CAPI
THE CANADIAN AGRI-FOOD
POLICY INSTITUTE

A Changing World: Looking at China

Learnings from *Trade, Trust and China*:

A CAPI Conversation

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The mandate of the Canadian Agri-food Policy Institute (CAPI) is to conduct policy research and analysis on emerging agriculture and agri-food issues. CAPI does this by consulting with academia, industry stakeholders and the public, by commissioning research, and by promoting dialogue on existing and emerging issues affecting the sector.

INTRODUCTION

CAPI recently identified four strategic areas of focus for prioritizing its policy research: ***enhancing natural capital***, ***optimizing growth***, ***facilitating trade***, and ***securing public trust***. It is in the context of ***facilitating trade*** that CAPI set out to learn more about the Chinese market, how it is evolving, and how Canadian agri-food exporters could expand trade to this growing market.

On October 9, 2018, CAPI brought agri-food industry leaders together in Toronto, Ontario, for a "conversation" with Andrew Wu, Group President for Greater China of LVMH, a leading marketing expert with deep knowledge of the Chinese market. This was a follow-up to an earlier CAPI event (2013), where Mr. Wu provided important insight into the Chinese market. The learnings from this 2018 conversation, presented below, are gleaned from the discussion that took place between participants at the event and presenters, Andrew Wu, Kim McConnell, a director of the CAPI BoD and the founder and former CEO of AdFarm, and Ted Bilyea, Special Advisor to CAPI and former Executive Vice President of Maple Leaf Foods.

Major Conversation Takeaways:

1) There is an increasingly wealthy middle class, and evolving demands of both young and middle-class Chinese consumers. Given this, there are indeed opportunities for Canadian agriculture and agri-food exporters in China;

2) The Chinese market has some major challenges and pitfalls that Canadian exporters need to be aware of;

3) The Chinese marketplace will be very competitive, as other countries will be vying for a share of this market as an export destination;

4) Canadian agri-food exporters should take time to learn more about Chinese consumers and the Chinese marketplace; and

5) Canadian agri-food exporters should also consider the trade-offs associated with expanding trade, so they maintain Canada's natural capital and future sustainability.

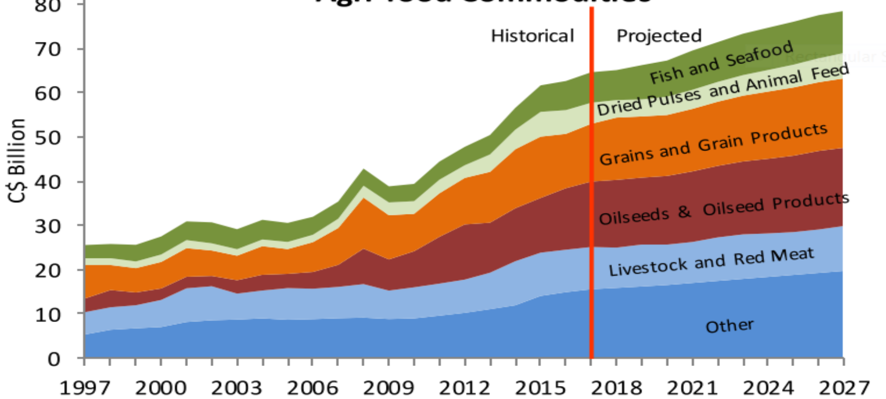
BACKGROUND

The standard of living of Canadians is closely tied to economic growth, which is strongly linked to trade. In February 2017, the Advisory Council on Economic Growth (ACEG) recommended that the government, in concert with the private sector, take a targeted approach to removing growth obstacles, thereby unleashing the significant potential of key sectors. The agriculture and agri-food sector was identified as one of these key growth sectors. It was chosen because of the strong prospects for growth of global food demand, Canada's abundance of natural resources, and a comparative advantage in producing safe, nutritious, and sustainable food.

The ACEG Strategy (the “Barton Report” 2017) called for an $11 billion increase in the export of bulk agricultural commodities and a $19 billion increase in the export of processed food products, to reach $75 billion by 2025. The target for bulk commodity exports may be achievable because of projected higher yields and the increasing demand from countries such as China and India. However, the target set for processed products may be more difficult to achieve.

