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Riding the Dragon

China's Spirits Market in Transition

Rabobank International

Food & Agribusiness Research and Advisory

Sandy Chen
sandy.chen@rabobank.com
+86 21 2893 4691

www.rabotransact.com
www.rabobank.com/f&a

Contents

With the ongoing fight against corruption in China surpassing expectations by outlasting past efforts, high-end spirits consumption and the traditional channels where they are sold are facing major headwinds. In order to continue to exploit growth in China, both domestic and international spirits companies will need to adjust their strategies to include demand from the more sustainable consumer side. While this may require trading down to sales of lower price point products in the short term, spirits companies need to maintain their presence in the high-end market for opportunities in the longer term.

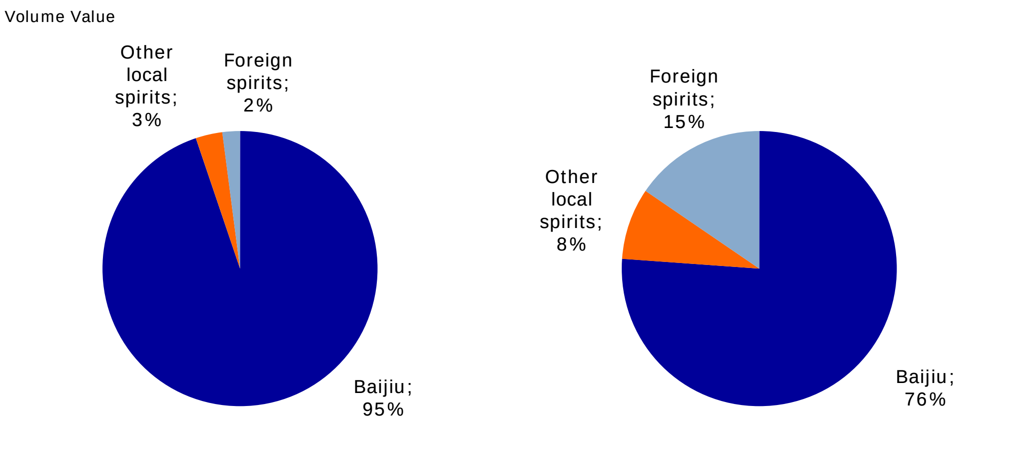
Introduction

China's spirits consumption is dominated by baijiu, which has a 95 percent share of the segment. The government's anti-corruption campaign put an end to what was clearly a trend towards premiumisation seen between 2008 and 2012. Domestic baijiu companies have now been forced to employ short-term tactics and adjustments in their strategies as they face plunging sales and profits. Foreign spirits companies are also feeling the effects of the current situation, as they are encountering the same headwinds.

Baijiu and premium western spirits, both hard hit by policy

Euromonitor estimates that baijiu accounts for the lion's share of China's domestic spirits consumption volume, standing at 95 percent. Due to lower acceptance by Chinese consumers, foreign spirits (e.g. brandy, cognac and whisky) only account for 2 percent of consumption volume in China. However, foreign spirits are generally positioned at the higher end of the market with a disproportionately high share in value terms (*see Figure 1)*.

Figure 1: Share of spirits consumption in China: Volume vs value



Source: Euromonitor, Rabobank, 2014

Between 2008 and most of 2012, the domestic baijiu sector went through a distinct premiumisation process led by major brand names such as Kweichow Moutai, Wuliangye, Luzhou Laojiao and Swellfun. A key driver of the premiumisation during this period was in fact institutional demand, as baijiu was typically consumed in the form of gifting, dining and entertaining involving government officials and senior management of state-owned enterprises. This drove hefty rises in product prices and lifted the overall volume growth in the baijiu sector.

However, in Q4 2012, the new government leadership launched a campaign against corruption, which has been having a negative impact on consumption of high-end spirits. As a result, the baijiu sector has seen a significant slowdown in production volume as well as a sharp deceleration in sales value during the course of late 2012 and 2013.

