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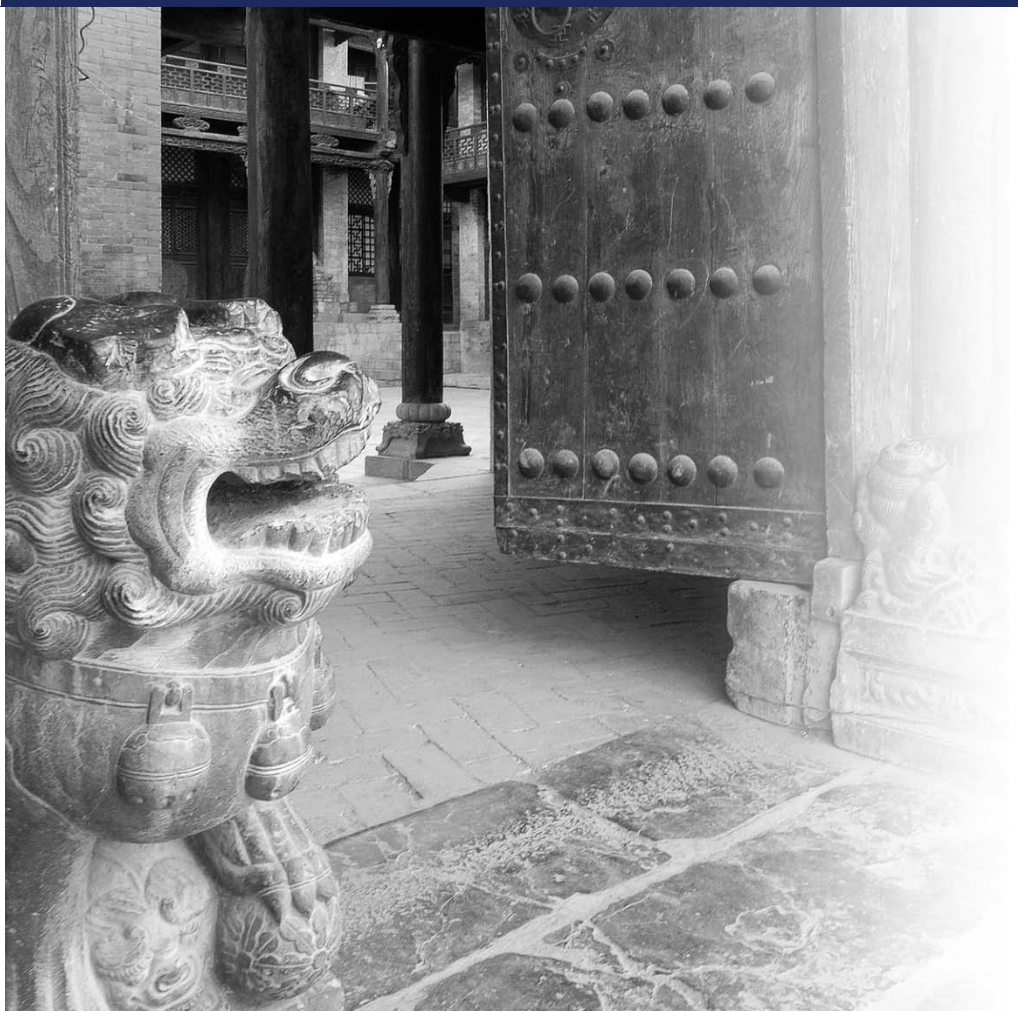
China's Dairy Industry: Modernizing Ahead of Schedule

An Interview with Huaxia Dairy's George Zhang

By **James Sinclair** | October, 2014



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Few of China's industries have come to embody the country's rise in the last decade better than dairy. Rattled by a well-publicized safety scandal in 2008, the industry turned its focus to modernizing farms and improving quality standards. The rate of progress since then has exceeded all expectations, with the transition from backyard farming to scale farms now almost complete.

