunities to comment and shape the regulations. Nevertheless, regulatory compliance costs are rising. The FSL has also made the operating environment more risky as consumers have become more aware of their rights. We will continue to see social media campaigns against brands or companies, some legitimate, but others driven by compensation objectives.

IMPACT OF POLICY CHANGES ON FIE'S

Key opportunities and threats arising from the policy changes reviewed in this report are summarized below:

Key opportunities

- **Higher, more diverse market demand:** The 12th FYP emphasizes economic rebalancing and consumption growth. The government will endeavour to stimulate income growth in central and western China as well as to create an enlarged middle class by encouraging wage increases. FMCG companies should gradually gain access to a larger and more geographically diverse consumer base. This will create growth opportunities but also require that companies adjust their manufacturing footprint and distribution strategies to serve tier 2, 3 and 4 cities where the biggest growth opportunities are expected.
- **Promotion of modern agriculture could reduce food-safety risks:** Requirements and incentives to improve farming techniques could potentially reduce food-safety risks, provided education initiatives targeted at farmers are rolled out to ensure the proper adoption of these techniques and raise awareness about food safety. Proper compensation of farmers will also be required to reduce incentives to cut corners.
- **Stricter enforcement of IPR:** The 12th FYP focuses on transforming China from a manufacturing-based economy to an innovation-based economy. China seeks to become a technological powerhouse by 2020 and a global leader in technology development by 2050. This will help reduce China's over-dependence on foreign technology and minimize licensing fees to foreign IP holders. In order to facilitate scientific innovation, the 12th FYP aims to improve the IP legal system and strengthen IPR creation, application, protection and management. In the short term however, IP violations remain a significant issue and FIEs are advised to protect their IP tightly and monitor for counterfeits.
- **Opportunities for companies in bio-agriculture:** The development of bio-agriculture is viewed as critical to increase production yields and address food security concerns. Bio-agriculture is a component of the biotechnology "Strategic Emerging Industry (SEI)" identified in the 12th FYP as being critical for China's long-term development. Overall investment plans for the seven SEIs are substantial and this will also apply to bio-agriculture. Moreover, the government will encourage the development of national champions and will be looking at partnering with foreign players to acquire technology, as in the recent case of the Makhteshim-Agan Industries and China National Chemical Corp merger. FIEs planning to take advantage of emerging opportunities in the bio-agriculture sector should, however, be aware that the ultimate policy objective is the "assimilation and absorption" of foreign technology. Hence, IP protection will be a key consideration.
- **Industry consolidation:** Industry consolidation, driven by government concerns over food safety, should ultimately

facilitate control over supply chains and ingredients. It will also have an impact on price by strengthening the pricing power of downstream players.

Key threats

- **Increase of input and operating costs:** The 12th FYP encourages minimum wage increases and has in fact created expectations for wage hikes at all levels. The plan will also raise environmental compliance costs. Regulatory changes in the food sector are also raising regulatory compliance costs.
- **Increase and/or greater volatility of commodity prices:** The 12th FYP states that farmers and growers should get more income for commodities. Government is also increasingly tinkering with market prices and food reserves to ensure food security and cap food inflation. This creates inefficiencies, fuels speculation and increases the price volatility of commodities sourced domestically. China will increasingly source crops in international market and this will affect global market prices.
- **Pricing power reduced:** Inflation has heightened consumers' and government's sensitivity to food price increases. While companies face rising costs, it is becoming increasingly difficult for them to pass these on to consumers.
- **Restrictions on foreign investments in agriculture:** To ensure greater levels of food security, the Chinese government is tightening its control over agricultural production and output. The consolidation of agricultural production and processing for essential crops in SOEs is underway. SOEs are also strengthening their control over imports and trading. Tight controls over foreign investments in agriculture have been gradually implemented and now apply to most aspects of the value chain, from seed to primary processing, particularly on essential food products.
- **Growing supply risks:** Foreign food manufacturers are increasingly dependent on large SOEs for their domestic supply of certain crops and ingredients. This creates a supply risk as the government can require that these SOEs sell their production to government reserves when these need to be replenished. Restrictions on investments in new capacity in areas such as corn milling as well as restrictions on the type of usage that can be made of certain crops could also create shortages.
- **Growing competition from Chinese players:** The government is encouraging the creation of domestic champions and giant food conglomerates. For instance, COFCO is moving up the value chain and strengthening its presence in the processed food market. Subsidies and other forms of support such as preferential access to commodities create unfair competition in the market. Eventually, some of these new champions will compete with FIEs in their traditional markets as Chinese companies expand overseas and acquire foreign brands to increase their brand portfolio.
- **Growing controls over foreign M&As in the agriculture and processed food sectors:** To protect domestic champions and avoid high levels of industry

concentration that could affect food prices, government will tightly scrutinize M&A deals involving foreign players.

