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HRI Food Service Sector

Mainland China HRI sector Annual Report

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Report Highlights: As one of the earliest sectors opened to foreign investment, China's Hotel Restaurant and Institutional (HRI) sector continued to enjoy phenomenal and sustained growth in 2005 with revenues totaling US \$110 billion. While the sector continues to undergo significant change, branding, franchising, off-site catering, informational technology, and portion control are all increasingly playing a role. Prosperous urban consumers are also changing with preferences moving rapidly toward healthy, nutritious, fast, and safe menus. High-end HRI markets have moved well beyond traditional major markets of Beijing, Guangzhou and Shanghai and into China's major Emerging City Markets (ECM).

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Part I. Market Summary

A. Market Overview:

As one of the earliest sectors opened to foreign investment in the 1980's, China's Hotel Restaurant and Institutional sector developed slowly until taking off in the early 90's. Driven by rapid and steady economic growth, rising urban incomes, and sustained prosperity, the sector has continued to enjoy double-digit expansion for each of the last 15 years. A growing urban consumer base combined with rising incomes has made the sector a key consumption driver. According to the Ministry of Commerce (MOFCOM), despite Avian Influenza, SARS, and other scares, HRI revenues totaled \$109.53 billion in 2005 or 16.8% over last year, accounting for 13.9% of total domestic consumption sales revenue.

China's HRI market is 159 times larger now than it was in 1978, and is characterized by: Annual per capita consumption of RMB 677 (US \$84.20) in 2005, or 17.6% higher than any previous level attained; Stable market conditions with less volatile growth; High-risk investment and expansion less common; Direct franchising is on the rise with profit margins averaging near 50%; Value of branding widely accepted and chain stores-franchising are key HRI elements; Consumer preference are moving toward healthy, nutritious, and safe menus.

HRI sales typically peak in December, and hit bottom in April. Working social events, outings with family & friends, biz entertaining all drive HRI revenue. As holidays tend to be concentrated in the last four months of the year, such as Mid-Autumn Festival, Christmas, National Day, and Solar New Year growth is more skewed to the second half of the year.



Consumers with the highest disposable incomes tend to be concentrated in cities along the Pearl River Delta, Shanghai and Beijing. Perhaps not surprisingly, in 2004 Shanghai's per capita dining out consumption levels were 3 times the national average with Tianjin, Beijing and Guangdong Province 2 times the average. However, Guangzhou at US \$515.30 per capita spent on dining out annually is clearly the undisputed leader at 7 times the national average in China. In Shanghai, consumers increasingly prefer to save time spent on cooking at home, even if on average it's US \$7 more expensive to eat out.

Chinese families like to celebrate holidays and personal milestones by going out to eat at restaurants, because most urban Chinese still live in small apartments with limited kitchens. Western-style fast food restaurants often run birthday promotions for children, while hotel restaurants target families. A family that might spend RMB 600 (US \$74) for a week's food at home will easily spend RMB 300 (US \$37) per person for a weekend meal, according to one Shanghai restaurateur who targets such business. Prosperity is spreading as the economy develops, bringing new tastes and higher-end dining to a much larger segment of the population. In fact, cities all across the country such as Qingdao, Dalian, Xiamen, Wuhan, Changsha, and others are all enjoying China's considerable economic prosperity.

Official government and business meals comprise a huge and growing market. The importance of 'face' dictates hosts pour out plenty for expensive meals, often featuring high-end imported or domestic products. Many more dishes than could ever possibly be consumed at one sitting are ordered since such meals are expensed and cost is not a factor. Restaurateurs are paying more attention to atmosphere, venue and décor to attract high-end business. In fact, one informal study completed last year estimates at least a quarter of the sector's \$109.53 billion was composed of expensed meals and beverages in 2005. Social, business and family occasions are all celebrated with a meal, where preparation, quality, and ingredients are often topics of passionate focus and discussion. Western and other cuisines including imported food are increasingly figure prominently into the HRI mix.

Insiders also cite curiosity and a growing taste for Western food as key drivers for food imports. In addition to fast food, Chinese are being drawn to more sophisticated Western-style food. Head Chef Shan, Chun-Wei of Maxim's de Paris, says most of the clientele at his Beijing restaurant used to be foreigners, but since 2004 about half are Chinese, and at the current rate expects the percentage to be nearer 75% by 2008. "Eating imported food at business-social events is regarded as conferring high social status here," says Chef Shan.

There has also been a large increase in overseas Chinese from Taiwan, Hong Kong and other places, as well as expatriates from Australia, Europe, Japan, Korea and the U.S. In some cities expatriate groups are large enough to create a market for international food by themselves, often introducing Chinese friends and associates to new tastes, preparations and hygiene. Qingdao may be a good example where large numbers of Korean expatriates have had a large influence on local cuisine in recent years. The middle class has become more aware of health and hygiene issues, propelled by SARS and Avian Influenza (AI) scares, and a series of adulterated-unsanitary food scandals. This has helped imported food indirectly as imports are perceived as safer; and it supports larger, cleaner restaurants serving higher-quality and more hygienic food. Fast food operators such as KFC, McDonald's, Pizza Hut, etc., have managed to survive food scandals such as Sudan 1, carcinogenic French fries, etc., by showing great flexibility in localizing menus to maintain market position. Nevertheless, social accountability is a new and key element for HRI operators in China, domestic and foreign.

Olympic Games Symbolize Global Integration: The 2008 Olympic Games should provide an opportunity to expose the China market even further to the world. Beijing is the focus, but the impact will no doubt be felt well beyond the capital in many other parts of China, especially Olympic cities like Tianjin, Qingdao, Qinhuangdao, Shanghai, and Shenyang. Dozens of new hotels are being built to accommodate the expected flood of visitors, and chefs from around the world have been invited to train local chefs to cook for athletes, tourists, and visitors. The Beijing Olympic Organizing Committee adopted Western Kitchen food that will reportedly account for as much as 70% of Olympic Village menu offerings, with Chinese cuisine making up the remainder. Caterers and catering service operators can apply for consideration as suppliers to the 2008 Olympics through an open-global tendering system.

2008 Olympic Games linked promotions are planned nationwide and many Chinese tourists are expected to sample international food for the first time as part of their Olympic experience. However, first and foremost, Beijing's HRI sector will directly benefit with US \$2.2 billion in incremental revenue expected in 2008. A recent provision stipulating food service operators with capacities of 100 or more must have a qualified nutritionist overseeing menu preparation. With China's extremely low ratio of 1 nutritionist for every 900 people, Beijing is desperate to meet the estimated deficit of 14,000 nutritionists in the capital alone.

Largest Restaurant and Hotel Companies in 2004					
Company Name	Sales	Outlet Name & Type	Outlets	Locations	Purchasing
Yum Group	\$1,439	KFC, Pizza Hut, Taco Bell, A&W (Fast Food)	1400	National	Direct from manufacturer
McDonald's	\$757.58	McDonald's (Fast Food)	600	National	Direct from manufacturer
Inner Mongolia Xiaofeiyang	\$524.85	Little Sheep Hot pot (Family Style)	703	National	n/a
Inner Mongolia Xiaoweiyang	\$341.31	Little Tail Sheep Hot Pot (Family Style)	417	National	n/a
Jinjiang Hotel Group	\$325.16	Jinjiang, Wanli, Xinya (Various)	160	Shanghai Region	Own buying subsidiary
Inner Mongolia Xiaomuyang	\$178.18	Little Mu Sheep Hot Pot (Family Style)	N/A	North China	n/a
Chongqing Dezhuang	\$148.80	Chongqing De Zhuang (Family Style)	240	North China, Chongqing Sichuan	Central buying for own outlets; franchisees buy locally
Chongqing Little Swan	\$146.10	Little Swan Shi Fu (Family Style)	308	National	Central buying for own outlets
Taiwan Dingxin Group	\$122.25	Dicos (Fast Food)	383	National	Direct importers
Quanjude Group	\$120.36	Quan Ju De (Family Style Peking Duck)	55	Beijing, Shanghai	Central buying from distributors
Zhongshang Haigang	\$115.50	Haigang, Prince (Family Style)	54	South China	Buy from distributors
Qinma Cultural Food & Beverage	\$102.23	Qinma Old Hot Pot (Family Style)	262	National	Central buying for own outlets
Shanghai Xinghualou	\$91.27	Xinghualou, Xinya, others (Family Style & Fast Food)	34	Shanghai-Yangtze Delta	Individual restaurants do own buying
Chongqing Huiyuan Hot Pot	\$87.27	Qi Hot Pot	150	National	Individual restaurants do own buying
Shaanxi Xi'an Catering Service Group	\$85.45	Various (Family Style)	60	Shaanxi	Pork, chicken central supply
Chongqing Oriental Caigengxiang	\$85.14	Cai Geng Xiang	138	Chongqing	Central Purchasing-Direct buying

Sales unit: Million USD
Source: China Cuisine Association;

