STAYING ON TOP

Of all the world's beer markets, China is arguably the most competitive – there's no clear-cut number one, with as many as six brewers possessing the means to claim the top rung. After a decade of consolidation and rapid expansion, the leader for the moment is CR Snow, buttressed by the success of the world's leading beer brand, Snow lager. Editor *Larry Nelson* met with CR Snow chairman and SABMiller managing director Ari Mervis to find out how the company plans to stay ahead of the chasing pack

China is a market not for the faint-hearted. You have to move quickly to keep pace, let alone gain ground, with annual demand for beer growing by double digit percentages each of the three years prior to 2009. Even the onset of the global recession hasn't dampened this enthusiasm with mid-term forecasts of continued three to five per cent growth in demand.

You can add to this continued pressure on production capabilities a scramble to consolidate the market. Undercapitalised state-run provincial and regional brewers have cashed in their brands, breweries and the loyalties of local drinkers en masse to the bigger players – multinationals such as A-B InBev, Carlsberg and Heineken/Asia Pacific Breweries, as well as home-grown participants Tsingtao and Yanjing.

Out of this melee is emerging China Resources Snow Breweries, currently claiming leadership with an estimated 21% of the country's beer volume. This is a modest percentage by the standards of most markets, but it represents an incredible 92.3 million hectolitres in a market totalling around 440mhl annually. (To put this in context, CR Snow's volume is not far off the total for the entire German market.)

Being on top of a market this big and volatile is akin to sitting on top of a volcano – there's too much bubbling up from competitor's efforts to ensure market supremacy. Staying on top requires clear marketing strategy, an ability to add capacity while controlling costs, and control of marketing channels.

Does CR Snow have in place a strategy that meets these requirements? It could well be, as detailed in a wide-ranging interview with Ari Mervis, chairman of CR Snow and managing director of SABMiller Asia, joint venture partners with China Resources Enterprise in Chinese brewing (see textbox). Our story begins with the building of the country's leading beer brand, Snow.

Snow's job

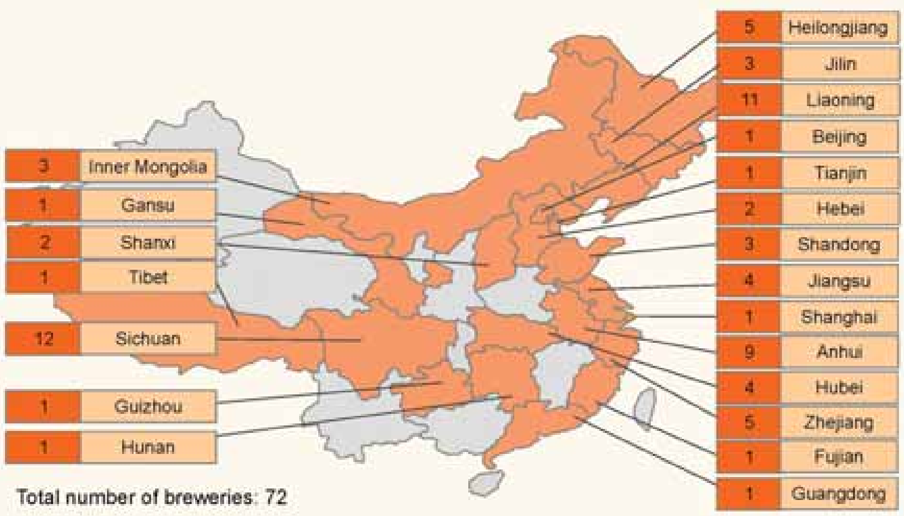
In regard to the brand portfolio, CR Snow has a clear strategy – create a national brand, taking it to an 'unassailable' position. Snow, a 3.9% abv mainstream lager, in combination with under development premium variants, accounts for 90% of the brewer's volume. That's a shade over 84mhl, making the brand the world's biggest. Its total surpasses the former number one and two brands, Budweiser and Bud Light, but not quite yet topping the combined volume of the A-B InBev stablemates.

That's a lot of faith in a single brand but Mervis makes the point that context matters, noting the success of Baltika's numbered variants in Russia, Bud Light and Bud Light Lime in the US, not to mention the global presence of brands such as Red Bull and Coca-Cola.

"It's hard to say what the ultimate solution is," he elaborates. "I think you are better positioned if you have got one healthy brand and if you have an ability to cover the majority of the mainstream offerings, which is what Snow does, and then have an ability to leverage up into premium.

"I think that as China evolves – and as it becomes more of a demand side environment versus a supply driven environment, so we tend to find more successful brands – I think the starting position will be quite an important one. That doesn't mean that everything should be Snow; there should be opportunities for other offerings within the portfolio."

There's still considerable scope to grow Snow's volumes thanks to regional variations. In some provinces it accounts for 70-80% of all



CR Snow's production network

In 2010 CR Snow added seven new breweries, three acquisitions and a further four greenfield projects. Five of these breweries are now in operation, boosting the total to 77 from the 72 presented here. According to China Resources Enterprise, annual capacity is in excess of 145 million hectolitres

Source: China Resources Enterprise

Ari Mervis: a clear strategy for Snow, the national brand, with further opportunities to develop a premium portfolio

beer sales; elsewhere the percentages are much lower, even negligible.