Recent projections from Agriculture and Agri-Food Canada (AAFC) and the Organization for Economic Cooperation and Development (OECD) appear to support these targets. In October 2018, AAFC projected agri-food exports of $66.3 billion in 2017, with the potential to achieve the $75 billion target, when seafood is included, by 2025 (MTO, 2018). The ACEG Agri-Food Table, appointed to suggest how this growth is to be achieved, raised this target to $85 billion in its recent report (ACEG, 2018).

Chart 20: Canadian Exports of Agricultural and Agri-food Commodities



Source: Statistics Canada, AAFC Calculations.

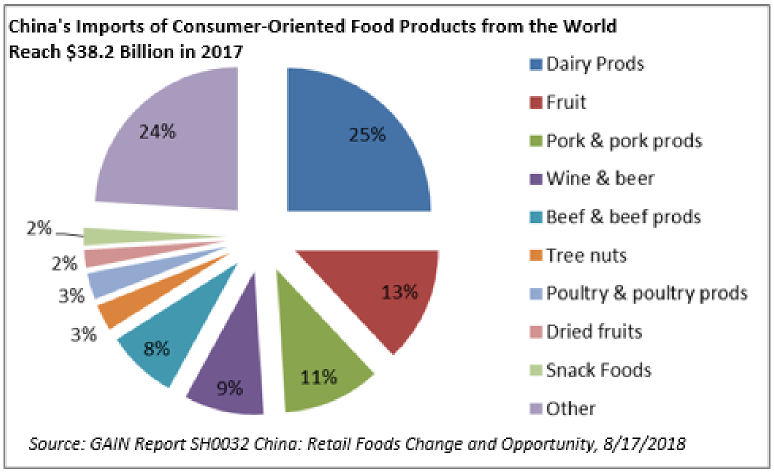
The OECD-FAO Agricultural Outlook 2018-2027 projected the growth in global demand, relative to the previous decade, to slow down over the coming decade. One major cause of this trend is the projected decline in the growth rate of Chinese Gross Domestic Product (GDP) to 5.8% per year over the 2018-27 period, down from 8% per year a decade earlier (OECD-FAO, 2018).

Canadian Takeaway:

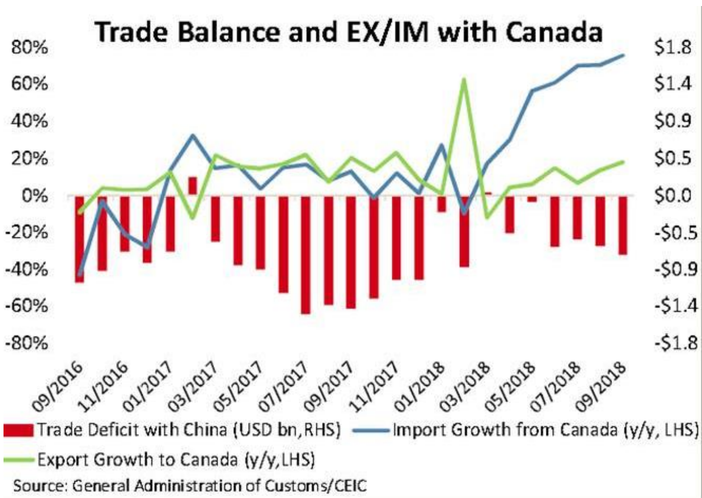
Despite the deceleration in growth, the Chinese economy remains far larger than it was a decade ago and the Chinese middle class is projected to potentially reach a billion people by 2030, with comparable purchasing power of an average Australian (CSIRO, 2017). So, China will remain the key growth market not only for Canada but for other major agri-food exporters. Therefore, it is important to understand how the Chinese market is evolving since this will be key for expanding Canadian agri-food exports there.

CHINA: A PLACE FOR CANADIAN FOOD PRODUCTS

In 2017, China’s imports of agricultural products totaled $U.S. 140 billion. Of that amount, imports of higher value consumer-oriented food products totaled $U.S. 38.2 billion. The U.S. provided approximately 10% ($3.6 billion) of these consumer-oriented imports (Global Agricultural Information Network (GAIN) Report Number: SH0032, 8/17/2018).