B. Sub-sector Profiles

1. Hotels and Resorts

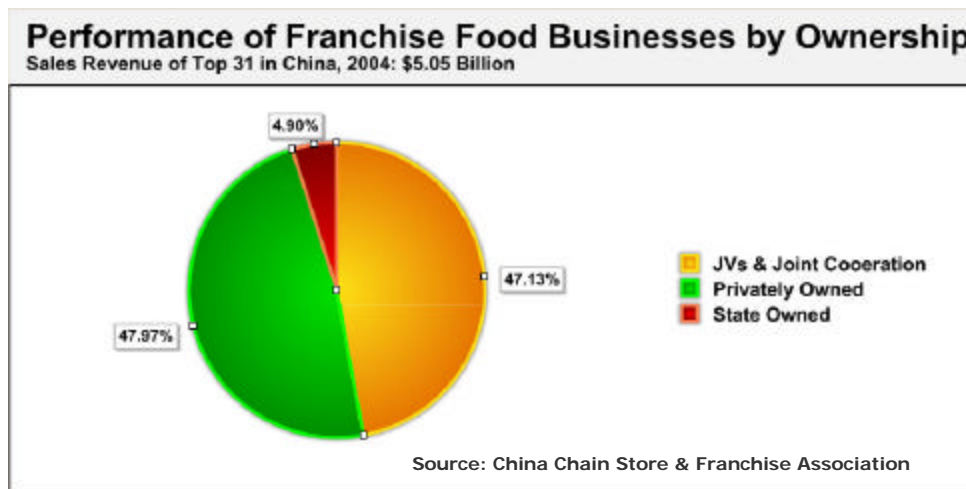
Currently only slightly more than 20% of the hotels in China are profitable according to industry insiders, and most of these are either Joint Ventures or internationally branded-managed hotels. About two thirds of the 200 five star hotels in China are foreign brands. However, with continuing economic development and a rapidly expanding tourist industry along with the 2008 Beijing Olympics and 2010 Shanghai World Expo, China's hotel industry is embracing new market opportunities. According to the latest National Tourism Administration statistics there are more than 10,000 star-rated hotels in China, with business hotels currently experiencing a boom. In addition to international management services, vocational training efforts are being strengthened to meet growing demand for food service workers. Most multinational hotel groups continue to look at the use of value added products, although executive chefs and purchasing managers continue to be driven mostly by price. Imported food traditionally makes up 30-50% of the value of food purchased by internationally managed five-star hotels although this can vary greatly from city to city.

Most Chinese hotel chains are still state-owned, but many are being forced to modernize management and develop efficient and profitable food service operations. China's largest hotel group, the Jinjiang Group, owns eight 5-star hotels in Shanghai and operates many

others all over China with reported sales of US \$300 million in 2004. Jinjiang spun off the group's food purchasing unit into a subsidiary and hired overseas consultants to modernize restaurant management. Chinese managed five-star hotels buy far less imported food than internationally managed ones, with \$350,000 the annual average for such properties.

Hotels in tourist destinations like Beijing, Suzhou, Hangzhou, Xian, etc., are more likely to have larger imported food budgets than business destinations like Dalian, Qingdao, etc. Influence of Japanese and/or Korean cuisine in northern cities is often significant

in determining local tastes and food imports.



2. Restaurants

The high-end restaurant sector is growing exponentially, although from a very low base. Restaurants specializing in non-Chinese food has tripled since 2000 in Shanghai, from 130 to 380, and nearly doubled in Beijing from 95 to 179. This market segment is more difficult to define and serve than the 5-star hotel market given import volumes are lower, with monthly expenditures typically running in the range of US \$7,500-30,000 per restaurant. Perhaps the most encouraging development is that more Chinese-style restaurants are using imported products. The Greenery, which specializes in modified foreign dishes, spends hundreds of thousands dollars a month on imported food. Louwailou, a tourist restaurant on West Lake in Hangzhou, only began buying imported food products in 2001. However, it's cuisine is 100% Chinese, but by the end of 2004 it has spent more than \$20,000 a month on beef fat; goose, duck and chicken feet; turkey; soup; wine; butter; cheese, and jam.

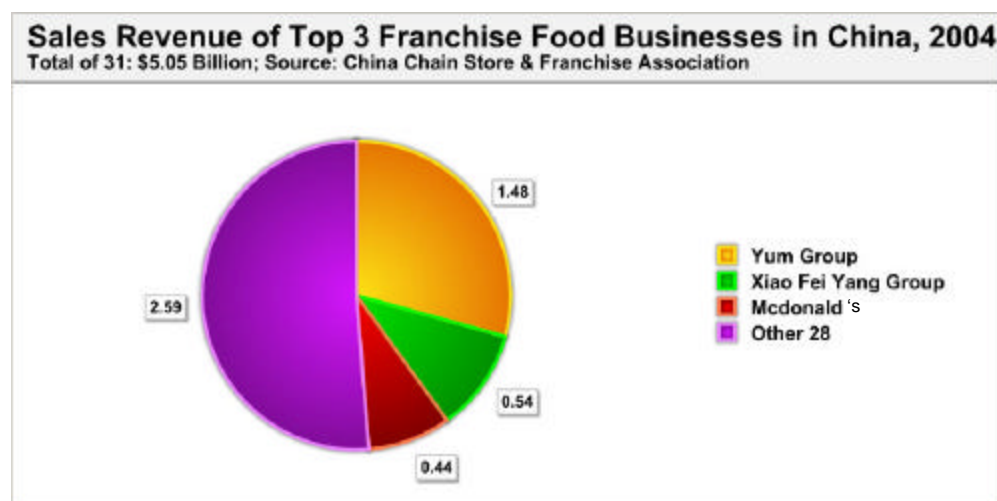
The appearance of 'fusion and modern Chinese' cuisines are helping create a new up-market tier in the Chinese Kitchen market segment, with higher checks and margins to justify imported food use. Chef Jereme Leung, at 'The Whampoa Club' on Shanghai's Bund has deliberately tried to create premium 'Shanghainese Cuisine' via a standalone restaurant outside a hotel where visiting foreign dignitaries or Chinese CEOs can comfortably be entertained. Another example of the internationalization of Shanghai's food map is the arrival of Hooters in 2004 although it took 3 years of market study for Hooters to finally make its move. The Group plans to move north to Beijing after securing the Shanghai market.

Successfully launching operations in Beijing and Shanghai in 2003, FLO Brasseries, the French restaurateur recently announced plans to bring new restaurant concepts to China this year with their higher end brands 'Hippopotamus and Romain' for French Cuisine seekers. Hippopotamus mainly serves steaks and barbecued foods and has 81 outlets world-wide while Romain is an Italian or South of France cuisine concept so far only present in France.

3. Fast Food

Yum Brands and McDonald's are by far the largest fast food chains in China. Yum has more than doubled its outlets over the past four years, from 650 to 1908 with 1,758 KFCs, 150 Pizza Huts, several Taco Bells and A & W's completing the mix. McDonald's has boosted its presence to over 666 outlets and plans to open up to 100 new outlets annually from 2006. After 15 years of successful business by rivals KFC and McDonald's in China, Burger King finally entered the market in Shanghai with its first directly managed outlet in June 2005. The company plans to develop the East China market first, then expand North to Beijing. Starbucks entered the China Market in 1999, and currently operates 165 coffee shops in 18 cities through franchisees although a transition to direct management of what the company predicts will become its largest future market. Taiwanese Dicos is another large and important player, and Yonho a traditional Chinese fast food chain that recently acquired Taiwan brand "98 Pizza" plans to expand outlets in the Yangtze Delta Region from 2006.

These companies import 5-10% of their food, a lower percentage than previously, although the volumes are not small. Often the suppliers of the companies above aren't Chinese domestic companies, rather multi-national manufactures in China. These companies have created their own standalone supply chains that overlies the domestic Chinese market.



Many new ethnic food chains are appearing such as Mongolian Hot Pot, dim sum, Beijing/Shanghai style dumplings, Cantonese, and Sichuan food in new geographic locations. And, successful chains are quickly and more often than not shamelessly imitated. Food

courts in malls have also become extremely popular although virtually none of these use imported products. A recent study found China's per capita HRI consumption is about 1/20 of that in the US. Considering the level of economic development, purchasing power, and percentage of fast food expenditures compared to total HRI revenue (60% in the US, 20% in China), it appears the fast food sector in China has room for development.

4. Institutional Food Service

In 2004 as much as 40% of HRI expenditures came from institutional food service. Working lunches, student meals, catering services for office and factory workers, travelers, exhibitions and event visitors are all contributing to a growing HRI segment. Institutional food service has gradually developed into a real market with several successful players such Shanghai's Fu Ji Food and Catering Service listed on the Hong Kong Stock Exchange in 2004 after reporting doubling of revenues in just one year. International companies such as Eurest, Sodexo, and Gate Gourmet have joined the market with a number of others reportedly on the way. However, absence of regulations, standards and transparency continues to hinder further development of this segment and to some extent prevents international brands from

entering the market. Recently issued catering business guidelines attempt to streamline procedures and at the same time tighten sanitary and health standards and awareness.

Sodexo first entered the market by winning the contract to serve Shanghai's American School catering needs in 1995, and now has over 250 food service operation points in 10 cities with revenues of more than US \$38 million in 2005. More than 90% of their business is a result of offering on-premise or built-in catering services to various production, R&D and other multinational corporate institutions and organizations. The growth of international schools catering to children of resident expatriates has given imported food a wedge in the market. There are now more than 25 such schools in Shanghai, 15 in Beijing and seven in Guangzhou. Meal budgets average RMB 25 (US \$3), and allow for the use of imported food like salmon, and other high-end products to be included several times a month.