And then there are the brand's variants. The number has been reduced of late from an unwieldy 66 down to five, expanding from mainstream into more profitable upper mainstream and premium segments with Snow Draft and Snow Superior Crystal Draft.

These are available only at premium outlets at higher price points; Crystal Draft relies on 100% imported malted barley and hops compared with local malt and hops for mainstream Snow. The packaging offers premium cues, with clear glass and pressure sensitive labels.

CR Snow is able to command price premiums by having the right offer in the right channel through the right distribution networks. And that's to a considerable extent: Mervis estimates that consumers aren't afraid to pay 20 RMB (US $3) alongside a meal that'd cost four to five times more than elsewhere.

The conversation shifts to a report last autumn by the China Alcoholic Drinks Industry Association and its concerns over declines in bitterness and colour, speculating that there should be limits set in these regards: successful beers are around 3-4% abv with the average brand between 11 and 17 bitterness units.

Mervis agrees that there have been noticeable reductions in bitterness and alcoholic content, driven in part by increased competitiveness in the market. In short, less successful brewers have had to reduce costs.

More positively, the changes simply reflect recognition of the preferences of Chinese consumers. "The Chinese palate tends to be lighter, a bit more less bitter and closer aligned to the American palate than to the north European traditional lagers," he says. "So it has become less bitter, more sessionable by Chinese standards."

In practice, successful beers band between 3-4% abv with average brands ranging from 11-17 bitterness units. Mervis adds that there is an opportunity in a niche environment for higher bitterness unit beers.

A second market trend concerns a discernable shift from the on- to the off-trade. Where in the last five years as much as 85% of beer was consumed in bars and restaurants, today it's more of a 60-40 split.

Mervis explains, "On-premise has continued to grow; it's just that off-premise has grown disproportionately." Part of this has been the development of the off-trade channels, with the rise of supermarkets and convenience stores such as CR Enterprise's Vanguard chain, but even at home beer continues to be paired with food.

While Snow is big in China, it's a virtual unknown beyond the country's borders. In fact, it isn't available in Hong Kong, with a sampling of bar owners there not even aware of the brand's existence. Surely there is a profitable future for Snow as an export – isn't there?

"That's the question that's rightly often posed," says Mervis. "Most of our competitors have already started entering into other markets.

"We've taken a more deliberate approach, taken a look at what a Snow export offering could look like and how best to leverage the SABMiller system in that regard to make it available. So we have a project underway at the moment that will hopefully lead to some positive conclusions."

The production possibilities

CR Snow has continued to add brewing capacity as demand has grown; in 2010 SABMiller reported a 10% increase in Chinese lager volumes while the latest financials from China Resources Enterprise have Snow volumes up 16% for calendar 2010. During the year three additional breweries were acquired and four greenfield breweries commissioned, adding a further 20 million hectolitres of capacity.

At the time of the interview in late February, two of the greenfield breweries had yet to come into production, leaving today's CR Snow with 77 breweries. (Such is the pace of expansion that the most recent accounting of brewery locations obtained from China Resources Enterprise's website lists only 72 breweries.)

Scalable capacities: CR Snow breweries built to adopt changes in market conditions

Further expansion of capacity seems inevitable – but by acquisition or by greenfield expansion. After the better part of the decade of market leaders buying up the best of state and provincially owned brewers, there's little of value left amongst aging brewing capacity.

Mervis agrees that it is true state-owned assets are coming to the end of their useful lives, and adds that there are no independent five to 10 per cent market share players left. However, there are assets of interest.

"There would certainly be within geographic areas and regions where we define our business, there would be some bigger players that are available – three, four million hectolitre breweries, which is just under one per cent national [market] share – that would certainly be complimentary in terms of our footprint in a geography."

That said, the cost of constructing new capacity is considerably cheaper than in most other markets. He places the cost "to put up good breweries" as under US $25 per hectolitre, making the price of a two million hectolitre plant around US $50 million.

Interestingly, according to Mervis at this time 2mhl is the ideal operational capacity for breweries in China. While there are variations according to local populations and geographic barriers, a 2mhl plant will serve a radius of 250 to 300 kilometres and, "tends to be at the bottom of the curve; it's the sweet spot of investment."

The largest CR Snow brewery is in Shengyang, with its six million hectolitre capacity scalable up to 10mhl. The majority of new breweries are being built outside of city centres and are built modularly so that capacity can be scaled up as conditions change.

Manning levels remain well above what would be expected at breweries outside China. Mervis makes the point that some jobs that would have been handled by manual labour in Chinese plants, for example, case packing, is now being handled by automated case packers and unpackers.

He explains, "So it's more along the line that when there is a benefit of capital over labour that one will take that decision in an economic fashion, in a commercial fashion. But there isn't as if there is a drive to increase specifically the hectolitres per man in that regard. It's more a drive of trying to drill in efficient quality production line running and what the optimal utilisation is of staffing of that is."