However, the recent U.S./China trade war, which has resulted in China imposing tariffs on U.S. agricultural imports, in retaliation for the U.S. tariffs on Chinese products, is posing some major challenges for U.S. exports to China. Canada has seen some of its agricultural exports to China rise by 80% since Chinese tariffs were imposed on U.S. agri-food products in the summer of 2018. Some of this is trade diversion, with little impact on prices of farm products due to increased supplies and lower prices in the U.S. However, Canadian meat exports to China are up, not so much due to the trade war, but more as a result of animal disease issues in China, which are disrupting China's ability to supply pork domestically, and increasing the Chinese appetite for beef and lamb.



Key Questions:

Can Canada use this time of great disruption to add more value to our agricultural products and particularly export more processed foods to China?
Can the sector achieve this level of projected exports without diversifying its export markets?
How will export market diversification occur?
Do we know enough about the Chinese market, as a target export destination, to successfully diversify trade?

Canadian Takeaway:

Recent Agri-food trade data show how dependent Canada is on the United States as an export destination for our agri-food products. In 2017, exports to the U.S. accounted for 52% of the total, while exports to China accounted for 12.1% and exports to Japan accounted for 7.3%. In order to achieve the agri-food export targets ACEG set for 2025, Canada may have to focus on diversifying trade beyond the United States.

CHINA: OPPORTUNITIES FROM A CONTINUOUSLY CHANGING MARKET

China has undergone extraordinary transformation over the past 40 years. While the country is still governed by one party, the economic environment has evolved immensely. The demographic profile of Chinese consumers has also changed considerably. It is now a *'youth driven'* market. Thus, doing business in China requires attention to the purchasing habits and psyche of the younger generation.

Current Economic Environment in China:

80% of the workers are employed by private companies

70% of the technology is generated by private companies

60% of the GDP is created by private enterprises

50% of the taxes are paid by private businesses

Currently 50% of the Chinese population is under 38 years of age. A conservative estimate would suggest there are at least 110 million middle class Chinese citizens today, with the average age of this income group at 28 years of age. This demographic group differentiates itself from previous generations by having a high propensity to spend, having new and modern items, and expressing themselves with stylish clothes as symbols of status.

Young, middle class consumers are seeking safe, healthy, and high-end products. In a recent Nielsen Survey in China, the two major trends in consumer preferences are safety (63%) and health (58%). These percentages are substantially higher than similar findings in the U.S. and Europe. China exhibits one of the fastest growths in luxury goods consumption. Name brands are very important to this demographic group. Chinese consumers want to be like consumers in other parts of the world, such as Europe and the U.S. in clothing trends, music, etc. Yet, Chinese consumers appreciate their unique trends. For example, Chinese music is really catching on and is easily accessible via WeChat, a popular mobile platform used for communication and payment in China.

Currently there are 600,000 Chinese students studying overseas. It costs approximately $70,000 per student, per year. While this is a substantial amount of money, the Chinese view this as a good investment for their future. Interestingly, over the past 40 years, 83% of these students studying abroad have returned to China. This has brought China closer to the rest of the world, in terms of earning potential and purchasing power of this younger generation. It has also raised expectations.

Canadian Takeaway:

The Chinese government, to a considerable degree, has shifted from trying to make rules to guide consumers, to simply following the market trends defined by Chinese youth. Yet, Canada and most of the Western world does not seem to fully understand this phenomenon and continues to focus on the Chinese government for promoting exports to China and resolving trade issues.

CHINA: A DIFFERENT BUSINESS MODEL

One of the significant changes in doing business with China is the evolution of the distribution models. The conventional business model is Business-to-Business (B2B) across various stages of value chains, that ends with the Business-to-Consumers (B2C). The conventional business model is used by most companies selling to China. In fact, for most companies the model looks like this: B2B2B2B2C.