George Zhang, CEO of Huaxia Dairy, is leading his company through the industry's unprecedented modernization. With over 20 years in the agricultural industry and 14,000 cows on his 3 farms in Hebei Province, Mr. Zhang is positioning the company as China's premium fresh milk brand. InterChina's James Sinclair sat down with Mr. Zhang to discuss China's growing demand for dairy, the modernization of the supply chain, and Huaxia Dairy's rising role.

InterChina: China's dairy supply chain has improved markedly over the last five years. How do you see the modernization of the supply chain progressing, and how much longer until we see a modern supply chain?

GZ: Modernization of dairy farming in China accelerated rapidly following the 2008 melamine crisis. The speed and scale of modernization has surpassed the expectations of everyone in the industry. It's been so quick that our 10-20 year timeline forecasts from 2008 were way off.

The majority of the roughly 750,000 backyard farmers that existed prior to the melamine crisis have exited the industry entirely – each sold their cow and never came back. Those who remained put their cows into so-called 'cow hotels' built and operated by the villages, and most of these cow hotels have now been bought and privatized. The major supply has already been modernized and consolidated, and very soon it won't be possible to buy from individual farmers.

If you look at the local majors like Mengniu and Yili, who are processing over 10,000 tons of milk every day, they are forecasting that it will only take a further 1 to 2 years for their supply structure to be fully consolidated into scale farms. This is happening across the board, and if the end-game for modernization is to go from backyard farmers to scale farms, then the modernization process will be complete by 2016. That is just 8 years since the melamine crisis in 2008.

InterChina: A modern dairy farm could be defined in a number of ways. For China's dairy industry, what does it mean to be 'modern'?

GZ: When we talk about modernization, I think about mechanization and how much of a farm is automated. The minimum, which is the first and simplest step, is the automation of the milking parlor. All of China's scale farms now have rotary milking parlors, typically 80-bail units which are quite sizeable and optimize the number of cows that can be milked by individual milkers. These parlors also have piping systems that collect and cool the milk, as well as pipe cleaning systems to maintain minimum standards of hygiene.

Mr. George Zhang *began his career at China National Chemical Construction Corp, which is now part of CNOOC. Since 1994, Mr. Zhang has held executive positions in several multinational companies, most notably ICI, Zeneca, Syngenta, and DeLaval. Mr. Zhang was appointed the CEO of Huaxia Dairy in 2012 and the Director of the Dairy Association of China in 2013.*

About Huaxia Dairy: *Huaxia Dairy was established in 2004 by several repatriated Chinese with the philosophy "nature is best." With the aim of producing high-quality and safe milk in China, Huaxia has utilized integrated technology in milk cow stockbreeding to produce pasteurized and fermented milks for distributors and their own brand, Wonder Milk. In 2014, a consortium led by Singapore's sovereign wealth fund, GIC, and Olympus Capital Asia invested an additional USD 106 m in Huaxia Dairy Farm. Huaxia's three farms are located 50 kilometers outside of Beijing in Hebei province, and are home to 14,000 cows.*

Beyond the milking parlor, there are other aspects of the dairy farm that can be automated. These include automated feed control and feed monitoring systems, breeding program aids with heat detection systems, barns equipped with temperature control and prepared bedding, and so on. These automation systems are becoming increasingly widespread in China.

There are also front running farms that are more sophisticated. At Huaxia Dairy, we are currently building two new farms and a processing plant in Jiangsu Province, which will involve a 100-bail milking parlor – probably the first of its kind in China. Then there is Sanyuan's flagship farm, the Beijing Dairy Cow Center, which is fully automated with a robotic milking system.

Looking ahead, the strengthening of China's animal husbandry waste regulations from the beginning of 2014 will continue to drive investment in equipment and technology. I expect a redirecting of investment from modernizing production processes towards modernizing waste management, manure treatment, and wastewater facilities. And just as China's dairy farms relied heavily on the expertise of international companies in recent years, so will they over the coming years.

