The Chinese Infant Formula Market: An Opportunity for Irish Producers?

Ross David Fehily
Department of Economics, Shanghai University, China

Abstract
In this paper we take a closer look at China’s infant formula market, as in recent years the demand for imported infant formula has amplified in many Chinese cities, discarding the domestic producers and witnessing of the growing price of imported powder for newborns. We begin by examining why Chinese consumers opt for imported foreign brands over their own domestic ones, and how much they are willing to pay for such produce. What action will the government take in this and should foreign producers treat China as a cash cow for years to come? We will also list and examine the main supplier countries and how Ireland compares and what level of importance they have attached to such a market, with China’s growing middle-class and massive population, have foreign producers, namely Western nation suppliers found a niche in China’s rising imported foods and beverage market?

Keywords: Infant Formula, Chinese imports of foods and beverages, consumer behavior

Introduction
Chinese economic growth has been one of the stories of the late 20th and early 21st centuries, with a massive rise in people’s incomes and an expansion in consumer patterns. The coastal urban centers along the eastern seaboard have been the driver of this impressive growth and hence its citizens the ones enjoying its vast rewards. Per Capita disposable income of urban households has increased 12 fold since the opening reforms in 1978. With the reforms and openness many Chinese were exposed to Western brands, deemed superior in quality, from automobiles and electronic devices to nowadays in the growing food and beverage imports. Quality has been a key issue, and moreover safety since the infamous melamine scandal in 2008, which left six infants dead and numerous more sick. The whole fragmented Chinese dairy has had to undergo reforms since, as consumer confidence in domestic produce was hit devastatingly. On that foreign producers eyed an opportunity, with demand for such produce increasing hence creating a surge in demand. Despite sounding like an opportunistic market for foreign producers there are numerous challenges in a number of areas. China is a market in its infancy in many regards, were many foreign companies have limited experience and know how on tapping into its true state. The role of the government is all empowering and must be approached with due caution. Black channels of trade exist with many bandit traders operating in China, understandable in this entrepreneurial state however proving frustrating for some players. Distributions and connections are all the more puzzling within this vast nations network. It is sure to be an interesting market segment for foreign producers who hope to cash in here, however advancing with a robust strategy and caution go without saying. For a small nation like Ireland, tapping such an enormous market could deliver a strong podium for export growth, and economic benefits in a country that has recently just emerged from a financial crisis in much need of investment for job growth.

The Growing Demand for Foreign Formula in China
The melamine scandal in 2008 acted as a catalyst for the growth in foreign producer demand. The fragmented supply chain in China, which includes many small scale dairy farms, had led to poor regulations and monitoring of dairy production, as well as market demands with increasing market pressures. When the crisis unfolded in 2008, only 10% of farms were considered large, a number of over 500 in their stock, opposed to nearly 43% in small backyard farms, which have a herd size of ten or less (Ma, Liu, Oxley, 2012). Dairy companies were hard hit with accusations, as were local government officials who have been accused of turning a blind eye. The discussion of food safety and quality assurance in China was rife in the aftermath. Although the government has acknowledged that food production in China needs urgent reform in many areas, this adaptation will be costly in opportunity costs and time. This opportunity has opened the way for numerous foreign producers to
enter the vast market, even if the asking price in supermarkets throughout China was several times that in their home countries. Many producers of infant formula have taken advantage that many Chinese opt to use such formula opposed to breast feeding their newborn, as China currently has one of the highest rates anywhere for non-breastfeeding mothers. Advertising and the general idea that value-added dairy product are beneficial in an infant’s healthy development and growth, an idea that has largely been influenced by western influences opposed to traditional Asian ones, albeit Wen JiaBao’s “I have a dream to provide every Chinese, especially children, with sufficient milk each day.” The change in lifestyle in China has also increased the rate of infant formula usage opposed to breast feeding, more mothers are in the workforce than before, often leaving their infant at home being looked after by the grandparents, usually in different cities. With a collapse in the domestic front for dairy and low consumer confidence in their own domestically produced formula, a higher number of middle and upper income households opted to buy imported substitutes. By 2012, four of the top five players in infant formula were foreign companies, Mead Johnson, Danone Dumex, Nestlé’s Wyeth and Abbot, accounting for 42% of a market which was worth over $6 Billion USD to the four companies. The onslaught of many foreign producers resulted in large scale slaying of dairy cows in backyard farms in China’s northern dairy belt as costs were rising with less demand to match.

