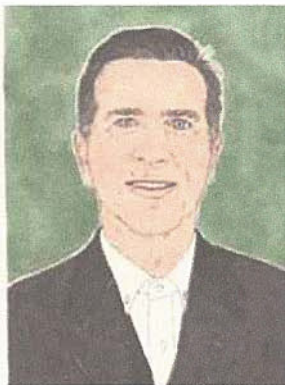


# The profit/volume paradox

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Illustration by Sophie Allsopp



Profits and volumes in China are poles apart, but as Glen Steinman writes, improved product mix and consolidation will narrow the gap

The Chinese beer market is beginning its transition from an emerging to a developed market. Since the early 1980s, China has been primarily defined by spectacular growth, evolving from less than 10 million hl to nearly 400 million hl last year. It has changed the global beer industry forever.

Yet high volume is contrasted by low pricing and, even worse, the lowest profit per hl anywhere. Indeed, from a profitability perspective, China is still a nascent beer market with less EBIT than Australia despite more than 22 times as much volume. Seema estimates China's beer industry EBIT margin was a slim 5.5% in 2008. The high volume/low profit paradox is a vortex, attracting unprecedented investment but generating low rates of return.

When and how can beer profits in China better resemble the market's volume? A considerable amount of time and, more importantly, systemic change are the ongoing prerequisites, starting with much further consolidation and a transition from the current dominance of low-priced volume to an improved segment mix.

Industry participants know too well that despite the billions of dollars that have been spent on Chinese brewery acquisitions, the market's consolidation rate is well below that of developed markets. The top three brewers, CR Snow, Tsingtao and A-B InBev (ABI), had a combined share of only 46% in 2008. Yanjing, the number four player, had 11%. Each of these players and their many competitors aim to be among the few major brewers who remain standing when the dust of consolidation settles.

A challenge for international brewers is that three of China's top four brewers (CR Snow, Tsingtao and Yanjing) are domestic-controlled, although SABMiller owns 49% of CR Snow and Asahi holds 20%

of Tsingtao. These brewers have the best recent volume and profit trends and have benefited the most from industry growth and consolidation. Indeed, we consistently advise clients to never underestimate local Chinese companies and their abilities to cost-effectively deliver quality products that are desired, and often preferred, by Chinese consumers.

The hands-on bet is that CR Snow (in close partnership with SABMiller), Tsingtao and Yanjing will be major players for years to come (although there is always speculation that Yanjing will finally tie-up with an international brewer – a notion that Yanjing has consistently resisted). ABI will also undoubtedly do everything possible to be a major market force. This all has wide-ranging implications to all other brewers seeking long-term success in China. Simply put, there will not be room for everyone in the overall market and niche strategies will reap rewards for many brewers.

In the meantime, China's beer industry will not become significantly profitable for anyone on a margin basis until it is substantially more consolidated. This scenario plays out today in most Chinese geographies where markets are ultra-competitive. The better news is that consolidation's benefits are already apparent in several markets where individual brewers, especially the national leaders, have dominant shares and EBIT margins that resemble global norms.

Ironically, decreased market growth is also part of the answer going forward. Seema has demonstrated for years that industry growth is slowing and, paradoxically, this is positive because it helps force change, specifically consolidation. Net-net, brewers increasingly compete for existing volume and they can no longer rely on natural growth,

which has hitherto translated predominantly into increased sales of low-priced beers with minimal profit.

As further context, Seema estimates China's beer market grew in 2008 by only 1.2% (much lower than official estimates). H109 growth was closer to 5%; but, the two-year CAGR will be only 3%, well below the projections of most industry watchers and participants.

Growth will continue to slow as per caps approach saturation. More positively, unitary turnover will increase as the top brewers focus on mix and consumers use increased wealth to trade-up instead of drinking more. Similar trends have been evident in several more affluent Asian markets where per caps are lower but premium mix is much higher.

In a nutshell, consolidation and increasing ASPs achieved via mix improvement are the keys to improved profitability and China's transformation into a developed beer market. Of course, there are also other critical needs, especially supply chain efficiencies and an effective regulatory system.

However none of this will occur over night. But the light at the end of the tunnel is growing brighter, as evinced by the H109 strong profit growth from low bases of CR Snow, Tsingtao, and Yanjing. Simple maths suggests that if beer pricing in China rises to a level resembling neighbouring markets and industry EBIT margin rises to just 10% (still low by global standards), the industry profit pool will grow from roughly US\$600 million today to US\$2 billion and more over time. At that point, the surviving global and local brewers will compete for a share of the market's profit and not just its volume. For those fortunate to still be around, it will have been well worth the wait and effort.