Modernization is a continuous process, and new equipment and technologies will have a market in China. At the moment, China is learning and borrowing from other countries. But international equipment and technology suppliers need to take China seriously, which means developing and building solutions specifically to meet Chinese needs. This isn't critical now, but will increasingly become so.

InterChina: Modernizing an industry in eight years is no small feat. What explains the quicker-than-expected development?

GZ: The supply-demand imbalance has been the greatest driving force. The imbalance has been reflected in the milk price, which has been rising up until recently, and attracted a lot of capital looking for a return. Then there have been the successful IPO's of the likes of Modern Dairy and Huishan Dairy, which have also raised a few eyebrows.

In addition to private equity and the financial markets, dairy farms have also received support from the dairy processors. Mengniu and Yili alone have made billions available to their suppliers in the form of soft loans for the upgrading of their facilities.

The Chinese government has also been very supportive. Dairy farm automation has been included in the national subsidy program, and this has been supplemented by a range of subsidies at the local level around cows, feed, and facilities.

InterChina: Upgrading equipment and facilities can be relatively straightforward compared to developing operational knowhow and running quality control systems. Has progress on the soft side kept pace with progress on the hard side?

GZ: Indeed, modernization requires more than just throwing money at the problem. I would say a well-managed quality control system is the real defining asset for a modern dairy farm in China. Progress has been made, and there have been several factors in play.

First, the national standards have been tightened up. This means that processors now have much stronger bargaining power over milk suppliers, and it is not uncommon these days for a major processor to decline subpar milk. This has made a strong impact on farms, and created the incentive to improve.

Secondly, the industry has adopted a knowledge sharing environment. Over the last few years, various industry interest groups have been providing training, including face-to-face instruction and reading materials, both offline and online. The number of people having undergone training has to be huge, and this has dramatically improved operational knowhow.

Thirdly, the big farms are helping each other. At Huaxia Dairy, we have an open-door policy, welcoming people to visit us for training and exchange, and we also learn from others too. This openness between milk suppliers was made possible by the supply-demand imbalance. Everyone has a market for their milk, and thus competition between farms isn't an issue. Moreover, all milk suppliers have a common interest in the industry upping its game. This benefits consumers and companies alike, and conversely, reduces the risk of one milk supplier spoiling the whole industry.

InterChina: The supply-demand imbalance has created a huge demand for imported milk. Will the gap between supply and demand close?

GZ: China is reliant on imports to meet the present shortfall. During the first half of 2014 China imported 750,000 tons of milk powder from New Zealand, which was more or less equivalent to the whole of 2013. In addition, the U.S. and Europe are also increasing milk powder exports to China, with Europe looking to benefit from the end of milk production quotas in 2015.

On the demand side of the equation, the urbanization trend will continue to drive growth. China's per capita consumption of dairy products is still very low at 30 kilos per capita. This compares with developed Asian economies, like Japan, Korea and Taiwan, which consume 70-80 kilos per capita. If China comes close to these levels, then we can expect a doubling of consumption.

These per capita figures include all dairy products. Right now, consumer demand for dairy items beyond milk and yoghurt is relatively weak – in the retail channel that is. But then demand from food processors and food service operators is easily overlooked. The rise of chains such as McDonald's and Pizza Hut is a significant force behind the growth of highly processed products like cream and cheese.

But while growth will continue, we are seeing a few trends that suggest that demand growth is slowing. In the first tier cities, such as Beijing and Shanghai, growth has already slowed from double to single digit figures. Of course there will be new sources of growth in smaller cities and individual categories, but demand will gradually stabilize over time.

Turning to the supply side of the equation, there is much potential to improve yields. China has a national average yield of 5 tons of milk per cow. If yields can be improved to U.S. levels, where the standard is 9.5 tons per cow, then we will effectively double output. If you look at China's leading farms, they are already working towards yields of 8 to 9 tons per cow.