Ireland as a Producer
Ireland has traditionally been an agricultural based economy for the most part of the twentieth century. Until the 1990’s, manufacturing was under represented in this Western European state, however since then, it has boomed and bust as has much of its competitive services industry after the 2008 crisis. Now Ireland again hopes to be a great producer of value-added agricultural products, of high quality foods and beverages to foreign nations. There are numerous world renowned food companies, and a government that has placed high importance on food and beverage exports. The value of Irish food and beverage exports surpassed the €10 billion mark in 2014, a remarkable figure for a small nation of Ireland’s stature. About a third of those exports are in dairy, from cheese, fluid milk, casein and SMP as well as infant formula. Irish dairy exports to China have grown strongly in the previous ten years, from a figure below €25million in 2004 to over €300 million in 2014 (Bord Bia, Market Opportunities for Irish Dairy 2025).

The overwhelming majority of these dairy products are infant formula and dairy powders, with little amounts of butter or cheese, a usual dairy export from China. As Ireland exports some 90% of its dairy produce, and with quotas on milk production being lifted in 2015 by the EU regulators, Irish produce is inclined to increase production. China has become Ireland second most important market, up from 13th in 2008 in terms of dairy. (BordBia) The Irish government have had a strong role in promoting the wellness and quality of Irish produce in international markets. Close cooperation between the Irish Dairy Board and farmers and the ministry of agriculture, fisheries and the marine have further accelerated Ireland as a strong producer that can meet the volumes of China’s market. Whereby China demands goods in huge volumes, Ireland can’t simply produce, unless in infant formula which it accounts for over 10% of the world’s production, and the largest in Europe. Can Ireland afford to over rely on one commodity in the whole Chinese market, as of 2014 over 58% of all Irish food and beverage exports to mainland China were in food preparations for infant use (CSO Trade), namely infant formula or should it be diversifying its exports portfolio in the hope that no major shock will upset the trend and ultimately affect Irish producers.