However, the more successful players in China are shortening the conventional distribution model, preferably to a direct B2C. The conventional business model caused problems for major consumer luxury brands. Part of this was the difficulty in preventing fraud along the chain. Many of these luxury brands built their own distribution chain that enabled them to go directly to the consumers. This has eliminated the middleman and management challenges and enabled them to maintain the authenticity of their products and protect the premiums that their brand commands. However, the B2C business model is difficult to make work for ordinary products that are not sold as premium/luxury brand items, or for commodities and intermediate goods. This makes it difficult to penetrate this particular market segment, develop consumer loyalty, and earn premiums.

Many of the most famous global brands were initially quite successful in China. This was largely because of the lack of local Chinese competition. Yet, local competition is learning fast and is arguably more sensitive to consumers and the evolution of retail. This is one of the reasons that Unilever, Proctor & Gamble (P&G), McDonald's, Starbucks, Kentucky Fried Chicken (KFC), etc. are not as successful at present as they would like in the Chinese market.

Canadian Takeaway:

Some advice for companies outside of China, who aim to do business in China, but lack in direct access to Chinese consumers: ***team up with companies who already have connected with Chinese consumers.*** *This may also provide a venue for influencing the government through the B2C partner, who already has the connection with Chinese consumers.*

CHINA: AN EVOLVING RETAIL SECTOR

Retail and food services in China are both expanding and rapidly evolving. New ideas in retail are now often happening first in China and subsequently spreading to North American and Europe, rather than the other way around. Local Chinese retailers understand the consumer and adjust quickly to their needs. They offer unique products, which in some cases have leapfrogged international brands, such as coffee with cheese instead of cream or milk.

> *"Chinese start-ups and established companies are testing new retail models, such as 24-hour unattended convenience stores and all-inclusive mobile payment platforms. E-commerce market leaders are also opening physical retail spaces throughout China, including second- and third-tier cities."*
>
> (GAIN)

Critical to retail in the rapidly growing density of Chinese cities is the dominance of six million independent corner shops, which currently have $1.6 trillion in revenue. The 'post-1995 generation' no longer visits supermarkets. Instead they visit local 'convenience stores' several times daily. The market share of the top 10 modern food retail trade channels, including hypermarkets, supermarkets, and convenience stores reaches only 42% in China. This is well below market concentration levels of food retail in the rest of the world (China Daily, 09/20/18). In 2016, China's total retail sales for all commodities totaled US $4.98 trillion, China's total food industry gross sales were $1.30 trillion, and total e-commerce gross sales were $0.75 trillion (GAIN).

Online buying is having an impact on brick and mortar retail stores in China. Alibaba is the largest Business-to-Consumer (B2C) on-line retailer in China. The company is expanding to off-line with 40 HeMa stores currently. They plan to have 2,000 HeMa stores in 5 years. They offer successfully integrated on-line, off-line roll out, with guaranteed 30-minutes home delivery within 3km of the HeMa store. The E-Retailer, JD.com is the second largest B2C on-line retailer, with 30% of the market share, while Amazon.cn accounts for less than one percent of the market share (GAIN). However, Amazon.cn is quickly becoming a force in on-line and off-line retailing. The rapidly evolving China on-line and off-line food retail business is explained in detail in the USDA FAS Gain Report SH0032, 8/17/2018.

Ideas for retail as 'fresh' are very appealing to Chinese consumers. For example, one shop in a big city offers 100% fresh products every day. At 5:00 p.m. they start discounting food 10%. Every subsequent 30 minutes another 10% discount is applied, until all produce is sold. In the case that there is still produce available at the end of day, then it is given away. Interestingly, 85% of product is sold at full retail price. With a focus on fresh products and short, 30-minute delivery times, local retailers are drastically changing food consumption. For example, dried instant noodles are no longer as popular as they once were, when currently you can get hot, fresh, superior noodles delivered to you in 30 minutes. Restaurant chains such as McDonald's, KFC, etc. will likely be feeling the impact of this linkage of on-line, off-line rapid home or office delivery.