The consolidation of farming is still the quickest way to that target. Firstly, feeding standards and feed quality have been improved. Secondly, breeding technology has tightened breeding reproduction cycles, helping to keep the herds productive for longer. And thirdly, capital has been invested in better living environments for the cows. All these things help.

And so with domestic output increasing and demand growth slowing, the imbalance will even out. However, it is difficult to say when. Milk powder imports will continue in the interim, but they won't account for a major share of total supply over the long-term.

InterChina: The other driver of imports has been consumer concern about the safety of domestic milk following the 2008 melamine crisis. This is particularly pertinent in the infant formula category, where the use of imported milk powder is common. Will these supply chains also localize in time?

GZ: The new quality systems that are being implemented across China's scale farms are raising standards. When quality and safety are no longer a concern, price will be the deciding factor.

As mentioned earlier, the farm-gate milk price in China has been on the rise in recent years, and reached RMB 6 per liter last year – this was very high. However, the price went into freefall earlier this year, dropping to RMB 4 per liter, and has started to converge with the international price. Commodity prices are difficult to forecast, but I expect domestic prices will match import prices before too long.

Many processors have facilities that can handle both fresh milk and milk powder, which allows them to switch between domestic supply and imported supply depending on the price. Where the price differential is less than 10%, domestic supply will win out, as processors prefer the proximity and security of a domestic source of supply. It is still too early right now, but over the next 2 to 3 years I expect domestic milk suppliers will return to prominence.

InterChina: With the vertical and horizontal consolidation of the industry, the local majors are getting bigger. What does this mean for international dairy brands?

GZ: I think we will see more horizontal rather than vertical integration, as vertically integrated players have begun to fall apart. The local majors are realizing that their processing and farming businesses are quite different. Mengniu, Yili, Bright and Sanyuan are all spinning off their farming businesses into independent farming units. There will still be vertically integrated players, but at the shareholding level rather than management level.

As for international dairy brands, China will continue to be a tough market. In liquid milk, the local majors are already dominant, just as local players dominate in most markets around the world. It will be difficult for international brands to pose a challenge unless they partner with a local company. Their best chance will be in highly processed dairy products, such as milk drinks, ice-cream and cheese. These products can be positioned as leisure items.

InterChina: Huaxia Dairy is active in both farming and processing, and has established itself as a leading player in pasteurized milk. What now lies ahead for you?

GZ: From the beginning, we crafted ourselves as a quality supplier, which led to our focus on pasteurized milk. China is generally a UHT market, but there is a demand for the taste and freshness of pasteurized milk, mainly in the first tier cities. It's for this reason that we located our farming operations where they are, close to our markets in and around Beijing and Shanghai, despite the higher operating costs.

We are mainly a B2B player. We sell fresh milk to dairy processors, which make chilled products such as pasteurized milk and yoghurt. We also sell to food service operators, but more gourmet than mass market chains, which are looking for quality rather than value pricing. Pretty much all gourmet restaurants and coffee shops in Beijing use our pasteurized milk.

Our B2C business is under our Wonder Milk brand. We have a portfolio of pasteurized milk and yoghurt, typically consumed by returnee Chinese and expatriates, as well as children and the elderly. While only a small share of our total business, Wonder Milk is an important demonstration of our quality, and in this way supports our B2B business. With more promotion and education, more consumers will choose pasteurized milk.

Another dairy product where there is a lot of buzz is Greek yogurt. Nobody has introduced a genuinely creamy and high protein product yet, although the conditions are right for this category to takeoff. In the U.S., Greek yogurt is now one of the biggest dairy categories, being very versatile and often used as a controlled dietary replacement. I know that some of the regional chilled players are looking at it, and I'm curious to see how the local majors will approach it.

Finally, we are also working on alternative ways to get our Wonder Milk portfolio to market. We have a new online-to-offline model in place in Beijing which allows us to bypass traditional retail channels and deliver products direct to the door within 45 minutes. This has been very encouraging, and for those in Shanghai we expect to be able to do the same for you by the end of this year.

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