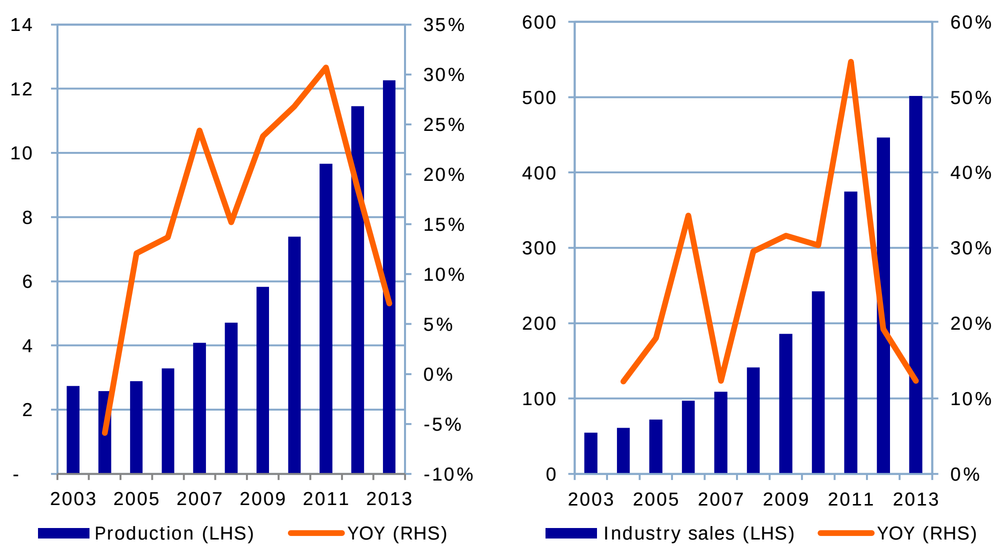
When the Chinese government began implementing austerity rules in late 2012 and pushing to curtail official extravagance, there was a broadly held belief that the measures would likely be symbolic and short-lived. However, over 20 months later these measures are still having an impact on all industries that trade in luxury goods. Many five-star luxury hotels, pinched by the anti-extravagance measures, are seeking to have their ratings reduced in order to help revive sales, while many high-end restaurants are adjusting their menus in an attempt to attract the patronage of middle income customers.

Continued pressure from the government's anti-corruption campaigns brought about a substantial slowdown in baijiu industry, with sales growth falling to 7 percent in 2013 from 19 percent in 2012 (*see Figure 2*). Kweichow Moutai, one of the leading premium baijiu companies in China, saw sales volume declining by 2 percent in 2013, down from a 21 percent increase in 2012. Swellfun, Diageo's premium baijiu brand, reported a sales volume decline of 18 percent and sales value decline of 66 percent.

The government's actions also drove a more drastic 19 percent decline in cognac import volumes in 2013. Likewise, Scotch volumes fell 27 percent in the last calendar year. The declines in imported spirits have created significant challenges, particularly for the cognac industry, which has become highly dependent on growth in the Chinese market.

Figure 2: Total production volume vs total sales value of baijiu, 2003-2013

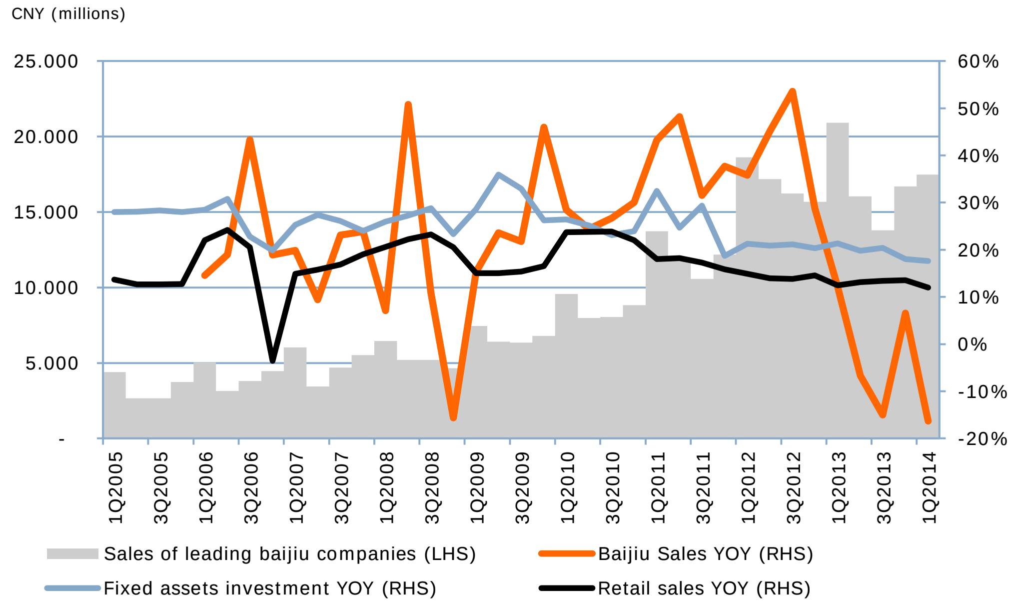
billion litres YOY (percent) CNY (billion) YOY (percent)



Source: China Alcoholic Drinks Association, National Statistical Bureau, Rabobank, 2014

Leading baijiu companies saw sales growth peaking in Q4 2012 before it decelerated sharply into Q1 2014 (*see Figure 3*). Aggregate sales for 12 major baijiu companies showed absolute year-over-year declines in Q2 and Q3 2013 and Q1 2014, despite a short-lived rebound in Q4 2013.