Canadian Takeaway:

Consumerism is driving growth in China. However, domestic supplies, particularly of food, are not likely to keep up as China may be reaching a tipping point with land, air, and water pollution choking the Chinese economy. At present, 12.3 million hectares, or 10%, of total arable land in China, is too contaminated to be used for food production. Hence, China is very interested in importing both commodities and processed food products. This is opening opportunities and challenges for Canada as a supplier of safe, sustainable, and nutritious food.

CHINA: FOUR KEY ISSUES DETRIMENTAL TO TRADE GROWTH

In November 2014, in partnership with various industry participants, CAPI organized a study tour to China and identified four key issues that are detrimental to trade growth with China: ***fraud, tariffs, regulations,*** *and* ***arbitrary inspection***.

An example of ***fraud*** is the adulteration and mislabeling of Chinese honey. Canadian honey producers estimate that half of all honey exported from China is modified by adding undeclared beet or rice syrups. There is also a history of finding chloramphenicol in Chinese honey. The practice of diluting honey not only makes Canadian honey look expensive when exported to China, but even affects sales in Canada. The price issue is compounded by unequal tariff treatment: there is no duty on Chinese honey entering Canada but there is a 16.5% duty on Canadian honey entering China. This possibly presents a good test for a premiumization strategy based on testing for authenticity.

Another area of concern is ***differential tariffs*** placed on processed products versus raw materials. China uses differential tariffs, thus making it attractive for China to import raw ingredients from Canada and process them in China. For example, there is a 20% duty on pea starch and only 7.5% duty on peas. The smaller duty on peas directs the processing of peas to China and even leaves Canada importing some of the pea protein back into Canada. There is a large enough deficit of pea protein in North America to build more protein extraction plants in Western Canada, but it would likely be difficult to sell all the starch produced. China is a large market for starch, which is made into noodles, but because of high tariffs on the processed product it would be more costly and thus more difficult to export the starch to China.

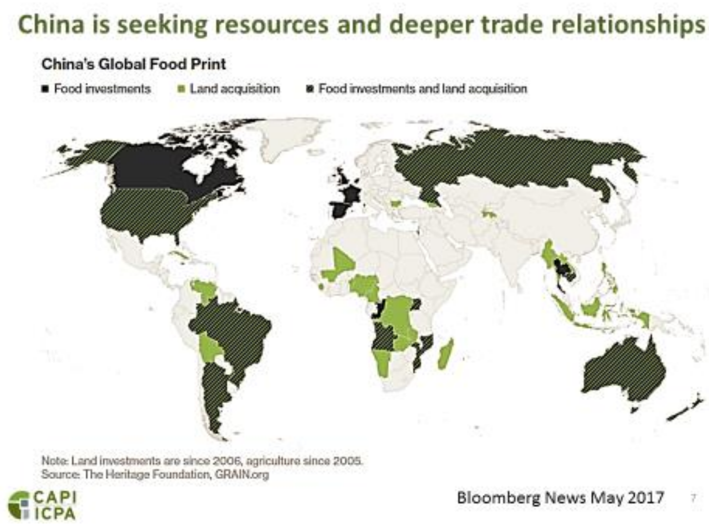
Some ***regulations*** create non-tariff barriers. For example, a major supermarket in China set up a North American buying office in Toronto, Canada. They bought frozen pork from Canada. They then made a major investment into the world's most sophisticated defrosting equipment, in order to sell case ready defrosted pork that looked and tasted better than domestic fresh pork.

The consumer ready Canadian pork shown in the counter (Ted Bilyea)

Shortly after this started, the Chinese authorities published a regulation that required date of freezing on the package of the imported pork. With transit time, clearance, and distribution in China the sticker had to show the pork as being 2 to 3 months old. Shoppers chose the "fresh" local pork despite it looking inferior. The "fresh" pork was supplied by local distributors, and its origin, and other information was opaque to consumers.