Food service clients include cafeterias at schools, government bureaus, hospitals, factories and other businesses. In the past, when most institutions were state-owned, each ran its own cafeteria, but now services are outsourced. For example, Fu Ji's client base includes such notables as: electronics manufacturer Panasonic, Shanghai Public Security Bureau (police) and the Suzhou Industrial Park. Individual meal budgets are low and imported ingredients seldom make it into the mix. However, Chinese workers demand a warm meal for lunch and clients are increasingly more demanding because a good cafeteria attracts and keeps good employees. Airline catering has expanded along with China's high growth airline industry, and is now estimated to generate revenues of RMB 2 billion or more than \$240 million annually. Imported food content ranges up to 50% on international flights, but is much, much lower for domestic flights, and includes products like juices, nuts and dried fruit.

China's catering industry is in its infancy, yet over the last decade momentum has been building, first in the urban areas of Beijing, Shanghai, and Guangzhou as well as more recently in other high traffic cities for business and tourism. A rough estimate puts



the number of Chinese Kitchen catering businesses near 1 million, and in Shanghai catering companies with more than US \$10 million in annual revenues continue to emerge. Local surveys indicate 90% of consumers would like to try catered food or catering services provided the food is delivered in both a timely and hygienic way.

C. Regional Market Profiles

Beijing Market Summary

As China's capital, Beijing is a large metropolis with numerous political, diplomatic, cultural, educational, R & D and business institution elite. In 2004, the city enjoyed a US \$53 billion GDP and urban per capita disposable income of US \$2,000 annually. Large events and international conferences happen frequently, with resulting socialization normally taking

place over lunch, dinner and banquets. With unique World Heritage historic sites such as the Forbidden City, Summer Palace, Great Wall, etc., Beijing played host to 120 million Chinese and 4 million overseas tourists in 2004. Beijing is one of the major HRI markets in China, and is the fastest and largest growth sector among consumer businesses here. At the end of 2004, there were over 40,000 food services outlets, employing nearly 400,000 people in Beijing. Retail HRI sales revenue here has been grown at an average of 20.1% 1980 to 2000. Beijing's HRI sector had \$2.5 billion in HRI sales in 2004 and continues to enjoy growth in the number of outlets, and trade volume. In 2004, 94% of the outlets were privately operated with local as well as overseas Chinese invested businesses emerging as key market players. Branding and chain operations appear to be two high growth areas for the future, and with the 2008 Olympics just two years away, the city's hotel, restaurant and catering sectors are all gearing up with a more focused and aggressive marketing effort. The sector is looking at a healthier, service oriented, and environmentally friendly approach in hopes of capturing a slice of the Olympic Games HRI revenue pie expected to exceed US \$2.2 billion.

Beyond Beijing, with continued economic expansion, rising incomes, and growing tourism in North China, Qingdao, Dalian and Harbin have all quickly emerged as major restaurant heavy destinations. ATO Beijing seized the opportunity to partner with local HRI operators in Harbin to promote American food via the Chinese Kitchen. Based on the response from local media and consumers US food products prepared Chinese style were a big hit in Harbin last year.

Food Service

Food service-catering in Beijing can be divided into 2 major cost categories:

1. Low and mid-end market segments are strongly dominated by Lihua Food Services, developer of no-outlet food delivery service in modern China. Lihua reportedly provides food delivery service to workers at more than 100 Embassies, major sporting and other events such as Spring Festival, National Day and express train service, etc. Almost no one is untouched by the long reach of this food service giant since most office workers in Beijing have their lunch supplied by Lihua at least once a week or more. The operation has a well developed website with an online ordering and online bidding platform for food ingredient and packaging material suppliers. Lihua's advantage is price, with meals starting from less than US\$.80 including free delivery, meat and vegetable dishes plus soup and rice. The enormous purchasing and distribution power of the operator has made Lihua the 'King of Catering' in Beijing. The company now operates more than 80 service centers in 11 major cities throughout China, but Beijing remains the largest and most important focus.

2. High-end institutional food service continues to develop in Beijing but several large players such as Sodexo, and Eures dominate. Pizza Hut and several others offer Home Delivery service that is also changing the way catering is evolving in this market. Pizza Hut Home Delivery offers a full range of meals by phone delivered within 30 minutes. The company also has a membership based online ordering site where set menus for 2 are priced around US \$10 plus a \$ 0.50 delivery charge. Papa John's Pizza followed suit in offering free delivery when it entered the market last year. While this niche market is still small it's growing rapidly as consumers become more sophisticated and time conscience. In addition, most Beijing neighborhood restaurants, Chinese and other cuisines, offer off-premise boxed meal delivery on a cash and carry basis within limited geographic areas. Increasingly, neighborhood food service delivery is a way for restaurants to capture business during winter or bad weather days as well as attract new and repeat customers.

The 2008 Olympic Game's will produce a huge catering market opportunity for businesses in Beijing. In addition to the actual venues and Olympic Village, the entire city of Beijing should provide enormous growth. Organizing Committee estimates predict more than 270,000

players, officials, staff, media and 7 million visitors will have to be fed. Another forecast puts the number of tourists in excess of 125 million in 2008, with 5 million coming from outside China's borders. Catering services within the Olympic Village will be 24-hour operations, with 22,000 people eating meals daily, 50,000 meals per day, or 6,000 per hour consuming 100 tons of food. The good news is the Olympic Organizing Committee decided to adopt western food as the main menu offering along with Chinese food inside the Olympic Village. Western food will account for up to 70%. Catering service providers can participate in an open and global tendering system to compete for this business.

Restaurants

The history and culture of food here dates back several dynasties with often colorful and highly diversified descriptions used to describe Beijing's restaurants. Time-honored brands such as Quan Jude Roasted Duck, Dong Laishun Mutton Hotpot and others represent the essence of Chinese Cuisine. Modern day imitations of 'Imperial Snacks' serve to attract the eyes, noses and tongues of Chinese as well as overseas tourists. At the crossroads, all regional and ethnic cuisines meet in Beijing, with international flavors adding yet another dimension to the gastronomic landscape. Maxim's, FLO, Outback Steakhouse, KFC, Pizza Hut and McDonald's, along with Yoshinoya, and Mawaru Sushi are all familiar brands not to mention recent entrant Papa John's Pizza now with 5 outlets in the Beijing area.

Twenty years ago, the city closed down early and was shut up tight by 8:00 pm. Today, in the city that never sleeps more or less everything is available, anytime of the day or night. Wealthy and fashion conscious Chinese, expatriate residents and visitors have an exhausting list of options from which to choose. Sanlitun, once the legendary heart of Beijing's nightlife is known for its wide stretch of bars, restaurants and other entertainment. However, by the end of 2005, South Sanlitun was well on its way to being only a memory although North Street continues to thrive, albeit, a more well-heeled clientele. Drinking places such as Boys & Girls, Lan Kwai Fong, Poachers, etc., all offer live music and small dancing floors. At first glance there is not much in central Sanlitun but upon closer inspection there are a number of places behind the hotels and shopping malls, like Rock and Roll Disco, and Salsa Caribe. Worker's Stadium, west of the Sanlitun is also packed with notable bars, restaurants and entertainment places such as the Outback Steak House, Baby Face, Vic's and Mix with the latest top-40 hip hop chart busters. Houhai, situated around a man-made lake at North of Beihai Park appears to be slowing but surely replacing Sanlitun as Beijing's major bar and restaurant destination. Intentionally reminiscent of 1920's Shanghai, the gentle waves of the lake and old Beijing courtyards (Hutongs) set the scene. Much different from Sanlitun, Houhai is place for people to meet friends for drinks and discussion. Women's Street (Nu Ren Jie) and surrounding environs of Chaoyang Park are places fashionable Chinese and international types go for live jazz, rhythm of blues and Pop.

While elite niche markets have become the hallmark of Beijing's restaurant trade, middle class, white-collar and the huge tourist influx sustain the mid-market. Consumption per meal is around US \$8 per person. Present dining patterns are changing with people under 40 eating out to save time and the work of home meal preparation based on a recent survey where 14% of Beijingers gave the above reasons for eating out. Demand has gone from filling the stomach to enjoying delicious and healthy food as gastronomic entertainment.

Beijing Hotel Industry Statistics 2003-2004				
Year	Total	Five Star	Four Star	Others
2004	562	29	62	471
2003	486	26	56	404
Source: Beijing Statistical Yearbook 2004 and 2005				

Hotels

During 2005, the run-up to the Olympics has prompted a refurbishing and construction frenzy of both old and new hotels in Beijing. For the first time since its inception, the 42nd Annual Conference of International Hotel and Restaurant Association was held in Beijing in 2005. International exchanges are predicted to reach new heights in the coming 2 years as the Games approach. China's continued economic growth has expanded tourism in the capital as in other parts of the country, and 2006 through 2008 is expected to provide steady growth in Beijing's hotel market now characterized by occupancy rates well above 85%. To better prepare for the large influx of tourists, domestic and foreign, management and staff training is being reinforced. Last October when the Director of the Beijing Tourism Bureau attended meetings in the State of Nevada, agreement with the Las Vegas Institute of Hotelier Industry was reached to provide 40 senior hotel managers from Beijing opportunities to receive professional training in top Las Vegas properties. Room availability must grow by 45,000 units by the summer of 2008 Olympics, with 100 four and five star hotels needed to meet this ambitious target. Several overseas players including Carlson, a large leisure and vacation industry services provider, and Inter-Continental Hotels are seizing the opportunity to open new hotels in Beijing. With the Olympic Game's looming the travel, food and cruise service operators of the world are lining up to get into the China market.

