The Chinese Flavor and Fragrance Industry—Local to Global?[a]

Can the country's industry expand and evolve to become a multinational contender?

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The first time I visited Food Ingredients China (FIC) in Shanghai I was blown away by not only the size of the show but also the sights, sounds and diversity of the exhibitors—particularly the local Chinese flavor and fragrance companies. In comparison to FIC, the annual expo of the Institute of Food Technologists (IFT) or Food Ingredients Europe are quiet affairs; walking the narrow aisles of FIC reminded me of the Great Wall, with hundreds of people trying to make headway all at the same time. Yet, below this apparent confusion lies a level of business activity that should not be underestimated. This is serious business and many of these companies are gaining valuable experience and expertise. Some of them will eventually become very effective competitors in the global flavor and fragrance market.

Many Chinese companies make the trip to IFT and other exhibitions to test the waters, but these modest efforts could lead to an assumption that their product offering is limited or they have a certain sameness about them, but this cannot be further from the truth. At FIC there are likely to be at least 100 Chinese flavor and fragrance companies exhibiting, all facing each other across narrow aisles as they vie for the attention of potential customers. The show covers three different venues and multiple floors and still hundreds of companies cannot get a booth, which shows the growing demand here. The one similarity FIC has with other international exhibitions is that the top 10 global companies choose not to have booths, perhaps believing that this hotbed of local business is not where they can win.

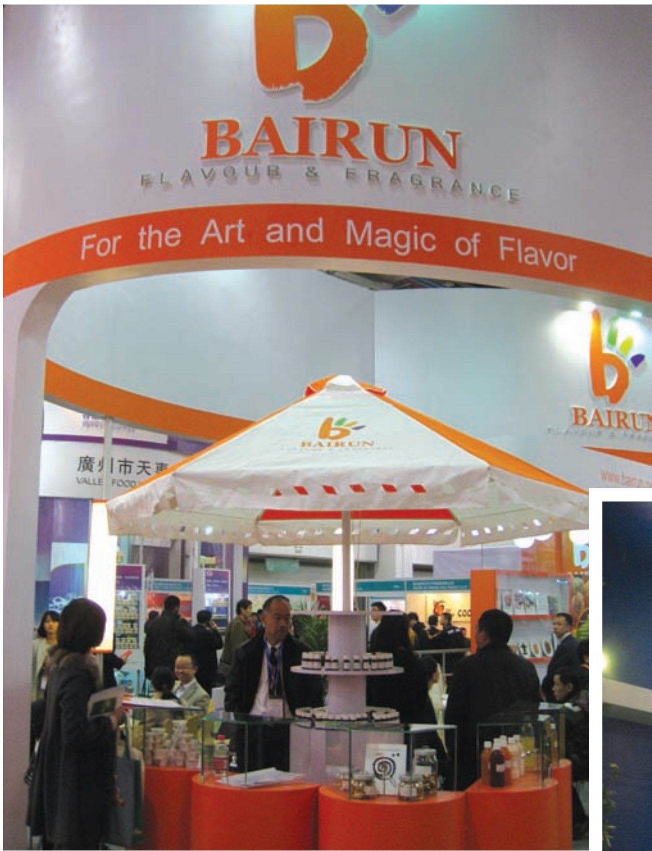
For virtually every product, the Chinese market actually presents two distinct markets: a foreign/local market, characterized by higher technology and higher price, and a second purely local market, which is characterized by lower technology and lower price.[1] The foreign/local market, while not always dominated by foreign companies, is the segment of the Chinese market with price and technology levels that are most familiar to those organizations. In the case of the flavor and fragrance industry, foreign firms dominate the market and compete with each other—and the best of the local Chinese companies—for business with multinational corporations and global and local consumer packaged goods (CPG) companies

The takeaway…

The Chinese flavor and fragrance market is characterized by:

- Low M&A activity
- Both low-tech and high-tech markets within every product category
- Progress tied to economic reforms
- Manufacturers that typically capture less than 20% of final profit on products
- A transition to higher value-added offerings

[a]I wish to acknowledge the valuable insight into the general dynamics of the industry in China gained from the following sources: AK Gupta, *Getting China and India Right: Strategies for Leveraging the World's Fastest Growing Economies for Global Advantage*. Jossey-Bass, San Francisco (2009); DH Rosen and T Hanemann, *China's Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications*. PB09-14, Peter G. Peterson Institute for International Economics, Washington, DC (2009).