CONCLUSIONS

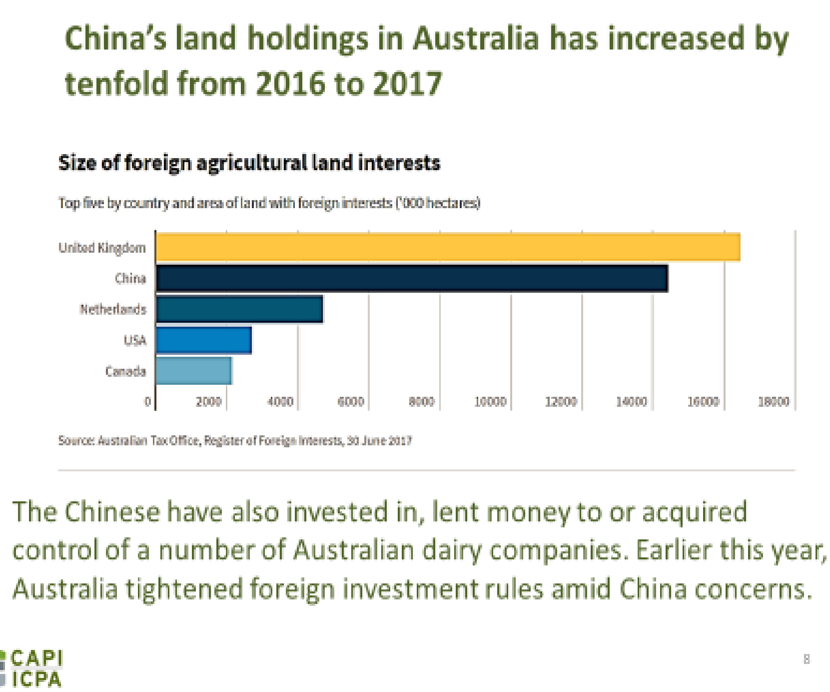
CHINA: THE RISKS



Despite a huge effort to modernize Chinese agriculture, China has a significant deficit in arable land, given its population. This has been made far worse by depletion agriculture, which has done damage to soil and water resources. Part of the solution China has taken appears to be large-scale acquisition of agricultural land and investing in primary food processing in foreign markets.

Canadian agri-food companies will find that capital is available from China to invest abroad. However, incoming foreign investment from China can lead to change in control, as demonstrated by developments in Australia and New Zealand following their Free Trade Agreements with China.

Trade with the largest market in the world could and has pressured productive capacity and the resources of a host country. In the absence of proper safeguards for the environment, the pressure for growth can lead to the deterioration of a country's natural capital. African countries that have increased trade with China have suffered from serious environmental pollution, triggered by rapid increases in production. New Zealand took a very transactional approach concerning trade with China. It became a significant supplier of dairy products and lamb to China. This led to changes in its production practices, including conversion of natural grasslands to exotic pastures, which resulted in New



Zealand becoming a country with the highest livestock emissions among developed countries. (A.J. Tanentzap, et.al., PLOS Biology, September 2015)

Canadian Takeaway:

China is an attractive destination to trade diversification. However, increased trade with China, based only on volume, could create significant pressure on Canada's natural capital.

CHINA: THE OPPORTUNITIES

China clearly presents significant opportunities for export growth and trade diversification for Canadian exporters. In order to succeed, exporters need a good understanding of the changing business model in China, as well as the consumer profile and preferences.

Canada needs more prominent *Canadian* brands to effectively penetrate the Chinese market. Canada must place greater focus and attention on premium, high-quality growing markets. Canadian exporters, particularly of premium products, need to work with extensive online and the integrated on-line/off-line distribution systems of Alibaba, JD.com, etc. They also need to market in "showcase" retail stores where their brand and actual product can be seen.

Public trust is important, as Chinese consumers are concerned about food safety and healthy food. Canada produces and exports safe and healthy food products. This needs to be translated into relevant and meaningful messages to Chinese consumers.

Finally, Canada is not effectively utilizing Canadian-educated Chinese students that return to China as ambassadors for Canada and Canadian products and could work with Canadian exporters of agri-food products to understand consumer trends in China.

The Chinese market offers significant growth opportunities which can contribute to the Advisory Council on Economic Growth's (ACEG) vision that: *"Canada will become the trusted global leader in safe, nutritious, and sustainable food for the 21st century*". In order to achieve that vision, however, Canada needs to make sure that proper policies, regulations, and legal framework are in place so that we can feed China sustainably, without being swallowed up.

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