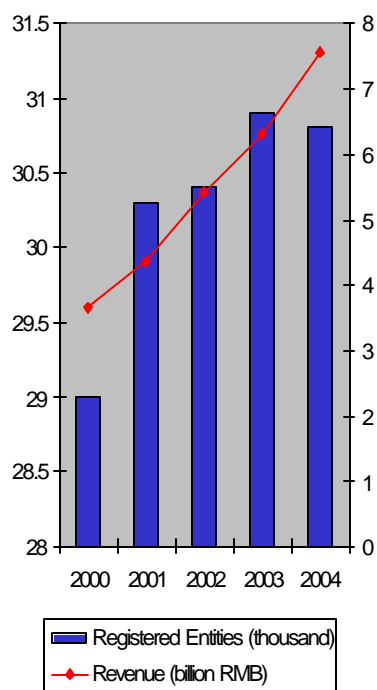
High-end hotels in Beijing have served or should continue to serve as excellent mediums for the introduction of new cuisines and foods. Mainstream locations, elegant décor and quality service all characterize such establishments that are a good place to test market and learn first-hand what the market demands. The Palace Peninsula, a five-star hotel located a block from the WanFuJing Pedestrian Street in the center of Beijing generated revenues of more than US \$11 million in 2005. The property's performance results from 600 restaurant seats generating nearly US \$20,000 per seat annually. Surprisingly, 85% of revenues come from non-resident customers. Other hotels like the Shangri-la Group operate not one but three five-star and one four-star Beijing hotels with more on the way by 2008.

Beyond Beijing, Olympic co-host Qingdao is the city with the most momentum in this sector. Kempinski, Accor, and Marriott groups are all competing to get enter the market there either via licensing or direct investment. Earlier market entrants such as: Holiday Inn, Crown Plaza and Shangri-La are all well established with highly successful high-end restaurant and catering businesses.

Shanghai Market Summary

Shanghai is one of China's leading commercial centers and home to its largest port. With a population of 20 million and a 2004 GDP estimated at \$93 billion, the city is at the center of a massive web of development. Shanghai's economy is becoming increasingly focused on finance and services, as rising prices drive manufacturing further afield, while international companies continue to pour in. Shanghai is an aggressively cosmopolitan city, which derives much of its strong sense of identity from bleeding-edge knowledge of international brands and fashions. Hence, while Shanghai has a very distinct food culture of its own, the Shanghainese are very open to new tastes, making it an excellent market for imported food.

Shanghai Catering Industry
2000-2004



Shanghai Statistical Year book

As with the rest of China, food plays a central role in all aspects of Shanghai's life. Business, networking, celebrations and friendly get-togethers are invariably conducted in conjunction with a meal. Food is widely given as a gift and an important niche market. Shanghai is also an affluent city, and local residents are more than willing to pay for quality products, provided they can be persuaded the product is truly special. As an example of this, a top local delicacy in Shanghai, the Yangcheng Lake 'hairy crab', can sell for as much as \$200/kilogram for selected 'live' crabs.

Food Service

Shanghai had a total of 30,800 registered restaurants in 2004, slightly less than in 2003. Revenues, however, jumped by almost 20% to reach RMB 7.5 billion (\$937 million). The declining number of entities relative to income reflects continued consolidation in the industry as chain stores and professional food service operations continue to displace small enterprises. It's also important to keep in mind: a.) this number lumps restaurants and catering together, and b.) the number almost certainly grossly understates the size of the industry, as many small or informal restaurants go unregistered.

Traditionally, the catering industry has been viewed as a poor venue for imported products, due to its focus on box lunches produced at a cost of less than \$1 per unit. This is starting to change, however, as consumer concerns about food safety have led many Shanghainese to distrust box lunch manufacturers. In response, several high-end restaurants have started producing box lunches, and several retailers (including Lawson's convenience stores) have begun offering Japanese-style box lunches. Significantly more expensive than traditional box lunches, the main appeal is combination of high quality with convenience. This has created a potential opportunity for U.S. products, and several companies have held discussions with Lawson's with an eye to including their products in box lunches.

Off-site catering has also become a booming business. All of the city's five-star hotels report offsite catering has mushroomed, and some report higher revenues from this than from onsite restaurants. Element Fresh, one of the city's first restaurants to stress healthy eating with large amounts of fresh, raw vegetables and functional foods, has also found big business in offsite catering. Element is also benefiting from the growing trend in favor of organic foods (noted below in the restaurant section).

Restaurants

Shanghai is home to one of China's most vibrant and innovative restaurant scenes. Although separate statistics on the restaurant industry are not available, the city has seen tremendous development. Shanghai now hosts a cohort of world-class restaurants, including Jean-Georges, Sens et Bund and Laris, catering to the city's growing business elite. Pizza restaurants are becoming increasingly popular, and important demand driver for cheese.

One of the most important trends in Shanghai's restaurant industry is the rapid emergence of high-end Chinese restaurant chains, such as Shanghai Uncle, Xiaonanguo, and Lulu's. Chinese typically prefer to entertain guests in restaurants rather than at home, and gain a great deal of 'face' by taking guests to a high-end restaurant. This is especially true for business dinners, which place a premium on over-the-top displays of generosity. At the same time, they prefer to go to a place that is seen to have reliable quality: foreign cuisines are interesting, but unfamiliar and unsuitable for some occasions. These high-end chain restaurants specialize in providing a reliably excellent dining experience with high-end ingredients and consistent preparation, at a price. They innovate in recipes, but only within certain limits. These restaurants' demand for consistent high quality, willingness to pay higher prices and very high volume (Xiaonanguo has twenty large restaurants), makes these

an excellent venue for imported ingredients. All already serve imported wine, and most import a number of other ingredients. Shanghai Uncle has an exclusive arrangement with Gallo Wines, and Lulu's featured fresh Washington Cherries as part of a promotion last fall.

Shanghai also has a large community of western restaurants, serving a mixed clientele of western expatriates, Taiwanese and local Chinese who have either lived abroad or are just interested in trying something new. Unofficial estimates put the number of western restaurants at 1,600, serving 20 different cuisines, to an expatriate community estimated at 350,000. Western restaurants are important both as customers for high end products such as wine, and as a means of introducing new products to the market. Some western restaurants have expanded to the point that they generate significant volume on their own: Moon River Diner (U.S. owned and operated), for example, now has three outlets in Shanghai. Specialty restaurants and ethnic restaurants are becoming increasingly common, creating niche markets for very high-end products. Organic food is also becoming an emerging trend, with at least two high-end organic restaurants opening in the past year. Demand is so strong that one local retailer has established strictly controlled greenhouse vegetable farms in the suburbs to cater to the needs of these restaurants.

Demand for knowledge about the preparation and handling of western food is at a premium, and the city suffers from a chronic shortage of well-trained western chefs. One estimate put the number of fully qualified chief chefs (for western food) at 100, most of them working in the star-rated hotels. This constitutes an excellent opportunity for exporters and distributors willing to commit the time to introduce and explain their products. In conjunction with the local chef associations, ATO/Shanghai regularly organizes chef seminars throughout East China that are invariably packed. These events provide USDA cooperator groups such as the Alaska Seafood Marketing Institute, the U.S. Meat Export Federation, the USA Poultry and Egg Export Council, Sunkist Growers, and the California Table Grape Commission, the opportunity to not just introduce new or unusual products, but to explain the proper preparation techniques and potential innovative uses of their products. ATO has taken these activities far beyond Shanghai to Chengdu, Chongqing, Hangzhou and Nanjing, and received an outstanding response from the local restaurant communities.

Shanghai Hotel Industry Statistics 2003-2004				
Year	Total	Five Star	Four Star	Others
2004	359	24	37	279
2003	338	20	30	288

Source: Shanghai Statistical Yearbook, 2004 and 2005

Hotels

Shanghai's hotel sector is already extremely well developed, but is expanding rapidly under pressure from overwhelming demand. Five and four star hotels are routinely fully booked, and during peak seasons there may be no rooms available at this level in the city. At the end of 2004 Shanghai had 359 star-rated hotels, of which 61 were rated four stars or higher—an increase of 21 over the previous year, 11 of which were four or five star hotels. Expansion is likely to continue or accelerate: Marriott has specifically targeted the Yangtze River Delta for development, while Holiday Inn plans to build hotels in every city in China with an airport in the next few years, including 7 new hotels in Shanghai. Business revenues for Shanghai's hotel industry amounted to over \$1.7 billion in 2004, and average room rates for 5-star hotels reached roughly \$150/night, according to local government statistics.

Restaurants and four and five star hotels continue to form the cutting edge of cuisine in Shanghai, despite growing competition from world-class standalone restaurants. This makes

the hotel industry an ideal entry point for new-to-market and high-end imported food ingredients. As noted earlier, top hotel restaurants have the most qualified chefs for foreign cuisine, and are generally more familiar with imported products. Whereas other restaurants are willing to be convinced of new product virtues, ATO's experience indicates top restaurants aggressively seek them out. They are also more familiar with menu promotions, and their high profile in the restaurant trade means that other operators tend to follow their lead.

Beyond Shanghai are literally dozens of boomtowns like Suzhou and Hangzhou, with growing expatriate communities. Hotel restaurants there often serve as the center of community life, giving them an even greater level of influence over the restaurant trade in their respective cities. Introducing new products into distant cities requires close coordination with local distributors, which is generally much more forthcoming with support of one of the city's top hotels. Once established, these distribution channels tend to persist, with product finding its way into additional venues. ATO has seen tremendous success cooperating with top hotels in these-other cities, like Wuxi, Chengdu and Chongqing, to introduce imported products.