Figure 3: Downturn in sales of leading baijiu companies vs fixed asset investment and retail sales momentum, 2005-2014



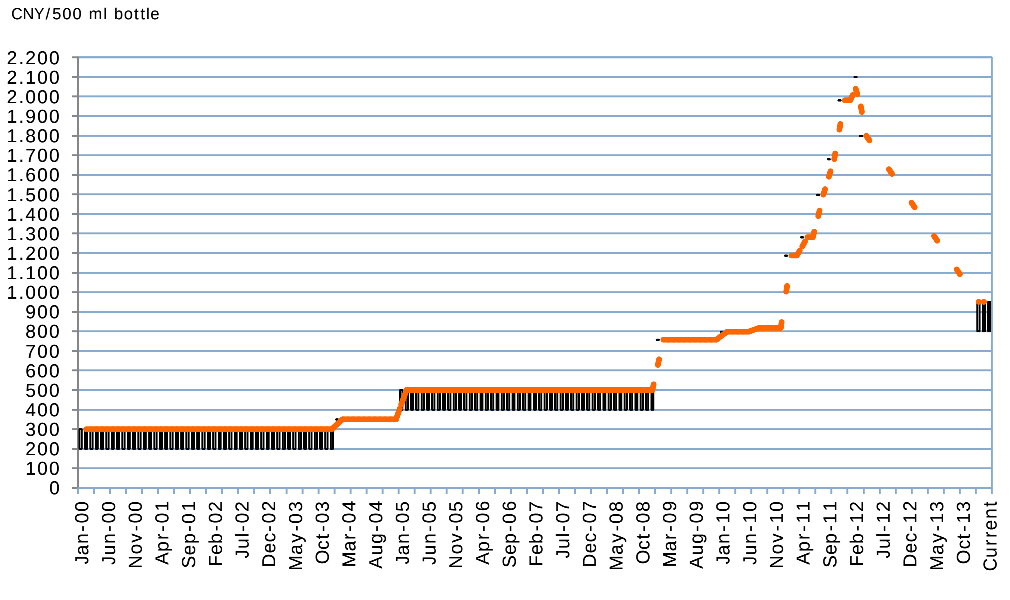
Source: Bloomberg, Rabobank, 2014

Baijiu companies: Struggling to weather the storm

Aggressive price cuts

Retail prices of premium baijiu products gained strong momentum during the period from 2008 through much of 2012. With strong headwinds starting in Q4 2012, prices could not be sustained at the levels seen previously. The prices of a number of high-end spirits were reduced by half during the course of 2013 (*see Figure 4*).

Figure 4: Feitian Moutai sees its retail prices (indicative) plummet, 2000-2013



Source: http://news.china.com/finance/11009723/20111122/16880430.html, Rabobank ,Retail channel checks 2014

Aggressive price cuts in the high-end segment were the last choice, the last resort even, for brand owners, as this destroys the existing pricing structure and makes it difficult to bring back the brand premium in the years to come. For distillers, these price cuts were not introduced of their own accord. During the heydays of 2008 to 2012, retail prices were rising faster than ex-distiller prices and high margins lured the multi-tiers of distributors to stock up. However, when sales finally started to slow in Q4 2012, excess inventory in the distribution channel led to tumbling retail prices in order to push sell-through and sell-out. A lack of control over distribution channels also ended up in cross-dumping. At times, some distributors were even complaining that retail prices fell below their cost of building the stock. This has also fed back to the distillers who have been forced to lower ex-factory prices.

Efforts to expand the distributor base or streamline layers of distribution

Some baijiu companies are beefing up efforts to expand the distributor base by offering greater discounts to those who are able to commit to volumes and pay in cash promptly. Squeezed margins in the distribution channels are also prompting those who adopt the multi-tier distribution model to streamline the layers and phase out inefficient distributors.