The Bargaining Power of Buyers & Suppliers
The bargaining power here refers to Porters five force analysis, with these two sections induced to give an imperative analysis of the advantages or disadvantages of consumers and producers. Beginning with producers, or suppliers of infant formula, they have long had a strong brand awareness in quality in China. Quality and assurance of safety are the leading factors of consideration in China or anywhere for infants, notably in China were single children families often invest and spend huge amounts on the best availabilities for the child, the two parents and all four grandparents as the one-child policy has left its impact on demographics. A great advantage in China is the recognition of foreign products,
often affiliated with higher quality, and used in gift giving as well as resembling one's status in society. The availability of foreign products has exploded, with the huge increase in outlet stores and supermarkets, both Chinese and foreign owned. Like Carrefour, which had 34 stores in 2002 to a staggering 236 in 2013 throughout China. The penetration of goods has flowed inwards, with the product availability, but the largest format has been no doubt the online retailing sector. The explosion of online retailing across China has been enormous. Business to Consumer, or B2C e-tailing figures have rocketed from about $55 billion USD in 2011 to almost $300 billion USD in 2014. The arrival of the e-tailing platform has exposed many products to consumers in all parts of China, even Tier 4 cities that are usually discarded by foreign producers as target markets. Despite this, Tier 4 online shoppers spend 27% of their disposable income (McKinsey Global Institute 2013) on online. Access and payments have been growing and becoming smoother for the growing online nation. Textiles remain the most common product sold online, however foods and beverages are also appearing with the popularity of online sites such as YihaoDian, YesMyWine and other promoting the sales of imported products, all discounted on the rates charged by grocery stores and supermarkets. The online sales platform has helped to increase the bargaining power of consumers in China, with easy to access and compare similar products, reviews, as well delivery services and reduced price. Many foreign producers of infant formula must tread with caution here many rogue traders on sites like taobao selling Dutch, German or New Zealand etc. infant formula at a lower price to the supermarkets. Underground exports are hurting for exporters, who often end up paying high distribution charges in China, as well as other barriers and costs for entering the Chinese market. Underground or black channels are a major problem in Hong Kong, and the Netherlands and Germany have introduced quotas in their supermarkets to clamp down on the illicit export of the white powder. Ireland hasn’t been directly affected by this as of yet, as Ireland has a much lower ratio of overseas Chinese in comparison and domestic Irish brands are not similar to the ones that have been exported to China, like the Dumex or Love+. The Chinese government also hopes to rejuvenate domestic production, and creating mergers between rival Chinese dairy producers. At present China’s dairy industry has no market leader, with a number of firms contesting nationally with marginal shares and a great number of local producers accounting for nearly half the market. The cross government department approach is from the top down, and hopes to see 10 domestic companies taking about 65% of the market. At present, in Tier 1 cities, some 80% of the infant formula market is in the control of foreign producer, but with this onset of substitutes and new entrants, a pricing war may be the resulting factor. This is in stark contrast to when foreign producers had such strong hold on the market they could form a oligopoly on fixed prices amongst each other, until an investigation by China National Development and Reform Commission in 2013, fining a total of 670 million RMB to a number of foreign producers and a Hong Kong listed producer. Mead Johnson, the firms which received the largest fine of about 100 million RMB reduced prices by as much as 15% according to the financial times. Going forward, is Ireland facing more challenges or can it emerge stronger in the Chinese infant formula market as the bargaining power of suppliers shirks whilst that of buyers may tend to grow steadily.

**Does the Exchange Rate have an effect on this trade?**

Ireland is currently one of the 17 members of the Eurozone, the single currency unit used amongst many EU nations, notably Germany, France, Italy and the Netherlands. In recent years the Euro has endured a massive debt crisis, stemming from Greece and other periphery states like Spain, Italy, Portugal and Ireland. On the other hand the RMB, the currency of the People’s Republic of China has strengthened severely against a number of currencies, however the Rmb/Euro exchange rate has been the most noticeable in major currencies. In 2008, one euro could buy more or less 10 RMB, however since then the euro devaluation has left the unit of one euro only equal to 8RMB in 2014. ([http://www.oanda.com/currency/average](http://www.oanda.com/currency/average)) More recently in 2015, the Euro has fallen below 7 RMB per unit. Evidently, Eurozone exports are cheaper in China than before, with Chinese consumption and income rising, and that in Europe staying modestly low, there’s a strong chance for Irish exports, as well as other Eurozone members to increase trade volumes to China. As of 2013, about half of the imported infant formula was sourced in the Eurozone into China, with the Netherlands the largest
supplier at 22% of overall supplies, followed by New Zealand at 18%, Singapore at 16%, France at 14% and Ireland at 9%. Other Eurozone nations like Germany only registered 2%. (EU SME Centre Importing Dairy Products into China 2014)

For Ireland to increase its market presence above the preceding four will be more than challenging. Netherlands and France also may avail of the currency depreciation and have a large product base with highly graded output. New Zealand has a free trade deal with China, and hence its products face less tariffs as well as the fact many Chinese dairy companies use New Zealand sourced dairy produce in their own end products. Australia, is also looking to sign such a similar deal with China, and could see them being more competitive, as they are currently 7th in the list at 5%.