Guangzhou Market Summary

Guangdong is often called the economic engine of Mainland China, and in 2004 the province's GDP reached RMB 1.60 trillion (US\$200billion), a 14.5% increase over the previous year. Disposable per-capita income in Guangdong is near US \$1,700 or 7.3% above 2003. With more than two decades of development, the Pearl River Delta (PRD) in Guangdong is one of the richest areas in China. The 2004 GDP of the PRD was RMB 1.36 trillion (US \$170 billion), a 19% increase from the year prior and 4.7% higher than the province's average. The provinces surrounding Guangdong are also developing at a rapid rate, with many emerging cities like Xiamen, Changsha, Fuzhou, Nanning, Guiyang, Sanya and Guilin.

The HRI sector in Guangdong province, and mainly within the PRD continues to develop at a relatively fast pace. Guangdong's HRI industry revenue in 2004 reached RMB 99.751 billion (US \$12.47 billion), a 13.7% increase over the previous year. The Cantonese are famous for eating and very open-minded toward trying new products. In Guangzhou, the capital city of Guangdong, per capita expenditures for dining out continue to rank as the highest among all cities in Mainland China at RMB 4143 (US\$515). Imported food products generally enjoy a good reputation for quality among consumers in South China.

South China HRI Sector Business Revenues			
Province	Revenues in 2003 (billion RMB)	Revenues in 2004 (billion RMB)	Percentage of change (%)
Guangdong	87.729	99.751	13.7%
Guangxi	11.528	13.712	18.9%
Fujian	21.122	25.265	19.6%
Hainan	3.099	3.543	14.3%
Hunan	2.699	3.174	17.6%
Guizhou	7.546	10.231	35.6%
Sources: China Statistics Yearbook 2004; US\$ 1 = RMB 8.04 Yuan			

Food Service

Similar to other foodservice markets in China, the catering industry in South China mainly focuses on providing lunch box types of food, usually ranging from \$1 to \$2 per unit. The low price puts the imported products in a difficult position to compete with local products. In saying that, we do notice that some local catering chains are expanding and target themselves at a higher position. One of the selling points used by these catering chains is

reliable quality, which suits the consumers' desire for food safety. The trend towards safety provides good opportunities for U.S. food products. The higher budget of those meals, usually around \$3 to \$4 per set, allows the catering company to consider using some imported products, like poultry, cheese and potato products.

The expatriate community also creates demand for high quality and western style catering service. To accommodate the growth of the expatriates living in the region, more international schools have been set up. Parents of children at these schools expect safe, high-quality meals that include a variety of Western-style dishes for their kids. This has helped give imported foods a wedge in the market.

Off-site catering is getting popular in South China. Most five-star hotels and high-end restaurants now offer offsite catering service and reported a steady increase in sales last year. Guangzhou Restaurant, a famous chain serving Cantonese-style cuisine, is providing both offsite catering service and whole sets of prepared dishes for take away. In addition to catering for special events, the holiday season also creates a large demand for such service. Usually the dishes will include some expensive ingredients, like lobster, prawns and scallops, due to higher budgets for offsite catering. Using imported ingredients will add additional value to the dishes and provides another outlet for imported food products.

Restaurants

Popular throughout China, dining out has always been a priority for Cantonese people. Famous for its food, Guangzhou is regarded as the center of delicious cuisines. Different styles of food find their own market here and the Cantonese are willing to try almost everything, though they still prefer the traditional Cantonese food. The restaurants have to be creative and offer innovative new dishes more frequently to maintain competitiveness. The chefs are integrating new food ingredients and different styles of preparation from other regions or even countries into traditional Chinese cooking, to create many "fusion" foods. California almonds are being used in innovative Chinese dishes in dozens of restaurants and last year, the "Made in Kitchen" restaurant chain in South China featured Washington State cherries in its fusion menu together with sweet and sour pork.

With the increasing awareness on food safety, consumers are more than willing to pay a premium to eat food prepared with "green/organic" and nutritional ingredients. To meet this growing demand for healthier, natural foods, more and more restaurants are offering dishes using natural and better quality ingredients. Some American products are highly appreciated by Cantonese consumers because of their various health benefits; two such examples are Wisconsin ginseng and California almonds. One of the most popular nutritional soups in South China is Wisconsin ginseng stew with chicken that is being featured in a number of restaurants due to ATO/Ginseng Board of Wisconsin initiatives.

Western-style restaurants are developing quickly in South China. Leading Western restaurant chains like the Greenery Café and Green Island serve a combination of Chinese, Southeast Asian and Western-style foods. Local owners run all of these chains; thus, the recipes are adjusted to suit local palates. Some U.S. origin food products are widely used in these chain restaurants, including pork, poultry, Alaskan seafood, and seasoning products. With increasing numbers of expatriates living in South China, more authentic Western-style restaurants are emerging. In addition to new McDonald's and Kentucky Fried Chicken outlets, new chains such as Starbucks, Taco Bell, Pizza Hut, Papa John's Pizza Hut, Subway, and Dairy Queen are entering the market place. These restaurants have been extremely successful and often play a major role in introducing Chinese consumers to Western cuisine and utilize many imported ingredients in their dishes. Cheese consumption is expected to increase rapidly due to the acceptance of pizza and other Italian style foods.

Wine consumption, especially red wine, has gone up over the past five years. In addition to old-world French wine, Australian and Chilean exporters have been very active in the market. US vineyards are slowly making a foothold in this rapidly developing market. Wine Dinners occur on a regular basis at leading restaurants in South China. Consumers here are curious about Western culture and are increasingly interested in learning more about how to select and pair wine with various cuisines.

Western fast food giants like McDonald's and KFC are expanding their business in South China. The sales revenues of these two chains in Guangdong are the highest in China. New ethnic food styles are introduced to local consumers at restaurants like Taco Bell, which serves Mexican food. As a result of the increasing number of privately owned vehicles in South China, McDonald's opened China's first two drive-through restaurants here during the past six months. About 50% of French fries used by these fast food chains are imported from the U.S. These chains also utilize corn on the cob and poultry products of U.S. origin. Currently most of the counties in Guangdong have coffee shops and western restaurants. And to meet the demand of late night working customers, from 2006 on, dozens of outlets of McDonald's in Guangzhou have been converted into 24 hours operation mode.

Local fast food chains are also striving to increase their market shares. The emphasis of local fast food chains is more on steamed foods-noodles, which they claim to be much healthier than fried items. J-Kungfu, a new Chinese-style fast food chain based in South China, is promoting its steamed meals and is the first Chinese fast food chain to have more than 100 outlets in China. Chinese fast food chains tend to use very limited quantities of imported food products because of their lower price (usually around \$2) per meal food cost formula.

Educating executives from the HRI sector to properly handle and use imported food ingredients will continue to be a main task. Education concerning the unique characteristics of U.S. food ingredients will help Chinese chefs to better understand the proper use of these products and how they can add further value to the menu. The rapid development in HRI sector has already suffered growing pains from the shortage of experienced and trained personnel, like chefs. One effective way to solve the personnel shortage is to provide proper training to chefs. ATO Guangzhou regularly organizes chef seminars and competitions in major South China cities, often with support from various U.S. producer associations. In addition to introducing new products, these seminars emphasize proper handling and preparation techniques as well as create opportunities for local chefs to understand different ways to incorporate imported products into menus. These activities are well attended and help the local industries better understand the characteristics and benefits of using U.S. food ingredients. Many U.S. products introduced to local chefs during these seminars have been widely adopted as a result of these programs. Chefs in South China are also very curious about US ingredients and western cooking methods. They are open to enhancing their cooking skills and differentiating their restaurants from their competitors.

Hotels

The hotel sector in Guangzhou is well established with many new comers entering the market. Guangzhou is going to have three or four new five-star hotels over the next two years. Many new, high-end hotels will open soon in South China's emerging markets of Shenzhen, Dongguan, Sanya, Xiamen, and Changsha. The Shangri-La chain plans to build 18 new hotels in China over the next few years, with one to open by the end of 2006 in Guangzhou. The JW Marriott, Ritz-Carlton, Shangri-La and Westin will soon open new hotels in Guangzhou creating more competition in the sector. Although there are no official statistics for Guangdong's hotel industry revenues, estimates for 2004 are about RMB 43.04 billion.

The average room rate for 5-star hotels in Guangzhou is somewhere around US\$100/night, but the price often triples during the Canton Fair period, held twice annually.

South China Hotel Industry Statistics 2004 (with star rating)				
Province/City	Five Star Hotels	Four Star Hotels	Other Star Rating Hotels	Total
Guangdong	39	124	908	1071
- Guangzhou	5	23	169	197
- Shenzhen	10	20	140	170
- Zhuhai	5	9	59	73
- Dongguan	13	18	53	84
- Foshan	1	15	59	75
Guangxi	5	19	274	298
Fujian	8	15	70	93
Hainan	10	37	92	139
Hunan	8	22	366	396
Guizhou	2	7	137	146
Sources: China Statistics Yearbook 2004 & 2005, ATO/GZ Market Survey				

The Western-style restaurants in four and five-star hotels continue to attract customers in pursuit of authentic tastes and higher quality foods. The executive chefs at these leading hotel restaurants are all well trained and experienced in using imported ingredients. Many of them have worked with ATO Guangzhou in the past through various menu promotions and chef activities, and thus were exposed to a wide variety of U.S. food ingredients. These highly respected executive chefs are market leaders in the HRI industry in South China and most of the other chefs tend to follow their practices. Continuously working with these market leaders through menu promotions and chef seminars will ensure they are properly educated and simultaneously generate demand for U.S. ingredients.