Engaging online B2C channels

Online B2C channels, which generally have a strong value proposition, are increasingly being employed to expand sales of baijiu. Jiuxian.com, a leading online retailer specialising in wine and spirits, was granted distributorship by Kweichow Moutai in 2013. On 11 November 2013, the 11/11 Bachelors' Day promotional event reportedly generated a total of CNY 221 million in online sales for jiuxian.com, a surge of 2.7 times YOY.[1]

While the value proposition of online retail channels is attractive to consumers, it has the potential to create tensions with other distributors and retailers of baijiu. There have also been disputes between baijiu companies and online retail channels, especially when the former are struggling to defend prices to traditional retailers and distributors after having fallen significantly. Striking a balance between online B2C channels and their offline distributors and retailers is becoming a growing challenge for baijiu companies.

Reallocating of marketing and advertising expenses

For years, baijiu companies have been major advertisers on the national CCTV station, investing billions in TV commercials. However, by late 2013, their bid for advertising hours on CCTV for 2014 was much more muted. The need has come to rationalise the allocation of marketing and advertising budget to the point that the most direct impact would be felt, such as incentives at the point of sales.

Beefing up mid to low-end products

The current headwinds have forced the leading baijiu companies to reconsider a switch in focus to lower alcohol content and value-for-money products. According to the Ministry of Commerce, 11 high-end baijiu brands saw their sales volume fall by 7.2 percent YOY in 2013, whereas total sales volume increased by 1.9 percent YOY, implying much stronger growth in mid to low-end spirits during the past year.

Implications for foreign spirits companies

Prior to the government's anti-corruption campaign, foreign spirits companies had been targeting consumers in the luxury segment. There was less focus on mid-range products, which tend to have better traction with young urban Chinese consumers versus their elder counterparts, given the increasing western influence. As demand for luxury products has fallen substantially, foreign spirits companies will need to revisit their strategies and focus on marketing mid-level spirits to the mass market by cultivating an appreciation for the taste of the product in order to pave the way for trading up in future.

Industry sources also suggest that cultivating the wine market could be a strategy for foreign spirits companies to continue to engage with Chinese consumers, especially the younger generation. However, it remains to be seen whether the cultural influence of baijiu will stubbornly persist among the younger generation as the current generation of heavy drinkers of baijiu cuts back consumption as they age.

Turnaround unlikely until Q2 2015

A double whammy

In addition to the government's long-lasting anti-corruption campaign that started in 2012, in Q1 2014, the government also decided to clamp down on prostitution and launched a series of raids on night clubs in South China, which has seriously impacted these channels in the region. These crackdowns are also spreading to other coastal regions. Discussions with industry sources suggest that high-end night clubs in a number of coastal regions are being raided repeatedly so are not willing to sign up higher volumes of foreign spirits. Chinese restaurants and off-trade channels for foreign spirits are also being negatively affected as business travellers to these regions are being entertained less often and are spending far less in these channels, which is not helping to improve the near-term outlook.

[1] 11/11 is known as Bachelor's or Singles' Day in China

Not yet at the bottom

The most recent data available suggests that the pressure on consumption of foreign spirits remains exacerbated to some degree by wholesaler inventory destocking. Earnings reports from Remy Cointreau, Pernod Ricard and Diageo suggest that the market has not yet hit rock-bottom.

Q1 2014 performances of leading domestic baijiu companies have pointed to continued downturn, both in the top line and bottom line. In addition, the cash collection situation for these companies has further deteriorated. A similar trend is being witnessed by industry sources in the foreign spirits space.

Silver linings

The headlines out of China for most spirits companies have been quite negative, but there have also been some bright spots. For example, while most exporters were struggling with the Chinese market, DISCUS estimates that exports of US spirits to China grew 40 percent. This was consistent with news from Brown Forman, which suggested that sales to China are continuing to grow in the double digits. American whiskey is likely seen as less extravagant than Scotch, and may be benefiting from the austerity measures. Similar trends have been seen in the wine industry (e.g. Bordeaux exports to China fell 16 percent in 2013, while exports of less expensive wines from Languedoc enjoyed solid growth) and suggest that spirits companies may need to rebalance their portfolios to focus on more entry-level and mid-tier products to generate growth in the Chinese market.

