CHINA 2012: A DIFFICULT YEAR

China is clearly the world's biggest market for beer but it certainly isn't the most profitable, a situation exacerbated by intensified competition and insufficient consolidation. *Glen Steinman* crunches the numbers

2012 is proving to be a challenging year for the Chinese beer industry's on-going evolution into a maturing, consolidated market with improved prospects for its survivors. Volume growth is slowing significantly and profits are down as brewers vie for market position.

China's somewhat weaker economy and poor weather are impacting beer consumption. Yet slowing growth mostly reflects market maturation from a per capita consumption perspective, while weak near-term profitability is primarily due to cut-throat competition in a still insufficiently consolidated market despite highly active M&A in the last decade.

Seema International estimates industry volume grew by just over 1% through September, well below the official 3.3% increase reported by China's National Bureau of Statistics. Indeed, we have cautioned for years against overzealous projections regarding beer volume potential. Days of high percentage growth are likely gone forever, even if volume trends in certain future years will look a bit better than 2012.

As further context, Seema estimates total industry volume in 2011 was 433 million hectolitres, 56mhl below originally reported official figures. Stated another way, volume is growing slower from a considerably smaller base than officially reported.

Credit: Jason Alden/ OneRedEye

Industry leaders' benefit

Industry profit actually declined in H1 2012 with the EBIT pool falling more than 10% vs. H1 '11. EBIT/hl dropped even more steeply as input costs, selling expenses and employee compensation each rose faster than the top line. Q3 evinced more of the same with trends further worsening for some brewers.

This reverses some of the encouraging progress in recent years when profits grew at a reasonably healthy pace, thereby increasing hope that the industry was nearing better days. Mid- to long-term this remains true; but, to state the obvious, the road ahead has many speed bumps and potholes.

While there is no positive spin for profit erosion, slower industry growth is paradoxically good for China's leading brewers. It accelerates concentration of volume among them and, to some extent, reflects increasing prices and trading up to premiums.

CR Snow, Tsingtao, and Anheuser-Busch InBev, as well as Carlsberg, all continue to achieve market growth at the expense of weaker regional and local players. Yanjing is the only 'Top Four' brewer to grow below the industry average thus far in 2012 but this is an anomaly and it remains an undeniably formidable player.

To date Tsingtao is the biggest volume gainer in 2012, jumping 12.8% overall and approximately 10% organically through September with particularly strong growth in Shandong, Jiangsu Hebei, and Shanghai. In total, Tsingtao grew by nearly eight million hectolitres, more than the entire industry. The Tsingtao brand rose at an impressive rate of 10.2%.

Credit: The Carlsberg Group

CR Snow, the market leader by volume, has yet to report its Q3 results as of the end of October but it was up 6.2% through June, including inorganic growth.

ABI, third in China, was up 4.2% in 9M '12 and its focus brands, Bud, Harbin and Sedrin, grew strongly at 11.1%. Yanjing grew only 0.8%, including a small amount of inorganic volume, while Carlsberg, the market leader in Western China, reported a national share gain in its H1 12 results.

In the premium beer segment, Tsingtao and ABI have distinct leads. CR Snow is aggressively playing catch up and Carlsberg Chill is the second-ranked brand in the international premium category behind the strong market leader, Budweiser.

Yanjing has less of a presence in above-popular segments and there is scarcely another brewer in China with a meaningful premium segment presence, excluding Heineken APB, which is third in international premiums.

In the aggregate, the Top Four grew their combined share to 71% in 9M '12. Their shares of both profitability and the premium segments are significantly higher. The implication is that the viability of being a smaller brewer in China is decreasing markedly.

Intensifying competition

As the Top Four dominate growth, turf battles rage among them in local markets throughout the country. A handful of remaining regional players with significant shares in their home markets exacerbate the competitive landscape. These battles, along with the escalation of costs cited above, are taking a toll on profitability.

Based on Seema analysis, a Chinese brewer targeting the mass market typically needs at least 60% share in a local area to earn truly attractive profit margins, whereas shares below 30% often translate to loss-making operations. It is impossible, according to these calculations, for four brewers to profitably co-exist in the same local market.

Moreover, cross-encroachment by each Top Four brewer into as many territories as possible poses stepped-up threats in markets where one of these four controls greater than 60% share and has historically reaped the benefits of local dominance. Ground previously regarded as sacred to the entrenched leaders has been encroached upon across a number of markets. Only a few, such as Shandong (Tsingtao), Liaoning (CR Snow) and Fujian (ABI) seem secure for now.

The Top Four are now notably relying much more on organic activities than acquisitions to grow as the industry evolves. There simply are not many targets left and the independents remain so for a reason – they are less and less attractive.

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Kingway's inability to date to confirm a buyer after announcing its plan to sell early in 2012 is a case in point. The substantial gap between its price target and the amount potential suitors are willing to pay is the biggest obstacle.

Yet Kingway's performance woes and poor growth prospects have tamed appetites, too. Its H1 '12 volume fell 16.2%, resulting in a net loss after earning a small profit in H1 '11. Kingway will likely be acquired before too long but the industry has entered a new stage whereby many smaller brewers may be consolidated out because of their own extinction, not because they are sold.

Meanwhile, greenfield breweries and capacity expansions are now often more desirable than acquisitions. As a result, they have become integral components of the strategies of each Top Four brewer.

For all of China's market complexities, the key required solutions may be difficult to achieve yet they are surprisingly straightforward: (i) much more consolidation; (ii) higher prices; and (iii) further premiumisation.

The industry is moving in each of these directions, although the amount of time that will be required to get there remains highly uncertain and, frankly, unpredictable. The goal for each brewer between now and then remains to be among the winners left standing in a much healthier and more attractive market, whenever that day comes.

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