D. SWOT Analysis for US Food Products

Strengths & Opportunities	Weaknesses and Threats
Rising incomes mean more people want, and can afford, imported food	High price of imported products limits market to high-end urban restaurants
Popularity of US culture extends to food; US fast food leads in introducing Western food	Competition from Japan, Europe, Australia, Southeast Asia and other nations
US has reputation for consistent high quality, health, hygiene, and reliable supply	European, Australian-trained chefs outnumber US-trained chefs in high-end establishments
Strong US brands in a low brand environment	Poor protection for Intellectual Property; fake products may damage brand image
WTO targeted tariff cuts specifically benefit major US products	Protectionist impulses and abrupt policy changes raise non-tariff barriers
US recognized as leader in food service techniques, technology and management	Lack of knowledge about how to handle and use imported products
Growing prepared food sector caters to US strong point	Substitution by Chinese-made products as food industry develops
Improving distribution system gives imported products access to more Chinese markets	Cold chain unreliable outside major urban areas of Guangzhou, Beijing and Shanghai
Globalization, travel leads to curiosity, willingness to experiment	Long lag time between product order and delivery; high trans-Pacific shipping costs
Importance of face, gift culture boosts consumption of aspirational, high-status food	Lack of serious commitment on the part US suppliers in developing China market

Part II: ROAD MAP FOR MARKET ENTRY

A. Market Structure

1. Target Population

The top tier of China's urban population now earns a per capita income of RMB 3,500 per month, RMB 42,000 or about US \$5,000 per year. These consumers have both the desire and the means to eat out regularly in good restaurants; tend to be keen on opportunities for being educated about real and perceived sophisticated tastes; curious about and seeking exposure to culinary experiences outside China.

"Imported foods appeal to adventurous, open-minded, young, affluent urban consumers, especially high-income white collar workers," says Xuan Qiming, a manager at Louwailou, a classic Chinese restaurant in Hangzhou that bought imported food for the first time in 2001.

Beijing, Guangzhou and Shanghai, first to benefit from economic reform and foreign investment, already boast substantial urban elite populations. Growth in the imported food market follows development and integration with the global economy, factors now coming into play in many emerging city markets, vastly expanding market potential. These cities include Tianjin, Qingdao and Dalian in the north; Suzhou, Wuxi and Hangzhou in the Yangtze Delta; and Shenzhen, Dongguan, Zhuhai and other cities in the southern Pearl River Delta.

Suppliers need to keep in mind, however, that the cost profile for imported food is far higher than for domestic food, and only a small percentage of China's 1.3 billion people can afford to eat in the kinds of restaurants that use imported food. Per capita income for 800 million rural residents was only \$308 in 2003. Urban income was higher, \$1,027 per capita, but at those levels little is left for high-end meals. Nevertheless, the top 15% of city dwellers in China can now afford imported food, a market of more than 150 million people at present, and one that is growing exponentially as incomes continue to rise.

2. Distribution

China is a big country and four days by truck from Hong Kong to Beijing, and six days from Shanghai to the Far West. Food products enter the country via two major routes: through Hong Kong by the so-called "gray channel," and through five more northerly ports, often called "direct imports" because products don't make a stop in Hong Kong.

Distribution has made great strides in the major markets of Beijing, Shanghai and Guangzhou, according to restaurateurs, executive chefs and food purchasing managers. National road, port and cold chain infrastructure has improved, speeding transportation and delivery times. Companies have developed expertise in imported food, becoming larger and more focused, while many small fly-by-nighters have dropped out of the picture.

With the above said, distribution still lags far behind Western standards, especially outside the three major metropolitan areas and inland China. Cold chain is often unreliable, and purchasing managers at major hotels in cities like Xian or Harbin say they take most, if not all, perishables by air, often personally going to the airport to pick them up. Even in the major metropolitan areas, unreliable and inconsistent supply remains a large problem. "We commit to a menu, but then can't get the product," says one restaurateur. Distributors have increased warehouse space but still can't keep many items in stock, partly because of the long lead time for transoceanic orders, and partly because the import process for food is often complicated by quarantine or customs delays.

Distributors also suffer cash flow problems, because buyers usually don't pay for 45-60 days after delivery. Meanwhile, normal payment for imported food takes place 30 days after

invoicing, usually upon shipment. As distributors become more professional, fewer suppliers require full payment in advance, but even under the best of circumstance top distributors still pay deposits ranging from 30% or more on meat imports, for example.

Distributors report air shipment makes up to 10% of their imports by volume and more than twice that level by value. Air shipment of meat and dairy products, as well as some fruits and vegetables, is routine. Distributors report fewer customs and quarantine difficulties with airborne imports, as opposed to imports by sea although port of entry is also a big variable.

Gray Channel

The Hong Kong gray channel is the main supply route for products going to the Pearl River Delta and southwestern China, including the provinces of Sichuan, Yunnan, Hunan, and Chongqing. However, distributors in northern China say they have reduced reliance on the gray channel to less than 20% of total food imports, and some to as low as zero. Gray channel goods are handled by Hong Kong agents who work with other agents, often family connections, across the border in Guangdong Province. Cargo is under-invoiced to reduce tariffs. In addition, some distributors say, it is easier and less expensive to source small quantities out of Hong Kong, rather than landing full containers in northern ports.

However, WTO tariff reductions have reduced the advantages of under-invoicing, and the central government has been cracking down on customs and tax avoidance. In addition, the leading edge of growth in the imported food market is moving north, away from Guangzhou, so transportation eats up a lot of the perceived savings.

Direct Imports

Economic development is creating a high-end food market in northern China, and imported food volumes are increasing at more northerly ports such as Dalian, Tianjin (Beijing area), Qingdao, Shanghai and Xiamen, all of which are modernizing docks, warehouses and container-handling. Clearing Customs has become more transparent as standard protocols for individual products evolve port-by-port. However, arbitrary treatment and policy changes can still impede or block shipments unexpectedly, and importers complain inspectors are finicky: "They will block something for slight variations in bills of lading," says one importer.

Major distribution options include:

- Full-service distributors, discussed above.
- Third Party Logistics. China has been liberalizing its distribution industry under WTO rules, and a small group of foreign-managed companies has developed in ports and free trade zones. They offer customs clearance, foreign exchange conversion, bonded warehousing and shipment. They don't specialize in the food business, so distributors or sales agents are still needed for sales, promotion, bureaucratic hassles, such as licenses, labels, and getting paid.
- Direct sales to end-users. This is limited to high volume importers like fast food and large hotel chains. You need a full-time office or agent to handle the China end, or risk losing container-loads of product to unexpected hassles.
- US consolidators fill orders for China-based distributors, and also fill direct orders for restaurants and hotels, so you still need to make your sale in China. The efficiency of US consolidators is considered an advantage for US exporters.

- Hong Kong distributors, who frequently make use of the gray channel. Many have a large number of offices or affiliates inside China, but basically provide the equivalent of 3rd party logistics services. The supplier remains responsible for promotion, training and building a market.
- Cash 'n Carry Outlets, such as Metro or Sam's Club. Many small Chinese restaurants buy at these outlets, so it can be an indirect way of reaching the restaurant market. In these cases, the retailers worry about the hassles of in-country distribution.

A new distribution development in 2005 is 4th party logistics, a concept invented-promoted by Accenture back in 1998 that mainly involves logistics information management systems. While still in the infant stage of its lifecycle, market leaders in the HRI sector are among the first to embrace it. A good example is Beijing's Yoshinoya Fast Food Co. Ltd., where the innovative system has allowed the company to streamline purchasing, distribution and integrate accounting with front-line outlets in real time. The system substantially decreases the response time to the market while keeping stock loss low and running in the fiercely competitive 'fast food' market here. While some here have called the introduction information technology early, the concept appears to be gaining growing acceptance in the HRI sector.