Mervis places gross revenue per hectolitre at US $30 per hectolitre; from this beer excise

The partner: China Resources Enterprise

SABMiller's joint venture partner in CR Snow is China Resources Enterprise Ltd, a Hong Kong-listed conglomerate with interests in convenience stores, food processing and other beverages in addition to beer.

CR Snow has an eight member board, with each partner naming four directors. The equity split isn't quite the same, with CRE holding 51% that it consolidates and SABMiller claiming the remaining 49%. Mervis sits as the non-voting chairman; the position is theoretically rotating between the partners but the previous chairman was also a SABMiller appointee.

Mervis is suitably enthusiastic about the joint venture, running through a brief check list of reasons for its success.

"Number one is it's our single beer path into China for both parties so there's no conflict, there's no competition, what have you," he explains. "The second one is that I think we both have very different skill sets that we bring to the joint venture. China Resources Enterprise is owned by China Resource Group, which is ultimately controlled by Beijing, has all the right absolute local knowledge, understanding, expertise, contacts, government relationships, and all the subtleties and nuances that we'll always be 4,000 years behind on.

"SABMiller have hopefully the ability to bring some of the brewing competency and expertise and industry knowledge to the arena. So I think the two shareholders together bring very complimentary skills.

"The third factor is that the two of us together hold and own an underlying asset. What you see often happening in China joint ventures that don't work is that Western capital is injected into a local company with the expectation that they are going to get some form of control and management. Ultimately all that they are doing is funding the local business and they get frustrated; the local business gets frustrated and falls over. So together we have this underlying business."

Professions of harmony aside, nevertheless there must be some fairly lively discussions around the boardroom at the quarterly meetings.

"Absolutely, they certainly are," agrees Mervis. "We encourage it – it's the only way to actually get to optimising, get the best results out is by having those lively debates. Do we buy that, do we build that, do we do this, do we do that? All of them simply warrant the input from all parties; that certainly lends itself to healthy engagement."

China Resources Enterprise is wedded to SABMiller in all things beer but that doesn't restrict it from partnering with other companies. In 2010 it announced a joint venture with Kirin to develop, manufacture and distribute non-alcoholic products in China.

duty comes in at about US $3 to $4 per hl, a calculation that excludes profit taxes, construction and employment levies as well as regional and local taxes.

Chinese suppliers are used for capital equipment; many are in partnership with the larger international brewery suppliers. It's not just tanks and vessels: local spend extends to IT systems and some high tech equipment such as empty bottle inspectors.

Given the size of the production network, it'd be reasonable to expect some transfer of knowledge and expertise out of China being shared across SABMiller. It transpires that with the move to centralise procurement in Zug, Switzerland the CR Snow procurement team in Heilongjiang province has been called upon, to source point of sale material and refrigeration, to the mutual benefit of CR Snow and SABMiller.

Past the brewery gate

Crucial to success in the Chinese market is the ability to get one's product in the hands of consumers as quickly and inexpensively as possible. In this regard CR Snow may well be ahead of its competitors.

"One of the things that has been done exceptionally well in China by the local management is the ability to control having the right offering in the right outlet," says Mervis.

The strategy, the "big drive," is to get a disproportionate share of a distributor who has a disproportionate share of a geographic area, which could be defined as an area as small as a few city blocks. It's a drive for dedicated distributors, in short.

"The service is exceptional," says Mervis. "You can be in an apartment block and phone down to a distributor and say, 'could I please have two bottles of Snow beer, one cold and one at room temperature,' and then five minutes tops, there'll be a knock on your door and the two bottles will be delivered. That's route to market, the efficiency is incredible and unbelievably impressive."

By targeting market-leading distributors SABMiller is able to strip out the inefficiencies of working through first tier distributors who would be holding product for three or for four different suppliers. As a bonus it avoids having the distributor playing off brewers against each other and diluting control at the point of sale. It sounds a lot like the old Anheuser-Busch preference for working with dedicated wholesalers in the United States.

Mervis explains, "Ideally you get close to your dedicated distributors, that's first prize. When he's fully supportive of you, you're fully supportive of him and he's doing a great job and you have an ability to also engage with the customer through the sales force who can execute at the point of purchase."

Despite premiumisation, the scaling back of brand variations and the resultant savings in both production and marketing, as well as the identification of optimal brewery operating capacities, the question mark for all brewers in China, not just CR Snow, is profitability. (As one industry executive noted dubiously of late, "China isn't a growth market – there's no growth in profitability at all.")

SABMiller's Chinese operations aren't segmented out in its reporting; instead the figures are bundled in with those from India and other Asian markets. The best figures are provided by the JV partner, China Resources Enterprise, which notes year-on-year growth in operating profit from '09 to '10. Turnover for 2010, expressed in Hong Kong dollars, totalled $21,525 million (US $2,772m); attributable profit totalled HKD $685 (US $88m).

That's not a tremendous return but, encouragingly, and in line with competitors in China such as Carlsberg, it was also a step in the right direction – CRE noted that profits increased by 26.9% for the year. Will this continue? Quite possibly; as considered here the company's strategy certainly suggests continued flurries of profitability. Whether banking on the Snow brand one day generating an avalanche of commercial fortune remains to be seen.