The Bairun booth at FIC.

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The Meiyi F&F booth at FIC.

that demand better technology and quality. Most foreign firms don't believe the local market is a battleground on which they can be successful and so for the most part ignore it.

Leading Chinese Players

People often ask how many Chinese flavor and fragrance companies there are in China. Excluding all of the foreign companies both big and small that are investing heavily in China, estimates vary, but the number most people talk about is in the range of 800 to 1,000, which is a staggering amount if you consider the mature markets of North America or Europe. While many of these companies may have the words flavors and/or fragrances included in their registered names, this does not mean that they all manufacture compounded flavors and fragrances, but rather their main focus is this industry. In fact many of them manufacture only raw materials such as aroma chemicals or extracts, or they trade ingredients to the flavor and fragrance industry. Despite the size of the Chinese market, even the largest Chinese players at present would only be considered small to midsize in a global context. The industry is extremely fragmented, but is viable due to personal relationships, regional coverage or vast distribution networks. Where merger and acquisition (M&A) activity has significantly reduced the number of flavor and fragrance companies in the West, there has been very little M&A activity in China to date.

Who are the top five Chinese flavor and fragrance companies? While information is sketchy, I would include in this group Shanghai Apple, Meiyi, Bairun, Boton and Huabao. The latter two companies are public; most of their business comes from the tobacco industry. There are also many dynamic flavor and fragrance companies under the radar with young management with MBAs, big ideas and a lot of cash. This could be the breeding ground for the new global competitors of the future. Many of them started as traders and have started to move up the value chain as manufacturers. There is no reason why this cycle should not continue.

Rapid Rise to Flavor and Fragrance Giant

Like most things in China the pace of change in the flavor and fragrance industry is closely aligned to the economic reforms that have occurred over the last 30 years. Economic reforms began in 1978 and occurred in two stages. The first stage, in the late 1970s to early 1980s (Planned Economy), involved the winding back of collective agriculture, the opening up of the country to foreign investment and permission for entrepreneurs to start up businesses. However, most industry remained state-owned and inefficient. Flavor and fragrance compound production was limited to the economic zones of Tianjin, Shanghai and Guangzhou, but the standard was quite rudimentary and low-cost. High duty rates on imported products and a shortage of foreign exchange also restricted the growth of the industry.

It wasn't until the second stage of reform that things started to get interesting. The new Open Door reform in the late 1980s and 1990s involved the privatization and contracting out of much state-owned industry and the lifting of price controls, protectionist policies and regulations, although state monopolies remained in some key sectors. The impact of this new reform on the Chinese flavor and fragrance industry was profound. State-owned enterprises (SOE) were privatized and more foreign flavor and fragrance companies entered the market, establishing offices, labs and production facilities that in turn brought in a higher level of technical skill and Western-style business ideas. Local employees of SOEs were now permitted to move around, and so began the Big Bang of the local industry, which continues to this day. China's recent membership in the World Trade Organization, its hosting of the 2008 Olympics and the rapid urbanization of the country—unprecedented in human history—have propelled the nation to the second largest flavor and fragrance market, second only to the United States. According to IAL, the 2011 Asia-Pacific flavor market will total $2,229.4 million, making it the second largest regional flavor market, behind only North America. By 2014, Freedonia predicts that the Asia-Pacific flavor *and* fragrance markets combined will eclipse all other markets, excepting North America.

Expansion Beyond National Borders?

So what about the future? And what will the continuing growth of China and its flavor and fragrance industry mean for the global industry? For the past 30 years China has sustained high growth by producing goods for export to the world without a significant presence in the world beyond its borders. In the food industry, this process is evidenced by the rapid increase in supply from China of many of the ingredients used in the food, beverage and fragrance-related industries, but they are, for the most part, only competing on price. China's firms are increasingly being forced to fight for the vast profit margins they have traditionally conceded to foreign customers able to operate abroad.

China is now shifting to a new economic growth model that will push firms from all sectors of its economy abroad, and has now entered a period of economic adjustment as it transitions from its old growth model to a new one, a change popularly referred to as "rebalancing." Rebalanced growth requires increasing household income and domestic consumption, while manufacturing growth must focus on greater value-added production rather than on further increases in the scale of production.

With domestic economies of scale maxed out, the Chinese government realizes that China's firms must capture a greater share of the production chain, both upstream and downstream from their factories, which often means going abroad. A rebalanced growth implies a reduced reliance on exports. To prepare China for future global financial crises, China's manufacturers must capture a larger share of the value chain. The government is now making it easier for Chinese companies to move abroad and has relaxed the requirements and approvals needed. This will be felt in the years to come.