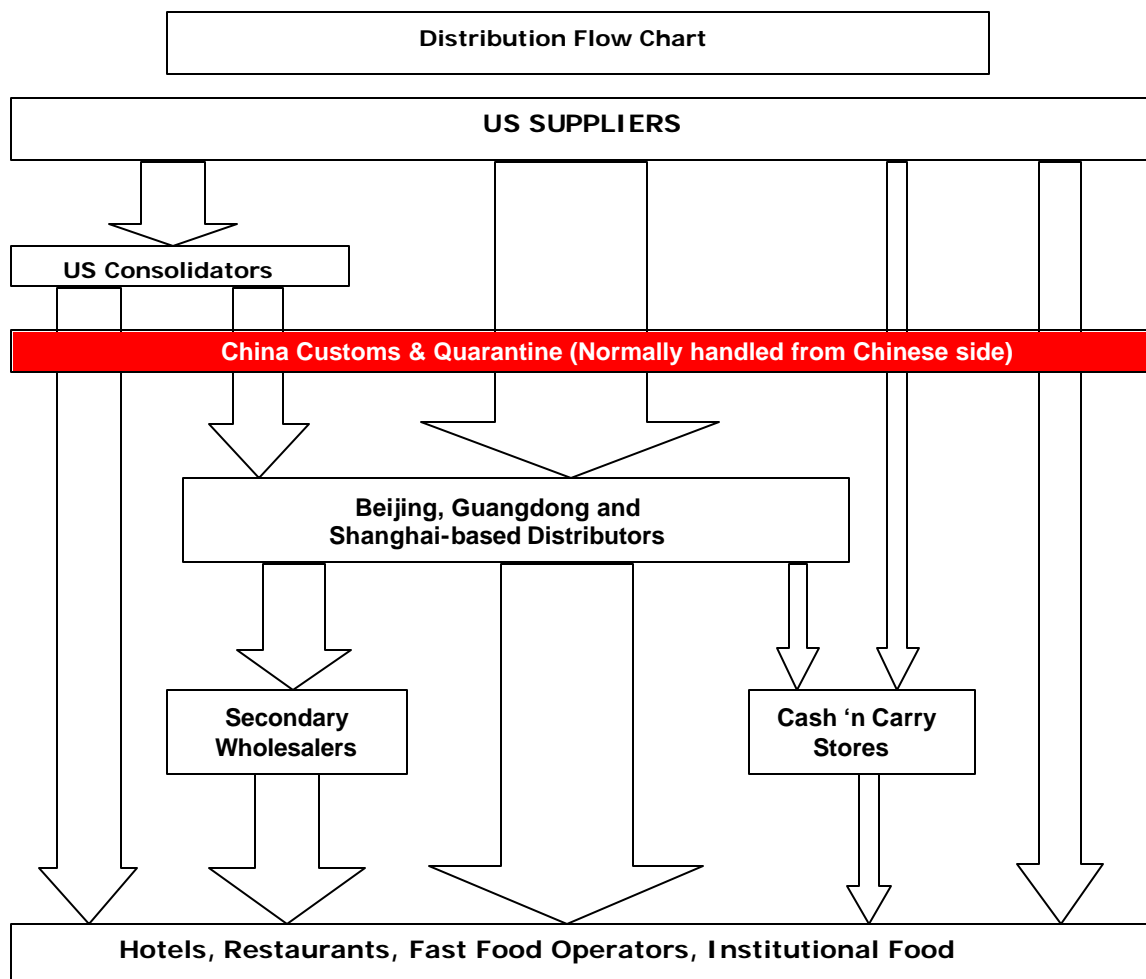
B. Entry Strategy

1. Overview

All along the value chain, experienced suppliers, distributors and buyers say the same thing: penetrating the Chinese market is rewarding, but hard work. Selling and distributing your product requires face-to-face contact, a special effort to educate the entire value chain, and attention to the details of distribution. Even good distributors in China lack marketing experience and it can also be difficult to get them to focus on promoting your product among hundreds or even thousands that they might carry. Some suppliers proceed on parallel tracks, with a small independent marketing and sales force that reports directly but also works with a distributor. Under this system, it is easier to work with several distributors while controlling rivalry and cannibalization. Whether you go for the two-track route or not, your strategy should cover two important elements as below:

- **Marketing, Sales and Education:** Introducing your product to end-users, and persuading them to use it is only the beginning. Chinese distributors and chefs are interested in handling imported products, but very often don't know how to go about it or how to properly handle or use a product. This can extend even to very elementary products, like condensed canned soup with English labeling, etc.
- **Maintaining a Distribution Channel:** At the same time, it is also important to make sure there is a physical channel for the product to reach your customers. The first question buyers ask about a new product is, "Can I order it now?" This can be bit of a chicken-and-egg syndrome for a new supplier in the China market.

2. Marketing, Sales and Education



If there is one mantra that emerges from extensive conversations with industry insiders, it is that the Chinese market needs to be educated from A-to-Z on most imported products. This means showing distributors how to handle and sell the product; developing recipes and showing chefs and kitchen workers how to prepare and serve it; and launching promotional events to familiarize consumers with the resulting menu.

Distributors won't do all this on their own, but more and more are willing work together with suppliers to make the product successful. Several full-service distributors say they focus on building worthwhile brands, which require technical support with staff, joint visits to key customers, and other joint promotions. "You have to make people understand the product," says Kerry Lu, Managing Director of Mandarin Fine Foods in Beijing.

Successful suppliers have developed a number of strategies to educate the market. On sales calls, they go fully prepared to demonstrate their product. They develop recipes for using their products in China's specialized cuisines. Some bring in chefs who set up at a local hotel for several weeks, giving intensive workshops for local chefs.

Catalogues, recipes and storage instructions are best provided in Chinese. This is particularly important at Chinese-operated hotels and restaurants, but even at five-star hotels with Western-trained executive chefs, the bulk of the staff will be unable to read labels and directions unless they're printed clearly and fully in Chinese.

Restaurateurs cite national or ethnic food fairs as an effective way to reach the ultimate consumer, the Chinese diner. Many restaurants look for opportunities to do special promotions, saying Chinese diners are always on the lookout for new sensations. Zhou Guoping, manager of the Prince Grill in Shenzhen, says a recent Mexican food promotion was successful, and the restaurant continues to serve the cuisine.

The US Department of Agriculture has several export programs that can help pay for promotion and training. Many US states and even some cities have offices in China, and many of them cooperate with the US Agricultural Trade Offices in Beijing, Guangzhou, and Shanghai. Some USDA cooperators have also held effective educational and promotional market development programs in China.

3. Establishing the Supply Channel

The most important requirement for entering the China market is to partner with a good distributor. Chinese business is famously a "relationship culture," and one major reason is that rule of law is weak and contracts are difficult to enforce. This is a major reason why face-to-face contact is necessary to begin and maintain a distributor relationship.

Your distributor should be able to handle customs, quarantine and any licensing procedures. Some distributors do their own paperwork, while others use import agents. These procedures involve so many requirements and red tape that few suppliers or end-users, including even Chinese state-owned companies, try to do it on their own.

Among the licenses and permits required may be a hygiene certificate from the US government; a Chinese import permit, and hygiene and quarantine inspection certificates on entry. Labels in Chinese may be required, but stick-on labels are acceptable if they are on the product on entry. Your distributor should be able to keep up with all this. But plan ahead – getting clearance for a label may take 2-3 months and cost RMB 2,500 (\$290).

It is crucial your importer or distributor be able to make payments in hard currency, or you will have trouble collecting payment. The government has considered plans to make the Renminbi (RMB) also called Chinese Yuan (CNY), into a fully convertible currency, but that may be years. For now, companies need special licenses to change RMB into US dollars. Also, Yuan-Dollar exchange rates fluctuate since it is no longer a fixed rate as in the past. Thus, it is important to make sure payments or costs are stated and payable in currencies agreed to by both the buyer and seller so that no one is surprised later.

Suppliers of perishable products need to be alert to cold chain procedure, because these are not well-established. Even in Beijing, Shanghai and Guangzhou, buyers use infrared guns and check in-transit thermometers for tampering. "You have to be a policeman; if not, they cheat you," says the local head of one institutional catering company.

4. Protect Your Intellectual Property Rights

Ideally, IPR protection should begin even before you begin exploring the China market. It's important to register and protect trademarks in both English and Chinese languages. China's State Administration for Industry and Commerce, involved in enforcing trademarks, has announced a special campaign to improve enforcement of agricultural related trademarks in

the autumn of 2005. Even if US goods are not being sold in China, IPR protection can be helpful in preventing fake goods produced in China from being exported to other markets. Chinese Customs provides an on-line recording service that is usually a prerequisite for customs detention of outbound infringing goods. Recognizing the large number of complaints from US manufacturers and traders regarding IPR protection, and with the aim of helping China develop an IPR system more similar to the United States, the US Embassy Beijing has developed a website-based "IPR Toolkit," providing information on Chinese laws and regulations along with steps-suggestions on how to protect American IPR. The site is at: <http://www.usembassy-china.org.cn/ipr>

5. Entry Tips

Experienced distributors and buyers offer the following advice for those entering the market:

- Take the time to investigate the market and how it works, and partner with a good distributor. Having a great product is only the beginning.
- Have some key target clients in mind before you enter the market. If a hotel, restaurant, fast food chain or air caterer is a client in the US, try to use that as an entrée to the China branch.
- Be sure that you aren't selling a commodity that competes on price and not quality with similar Chinese-made or competitor country supplier products.
- You can take a quick reading on the market by making your initial visit coincide with a food exhibition such as SIAL China or Food & Hotel China (Beijing, Guangzhou, Shanghai), or by contacting Chinese representatives at US food shows.
- In calculating your final costs, make sure you've got everything included, such as promotion, education, freight, handling, tariffs, and VAT.
- Unless you are supplying one of the fast food chains or a hotel group, only a few products ship large volumes. Most likely you won't be able to start with full container loads. Consider waiving order minimums for market entry.
- China is broken up into distinct regions and tastes vary, just as they do in the US. Shanghai food is considered sweet, for instance, while Shandong is salty. If you are successful in one region, you may still need to test when you enter another region. You may need to test or modify a product to make sure it conforms to regional tastes.
- Don't try to do too much at once. Take expansion one step at a time. Master the business at one location, among one set of clients, before moving on to others. One of the biggest mistakes you can make is to spread yourself too thin, too quickly.

Consider linking your product to special occasions such as weddings, major business successes, Christmas and Valentine's Day, or international events like Shanghai's annual Formula I Grand Prix, NBA team visits, and the 2008 Olympics in Beijing.