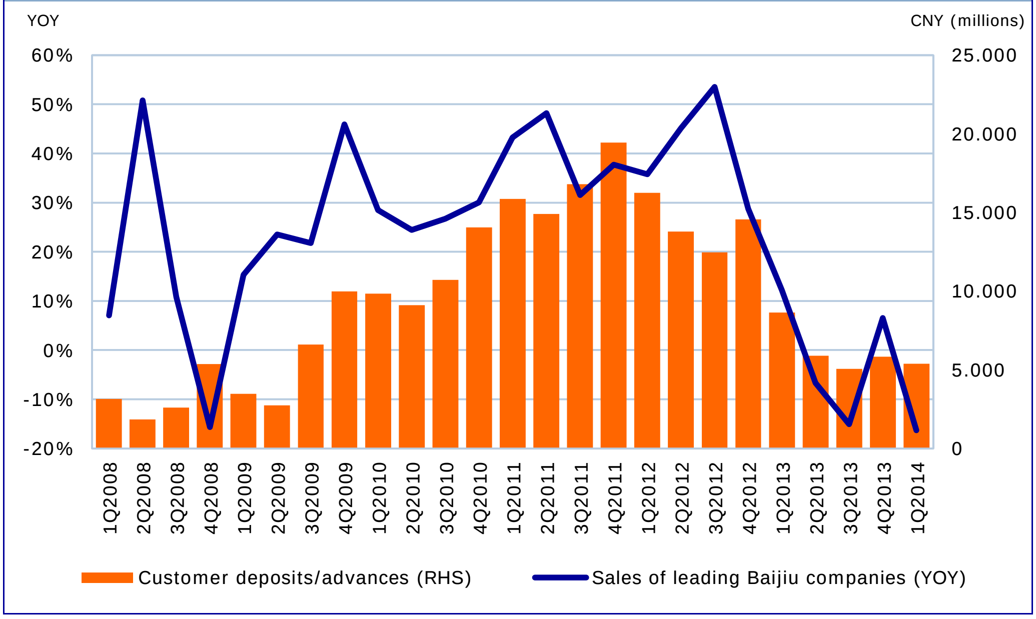
Channel checks suggest that another bright spot is the strength of consumption of foreign spirits in modern on-trade channels (e.g. discos and karaoke bars catering to the younger generation), as is taking place in many parts of China. This reflects the efforts of some foreign spirits companies that are adjusting their marketing strategies and allocating more resources to below-the-line marketing support at the point of sales and signing up more new contracts. So far, this has had a positive impact on volume but not profitability.

Outlook

The anti-corruption campaign will likely stay in place in a more sustained manner, while other crackdown activities may prove more temporary as the government reallocates resources to other aspects of public security. At some point, the impact of the austerity measures will bottom out and consumption growth will return, although it will be driven by consumers in the private sector rather than spending by government officials.

The performance of the high-end baijiu sector is a coinciding indicator for foreign spirits in China, if not a leading indicator, so it is very important to keep an eye on it. Recent channel checks also suggest that destocking of high-end baijiu appears to be coming to an end. However, Q1 2014 financial reports of leading baijiu companies do not give positive answers to the slightest improvement in market sentiment over the next six months, with the key leading indicator of customer advances paid in to premium baijiu companies as of the end of Q1 2014 still pointing downwards (*see Figure 5*). The destocking process may be coming to an end, but the continued weakness in this indicator means that distributors are still pessimistic about the near-term outlook as sell-through and retail sell-out remain difficult, and they are still very cash-tight.

Figure 5: Leading baijiu companies: Sales momentum vs customer deposits trend, 2008-2014



Source: Bloomberg, Rabobank, 2014

For foreign spirits players, the destocking process may continue further still. Domestic premium baijiu companies generally adopt a cash-on-delivery policy or, in many cases, impose a required payment before delivery to distributors in the form of advances. This is to ensure availability and desired quantity of products based on the strong bargaining power they enjoyed in the heyday. Foreign spirits companies generally adopt a different practice, in which they extend credit to their distributors. While domestic premium baijiu companies are seeing advances from customers falling, their different collection/payment practices mean that foreign spirits companies are finding that cash collection from distributors is becoming more difficult. Under such circumstances, it is a challenge to push for more volume growth in these channels without creating more cash collection problems.

All of this indicates that the market will not begin to stabilise until late Q1 2015. Slow turnaround in volume growth will only become possible towards Q2 2015.

Conclusion

Both domestic and foreign spirits companies are currently experiencing the same headwinds. The anti-corruption campaign aside, China's overall economy is in the midst of rebalancing with a strong likelihood of slowing down. The reality calls for employing short-term tactics and adjustments in strategies. The core theme is to direct more efforts than before to more affordable categories with low to mid-end positioning to meet the genuine and sustainable consumption, and then gradually cultivate the taste of the younger generation of consumers who will have the potential to trade up in the longer run.