For a typical product manufactured in China, less than 20% of the final profit is captured by the Chinese manufacturer. More than 80% is enjoyed downstream in distribution, marketing, retail and customer relations, and upstream in product design, quality control, sourcing, branding, and research and development. In the flavor and fragrance industry, Chinese suppliers are commonly seen as ingredient suppliers to the foreign flavor and fragrance companies who then use these ingredients to provide value-added solutions to their customers.

Primarily, Chinese flavor and fragrance companies have largely remained within their own borders. Shanghai Apple made a foray into the United States a number of years ago, with mixed success. There is a growing trend for local companies to hire both Asian and Western flavorists and perfumers from the big global players to build the necessary expertise for future success. Chinese firms should also have a huge competitive advantage if they can take the Chinese cost model and apply it in international markets. The emerging markets of Southeast Asia, Latin America and Eastern Europe should also be fertile ground for a nimble competitive Chinese flavor and fragrance company. This could certainly impact the top 10 companies, which are gaining significant growth from these markets. Chinese CPG companies are becoming more sophisticated and are looking abroad while also demanding higher quality, better service and technologies. If the more sophisticated Chinese flavor and fragrance companies want to be part of this growth, they also need to be able to compete with the foreign firms on the global stage.

The Boton booth at FIC.

China's manufacturers ultimately will need to pursue greater profit by improving the sophistication of their operations, which similarly points abroad. The hard-to-replicate elements of economic value-added activity are intellectual property, intangible brand value, and human resources with global operating talent. The imperatives of upgrading the sophistication of Chinese manufacturing and competing for the most lucrative portions of the value chain create powerful incentives to go abroad.

The Shanghai Apple booth at FIC.

It is an interesting exercise to ask Westerners to try to name five Chinese brand names that the average Westerner would recognize. Few would be able to do so. It takes time to achieve brand recognition abroad. After 20 years following the beginning of the Japanese postwar recovery, there were at least several dozen recognizable Japanese brand names, but not so for China, despite that it is now 30 years into China's reform era. I sense that the next 10 years will see a repeat of Japan's international expansion from China. So far we are seeing this in mineral exploration, energy and the automotive industry, but the flavor and fragrance and food ingredients industries are also logical candidates for overseas expansion, given the prominent role played by Chinese ingredients in the world. Japan currently has two of the top 10 global flavor and fragrance companies—Takasago and T Hasegawa. It only makes sense that despite the slower start in China that over the next 10 years the industry should see the emergence of at least one global Chinese flavor and fragrance company, if not more.

So what is holding back these potential Chinese flavor and fragrance global players? While not wishing to oversimplify, three key areas stand out: quality, management experience, and expertise supported by good systems and technologies.

Quality and Safety

We all know about the food scares in China, so it is not surprising that food safety is the biggest concern not only in the West, but also in China. The Chinese government and its Food and Drug Administration (FDA) equivalent take this matter very seriously—as evidenced by some of the punishments meted out—and are working hard to clean up the industry and remove the low quality companies from the supply chain. However, that will take time. We shouldn't forget that in the early 1900s the United States had the same problems, which is why the US FDA was set up. Clearly, those Chinese flavor and fragrance companies that wish to go global need to overcome this perception, and quickly.

It must be remembered too that most Chinese flavor and fragrance companies have only been in existence for a short time relative to their foreign competitors. And so they are still learning and developing. The Cultural Revolution had an incredible impact on business development, which many Westerners find difficult to comprehend, but a whole generation of educators, managers and business leaders' careers were cut short. It is only now that the new business leaders are starting to catch up.

A Hybridized Future: East and West

We are witnessing incredible change in China, and the battles for market share being waged in China today could ultimately determine the fate of just about every global industry. The flavor and fragrance industry is no different. However, there are still many hurdles to be overcome. The solution for Chinese flavor and fragrance companies is not to just emulate the West, but to develop their own international model that borrows the best of the East and West. This will allow them to compete both at home and abroad. This type of hybrid approach could provide a significant competitive advantage for the Chinese flavor and fragrance companies with the right vision and ability to rise to the challenge. The benefits could be immense.

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Reference

1 J Perkowski, *Managing the Dragon: How I'm Building a Billion-Dollar Business in China*. Crown Business, New York (2008).