Part III: COMPETITION

The Chinese market for imported food is extremely competitive in almost every sector, with suppliers from around the world battling for market share. Australia, New Zealand, South Africa and the European Union are most likely to supply products that directly compete with

American goods. European suppliers in particular provide heavy support for chef training missions, and other forms of support according to local trade sources.

Future western fast food trends in China include: 1. Western food popularization via mass marketers in China like KFC and McDonald's; 2. Fusion of the cultural ambiance of western food with local flavors accepted by consumers as huge new market niche is created; 3. Green and Healthy western food become mainstream as food safety and nutrition continue to draw attention; 4. Olympic Games serve as a catalyst in the acceleration of western food internationalization in China, featuring self-service, individual western food portions influence the individual Chinese food servings, perceived as cost saving (good value) and sanitary.

Currently the big 3 US fast food operators are all present in China, with Burger King the latest entry. McDonald's and KFC are racing against time and each other. To extend the market niche, McDonald's opened 2 "drive-through" outlets in Shanghai and Dongguan early in 2006. In response to consumer demand for "health and nutrition" foods both McDonald's and Yum announced a departure from traditional western fast food, stereotyped as high in fat and calories. Yum launched its Chinese style fast food Dong Fang Ji Bai (The East is dawning) in May 2005. However, difficulty in standardization of ingredients and fabrication without losing the flavor and taste of higher calorie ingredients continues to be a serious impediment to Chinese fast food development. The ambiance of western fast food restaurants is what Chinese fast food restaurants lack and customers want most.

US food products have an excellent reputation for consistent quality, whereas some other supplier countries are considered less reliable. Chefs and buyers associated with US premium beef, France with up-market cheese, chocolate and yogurt and Norway with high-end seafood. New Zealand and Australia with clear advantages in shipping times and cost, dominate standard dairy imports destined for the HRI Sector here.

Most imported products face at least some locally manufactured and lower priced competition, unless it's something China doesn't produce at all, like olive oil. In addition, multi-nationals such as McCormick and Danone manufacture product in China. Chinese-made products are improving, and chefs frequently have to decide whether they really need import quality or prestige, or can they get by with the improving local products.

Some buyers believe China will never be able to produce commodities that require large-scale corporate farming operations. Fast food chains still need to import frozen French fries, because Chinese growers can't produce consistent quality-economically viable potatoes. Counterfeit or fake goods are another competitive factor for US products. When a brand gets established, counterfeit and cheap imitations usually follow. Fast food chains and high-end restaurants vigorously check for counterfeit products, but it's not the case everywhere.

US products currently have a slight currency advantage given the Chinese Yuan is no longer linked directly to the US Dollar, and exchange rate changes have made American products slightly less expensive and European and Australian products slightly more expensive. However, differences are minimal given US products tend to be high priced in general.

Imports and Competition			
Product Category	Major Sources	Strengths of Key Suppliers	Advantages & Disadvantages of Local Suppliers
Red Meat Imports: 106,956 tons	1. US – 28% 2. New Zealand – 22% 3. Denmark - 16%	US leads in pork, with extremely efficient Denmark no. 2; NZ specializes in lamb and mutton; Australia now leads in beef (with US out of beef market)	China is world's largest pork producer, also strong in mutton. Beef industry is nascent. Imports for all meats appeal to high quality buyers.

Poultry Imports: 185,471 tons	1. US – 43% 2. Brazil – 33% 3. Argentina – 23%	Brazil and Argentina are aggressively seeking to build on their low-cost production to expand share and attract Chinese investment in their facilities.	China's poultry industry has modern producers who are expanding into export. Much of the industry still produces live chicken for retail.
Fish Imports: 1,377,744 tons	1. Russia – 43% 2. US – 10% 3. Holland – 7%	Much of Russia's exports are fish-meal; US leads in fish fillet category with 8,639 MT	China has a large international fishing fleet
Shellfish Imports: 350,032 tons	1. North Korea – 24% 2. Peru -12% 3. Canada – 11% US – about 3%	North Korea profits from its proximity; South Korea ranks 4 th .	China has a large and aggressive domestic aquaculture industry that produces shrimp and other shellfish.
Dairy Imports: 21,098 tons	1. New Zealand – 56% 2. Australia – 17% 3. Spain - 3% US - negligible	New Zealand and Australia are aggressive suppliers and have an advantage in shipping time. France has a strong reputation among high-end cheese buyers.	China's dairy industry is growing rapidly, but still in an early stage of development. It produces milk and yogurt but doesn't compete in cheeses or butters.
Berries Imports: 13,935 tons	1. Chile – 25.5% 1. Morocco – 17% 2. Argentina – 15% US – 9%	The three leaders supply mostly counter seasonal strawberries. Canada and US lead in blackberries, blueberries, etc.	China produces strawberries, but production of other berries is just beginning.
Nuts Imports: 77,872 tons	1. Russia – 31% 2. South Korea – 17% 3. Australia – 12% US 4 th , 9%	Russia is the leading supplier of pine nuts; US strong in pistachios	China is a large grower of walnuts and other temperate nuts, but quality remains low.
Sauces & Condiments Imports: 42,713 tons	1. Japan – 58% 2. South Korea – 8% 3. Taiwan – 7% US – 4%	Leaders produce popular Asian styles. The US leads among non-Asian suppliers.	Multinational suppliers are taking market share with domestically made products.
Soups, Broths, Preparations Imports: 2,146 tons	1. US – 32% 2. Japan – 27% 3. Australia – 11%	The US is considered a technology leader in this field.	Restaurants used labor to make their own, but demand for prepared products is beginning.
Beverages Imports: 138.692	1. Brazil – 28% 2. Chile – 22% 3. Mexico – 10% US supplies small amounts of fruit juice and wine	Brazil leads in fruit juice, Chile in wine (much shipped in bulk), France in mineral water and Mexico in beer. Chile, France, Spain, Australia and US supply high-end wines. Distributors are bullish on mineral water.	China's fruit juice industry is well-developed; wine suffers from low and inconsistent quality. The highly competitive domestic beer industry includes multinational players like Budweiser.
Fresh Vegetables Imports: 2,783 tons	1. Taiwan – 43% 2. New Zealand – 18.6% 3. South Korea – 18.5% US - negligible	Taiwan and South Korea profit from proximity. Small amounts also come from European Union. Most is for high-end restaurant salad use.	Production of fresh vegetables in China has been rising by 5-10% a year for the last decade, and some imported products have been substituted domestically in recent years.
Frozen Potatoes Imports: 20,483 tons.	1. US – 65% 2. New Zealand – 24% 3. Australia – 3%	The US is the clear leader and preferred supplier.	China still has difficulty producing consistent product for the fast food French fry market
Fresh Temperate Fruits Imports: 111,099 tons	1. US – 51% 2. New Zealand – 25% 3. Chile – 12%	US leads in citrus, apples, pears; New Zealand in counter seasonal stone fruit	China's fruit production has been rising and improving in quality

Source: China Customs Statistics

Part IV: BEST PRODUCT PROSPECTS

There will always be a market for imported food products in China because restaurants want to provide customers something unique. However, the nature and product mix is fluid due to intense competition and domestic substitution. Baked potatoes and onion rings have nearly vanished, only to be replaced with imported frozen potato wedges. While many chefs cite products they'd like to access, some successful market entrants like high-quality US Pork for the up-market HRI trade is a bit surprising given China' is the world's largest pork producer.

US beef banned in 2004 due to BSE continues to be a product many chefs and food purchasing managers say they want to order as soon as the ban is lifted, because of the consistent and unparalleled quality of US beef. Salmon, from a variety of country suppliers, was the second most popular import item named by chefs and buyers.

Ready-to-use and value-added products considered unlikely prospects only a few short years ago because labor was perceived as cheap enough for restaurants to make nearly any product from scratch. However, today chefs and purchasing managers increasingly say there is now a market for ready-made, pre-cooked and portion control sauces, soups, pizzas, vegetables, fish fillets, meat products, and frozen dough.

In the Market with Potential	Present and with Good Potential	Products not Present or Diminishing
Seafood (lobster, tuna, salmon, mussels, seaweed) Beef Lamb Pork Veal Chicken paws Cream Premium yogurt Nuts and dried fruit Condiments (mustard, meat tenderizer, hot sauces) Frozen potatoes (French fries, wedges) Potato preparations Wheat flour Pasta Olive oil Coffee Chocolate Breakfast cereals, including muesli Premium fruit juices Fruit (grapes, grapefruit, oranges, Kiwi fruit) Frozen berries Wine Beer Bottled water	Pre-cooked sauces, like bolognese, portion control fish fillet and meats, cheese, Butter, Mexican, South American food, other ethnic food items like Indian, Italian, etc. Bulk cheese for catering use. Colors and flavors, canned and maraschino cherries. Turkey and other poultry.	Some Fresh Fruits (domestic substitution of apples, pears) Mayonnaise (JV manufacturing in China) Catsup (JV manufacturing in China) French jam (JV manufacturing in China) Simple cereals (corn flakes, made in China) Baked potatoes Onion rings Red cabbage (domestic substitution) Orange juice (domestic substitution) Macadamia nuts (some Chinese say these are too oily)

Part V: Post Contact and Additional Resources

For further information about the China market, as well as upcoming events and activities, please contact one of the offices below. USDA has five offices in China:

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