Further Obstacles
Despite a favorable exchange rate for exports to China, the price of Irish infant formula still remains extortionate in comparison. The Kerrygold’s addition of Love+ retails at close to four times Irish prices of similarly produced goods. Any foreign producer that can afford to offer products at a lower price may increase sales, as economic sense may instigate. The real factors driving up prices in China are the costs of distributions, with many middle men cutting a slice, as is the government in import tariffs. In order to tackle the difficulty with distribution, Kerrygold signed a joint venture with Beingmate, who control their own distribution networked based out of Hangzhou. Although many foreign producers have been reluctant to join joint ventures because of the opportunity for their joint partner to indulge in technology theft via transfers. However in this case, the product in question is not such and Kerrygold made a strong decision.

Joining with Chinese firms give them access to market know-how, simplified import restrictions, better distribution capacity as well as product appearance and marketing.

More obstacles may be arising as other Chinese firms have gone steps further and bought foreign production abroad outright. This has been a bold move, looking to undercut foreign producers who may face the hurdles once they arrive in China, dealing with customs and finding an appropriate distribution chain.

With the growth of China’s GDP slowing, and in fact hitting its lowest level in 30 years, albeit still growing at 7%, there are fears that China’s slowdown may have a traverse effect. As China shifts from an export orientated to a consumption orientated economy, the growth in consumption should be a prime market for foreign exporters, however this is not the case. Mass stock building by Chinese buyers, as well as the import ban imposed in Russia has seen dairy prices drop drastically in 2014, and many supermarkets offering discounts on imported milk, notably UHT milk close on expiration. Dairy output grew in 2014, some 6% in Ireland, 10% in New Zealand. Are these nations putting too much emphasis on export admirations?

It appears the short lived white rush in China may have crashed prematurely. Dairy prices have struggled through the latter half of 2014, and with many Chinese now availing of lower prices in fluid UHT milk, there’s certainly an unlikely time to return to high price era of a couple a years ago. Could this same phenomenon be replicated with infant formula?

The Future of Infant Formula in China
As mentioned, global dairy output increased drastically whilst demand seemed to falter. China is a key target market, not just for Ireland but a number of producers, from all across Europe, Oceania and North America. The relaxing of the one-child policy has not seen any major changes in demographics that were expected in urban centers. The product in question has little opportunity growth for innovation, unlike for example the Apple iPhone, constantly reinventing itself with year on year releases to an eager audience of consumers in China forking out high prices to attain the latest model.

The attractiveness in infant formula may be in its pricing, although should one move, then should we expect a similar reaction from others in a tit-for-tat scenario. Also, Chinese consumers are wary at lower prices, which may imply quality inferiority in comparison to other similar goods.

Expanding a consumer base will be more difficult, with a Chinese clamp down on TV advertising expected, to prop up the nation to be more breastfeeding friendly as opposed to the current situation.
Ireland’s focus on increasing dairy production by 50% by 2020 is the EU’s most ambitious member to take advantage of the EU quota removal, and thus may face the benefits of exports, however strong oppositions from dairy reliant New Zealand, domestically reformed firms and a possible falter in demand may also have spelled the end of the road for Irish exports.

**Conclusion**

Ireland is heavily reliant on infant formula exports to China in its food and beverage export policy push. The ratio has been ever increasing and today is over half of all such exports. Diversifying the export portfolio will be a prudent move should an external shock occur and Ireland will see its exports decline rapidly. The push for diversifying has already been initiated, with the approach of beef, the EU’s only approved supplier to China, as well as alcoholic beverages. However dairy will be dominant, with an increase in output expected. Diversifying the dairy portfolio will be more challenging as cheese and butter exports are immensely low.

**References**


http://www.ft.com/intl/cms/s/0/d40bda56-ff06-11e2-97dc-00144feabde0.html?siteedition=uk#axzz3ZdGBe2DA


“Spilt milk, Why farmers are giving milk to pigs” 23 January 2015. HSBC. Web. Feb 15

http://www.forbes.com/sites/ywang/2014/06/13/china-consolidates-infant-formula-market/


http://english.caixin.com/2012-10-30/100453771.html?p1