- **Heightened risk of crisis:** Inflation has heightened sensitivity to food price increases and exposed companies who wish to raise their prices to a strong risk of backlash from both government and consumers. Food-safety risks also remain prevalent. Awareness and understanding of food-safety requirements among producers remain low, and many of the new food standards and testing requirements are difficult to comply with, encouraging companies to dodge standards. Restrictions on foreign investments in agriculture are slowing down the adoption of modern farming techniques and agro-chemicals. Instead, highly toxic substances are still being used to increase crop yields. The revised and highly publicized Tort Law and Food Safety Law encourages consumers to report product safety incidents and claim compensation. As a result, consumers are now more aware of their rights and empowered by social media to exercise them. This has led to a proliferation of incidents, some real, some more driven by profit-seeking motives. For all of these reasons, the risk of crisis for companies in the food and beverage sectors is on the rise.
- **Development of GM:** Given growing concerns over food security, government is increasingly looking at GM crops to increase production yields. As imports of GM crops develop and China strengthens its control over GM seed technology, the use of GM crops in China should expand. This is both good and bad news for companies depending on where they stand with regards to GMO.
- **Restrictions on health claims, advertising of unhealthy food and new requirements for nutrition labelling:** Chinese regulators are monitoring the on-going review of health claims by the European Food Safety Agency, and China's CDC is working on a revised classification of health food and claims. New labelling requirements and advertising restrictions are set to come into force in 2011 for health food. The government is also striving to promote better nutrition and may consider some of the initiatives adopted elsewhere such as restrictions on advertising to children. An initiative to develop a nutrient profiling scoring system is already underway.

KEY RECOMMENDATIONS

- **Prepare to operate in an increasingly diverse consumer market:** As a result of China's macro-economic policies, the fastest growth in China's middle class and wealthy consumers in the next few years will occur outside first-tier cities. Companies focused on serving consumers in tier 1 cities will no longer remain competitive. Thus, companies will need to adjust their product, distribution, advertising and staffing strategies to serve consumers in emerging markets inland.
- **Implement a multi-channel sales strategy to serve inland consumers:** Given China's relatively underdeveloped or

inadequate retail channels inland, e-commerce can help companies serve otherwise difficult-to-reach consumers in second- and third-tier cities. By June 2010, China had 420 million internet users, double the number of users in the United States. Forty percent of China's internet users resided in rural areas. Internet sales are expanding very rapidly. According to EIU, in Q2 2010, online shopping revenue in China reached USD 17 billion and by 2013, online sales in China are expected to reach USD 155 billion (about 40 percent of total retail sales). The development of e-commerce should be further stimulated by the recent revisions of MOFCOM policies on internet sales activities of FIEs. The average total purchase value per visit for buyers in tier-2 cities is about 20 percent higher than for the first tier. The internet is an effective way to reach consumers that are "hidden" in China's vast market.

- **Conduct regulatory due diligence and prepare stakeholder engagement plans for new investments and M&As in food and agriculture:** As a result of China's concerns over food security, inflation and of the government's objective to strengthen domestic brands, foreign investments will be closely scrutinised and could trigger China's new national security review mechanisms. Accordingly, tight regulatory due diligence, government soft-soundings and sustained, multi-level engagement with media, government and other stakeholders are necessary to facilitate the review process and maximise chances of success.
- **Conduct intelligence-gathering on regulatory changes in food, ingredients, packaging, health and nutrition:** Intense regulatory activity in these areas is to be expected in 2011 and onward. Companies should put in place mechanisms to identify regulatory changes at an early stage. This will help minimize exposure to regulatory risks, facilitate business preparedness and even provide opportunities to influence new draft standards and regulations.
- **Develop effective government relations strategies:** While the FSL has led to the revision and creation of numerous standards and regulations, regulatory agencies lack the administrative capacity to implement rules and decisions on licenses, new ingredients and other special approvals are being delayed until clear implementation guidelines are issued. The FSL has resulted in institutional reshufflings, and this has aggravated decision gridlock. To help navigate this complex regulatory environment, managers should update their understanding of relevant issues and stakeholders and develop good engagement strategies. A clear understanding of the regulatory apparatus and robust relationships with key institutions will enable companies to better monitor potential issues, manage crises and inject their views into standards creation and policy development.
- **Implement cost-increase mitigation strategies:** With commodity, HR and regulatory compliance costs all increasing, we recommend that companies put in place strategies to manage rising costs. These could

include: business excellence to increase production and operational efficiency; monitoring of government speeches and social/economic trends to anticipate government market interventions on prices; strategies to hedge raw materials cost increases; and product differentiation to retain pricing power.

- **Prepare crisis preparedness and risk mitigation strategies:** With product safety regulatory risks increasing as well as rising nationalism, companies should put in place strategies to hedge risks as well as prepare for crises. Strategies should include: tight control over the supply chain; tight control over IP and monitoring of counterfeits; mapping of potential risks; developing a crisis management and communication plan; monitoring media and social media; and building relations with key stakeholder groups including key opinion leaders, experts, government regulators, media, bloggers and consumer associations. ■

ABOUT APCO WORLDWIDE IN CHINA

APCO is a global consulting firm and a leading provider of market entry, government relations, strategic communication and corporate responsibility services in China.

We have been serving clients in China since 1989. Today, our China team includes more than 100 professionals from a diverse range of backgrounds, including business, government, journalism, academia and civil society. We are based in well-established locations in Beijing, Shanghai, Guangzhou and Hong Kong.

Our clients include multinational firms, leading Chinese companies, governments, chambers of commerce, issue-based coalitions, multilateral organizations and nonprofit interest groups. Client success is our measure of achievement, and we help clients realize their objectives at every stage of their engagement in China.

APCO's specialized food and consumer products (FCP) practice in China tracks regulatory changes and emerging issues and has specific expertise in assisting companies in this sector in addressing the unique challenges that they face in China.

We combine our strengths in corporate advisory, public affairs, strategic communication, and corporate social responsibility (CSR) to provide end-to-end services to our clients from the moment they enter the Chinese market through all steps of their business cycle.

We have worked with a wide range of companies operating in multiple sectors to help them achieve business success.

For further information on how APCO Worldwide can help your organization understand China's political/regulatory environment, please contact:

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