



The Asian Consumer



Exploring

10

HOTTEST Local F&B  
brands and their  
key drivers

From duck snacks to nuts to fresh milk tea, China's increasingly wealthy consumers are splurging on innovative food trends, with both start-ups and large established players racing to offer up new products that feed this demand. In this report, we profile the 10 local F&B brands that have risen to the top of the pack and connect the dots between them by identifying the trends they've harnessed for success: health awareness, innovative packaging, brand connection and differentiated taste. We also share strategies incumbents can use to defend their share, and highlight three names we see as best-positioned: Yili, Dali Foods and Zhou Hei Ya.

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Prices in this report are as of the September 15, 2017 market close unless indicated otherwise.

### The Asian Consumer & Global Snacks

This is the latest report from our Asian Consumer series where we explore how the new pool of customers in Asia is evolving. See below for related global reports or visit our [portal](#) for more:

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#### Global snacks:

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[A big brand playbook as the small rise up & generations transition, June 11, 2017](#)

[Food for thought - Is the world eating healthier? Jun 13, 2017](#)



# China F&B: 10 things that surprise you

## THE OPPORTUNITY



**US\$545bn**

In 2016, Chinese consumers spent RMB 3.6tn (**US\$545bn**) on packaged food and beverages. (p. 74)

## LOCAL BRAND STRENGTH



Cumulative growth of domestic vs MNC brands in China market from 2012 to 2016 (Kantar) (p. 65)

## SNACK BRAND EMERGING ONLINE



**0 → \$670mn in 4 yrs**

Established in 2012, Three Squirrels sales reached RMB 4.4bn (**US\$670mn**) in 2016, 320% of Glico China or 40% of Want Want snack sales (p. 15)

## PRODUCTIVE OFFLINE STORES



**\$0.8mn in 30m<sup>2</sup>**

Zhou Hei Ya sales per transport hub store more productive than FamilyMart and 7-11 in Shanghai (p. 22)

## CRAVING FOR QUALITY MILK TEA



Consumers are willing to wait for **60mins** in order to have a cup of milk tea in HeyTea Shanghai (p. 25)

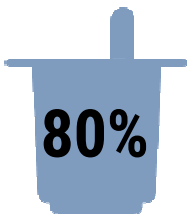
## POWER OF PACKAGING & BRANDING

**2% → 14%**

Nongfu Spring RTD tea retail sales market share gain significantly since launch of Tie Pie in 2015 (p. 29)



## THE POWER OF THE INTERNET



Le Pur Greek yogurt has **80%** of online sales, allowing ongoing monitoring of consumer preference changes and monthly launch of new flavors (p. 35)

## 'Healthy Concept'

**US\$1.5bn**

Sales of Yili's UHT yogurt brand Ambrosial are expected to reach Rmb 10bn sales (**US\$1.5bn**) in 2017E, driven by desire for yogurt flavors in low-tier cities (p. 38)

## DOMINANCE IN CHILI SAUCE



**60% for 10 yrs**

Laoganma has maintained stable market share in China for over 10 years. (p. 44)

## SPEAKING OF BRAND EQUITY

**200% premium**

Chu's Orange sell twice as expensive as other oranges of good quality in China. (p. 41)



## Overview: 10 hot brands; 4 key drivers; 3 leaders and 3 laggards

### Chinese consumer tastes diversifying rapidly; locals gaining share

In recent years, the F&B choices made by Chinese consumers have become increasingly diverse: On the one hand, we see a trend toward healthier, fresher products (e.g., chilled yogurt, reduced sugar beverages). On the other hand, more spicy but tasty products are also gaining share (savory duck, Sichuan dishes, etc.). Also, consumers prefer more convenience (online Tmall, CVS increases penetration), but there are still many consumers willing to sacrifice convenience for sought-after F&B products – such as those willing to wait 60 mins in a queue for a cup of fresh milk tea at a Heytea outlet in Shanghai’s CBD.

We see a similar divergence in brand performance as well. As consumers prefer more diversified products, some niche brands (such as Three Squirrels) are quickly gaining share and become almost comparable to the dominant F&B players; however, some large incumbents have seen declining sales in the past two to three years, citing the shortening product cycle and weaker consumption demand.

Interestingly, local brands are now quickly taking shape and building overall market share by continuing to push new brands and products. According to Nielsen, 65% of the incremental FMCG growth is driven by new products, and local companies already account for 80% of those innovative products.

### 10 hottest local F&B brands in China: What are they?

In this report, we pick up the 10 most trending brands in various subcategories based on popularity and respective sales size/growth. We surveyed the key F&B categories in China and chose brands with the highest scores on Tmall, Wechat and Baidu.

These 10 brands range from snacks (**Three Squirrels/Be & Cheery**), braised food (**Zhou Hei Ya**), fresh tea (**Heytea**), and beverages (**Nongfu Spring/Classmate Xiaoming**) to yoghurt (**Le Pur/Yili Ambrosial**), fruits (**Chu’s Orange**) and sauces (**Lao Gan Ma**). They are either start-ups or new brands founded by large F&B companies, but all of them have posted strong brand growth and established leading market positions. We identify the key success factors for each brand, how they gain market share, and how they differentiate themselves.

#### Exhibit 1: We select the top 10 brands across a wide variety of F&B segments

Top 10 hottest brands

Three Squirrels Nuts	Be & Cheery Nuts	Zhou Hei Ya Casual braised food	Heekcaa Fresh milk tea	Nongfu Spring Soft drinks
				
UPC Classmate Xiaoming RTD tea	Le Pur Greek yogurt	Yili Ambrosial Room temp yogurt	Chu's Orange Fresh oranges	Lao Gan Ma Chili sauces
				

Source: Company data.

## Four key drivers: Healthy, packaging, branding, addictive tastes

Based on this analysis, we also identify four key industry drivers:

### 1) **Healthy concept now more critical, especially for sugary categories**

Along with the gradual increase in volume penetration that China has seen in recent years, Chinese consumers now prefer quality rather than quantity, and we have seen a general trend toward healthier products or healthier concept products. Beverages with less sugar content (such as bottled water or sports drinks) have gained strong momentum in China. At the same time, we have seen a decline of carbonated soft drinks and low-content fruit juice drinks.

In this “healthy” category, we have found that room temperature yogurt (yogurt that is sterilized at high temperatures) has gained popularity in China in the past three years due to increasing consumer awareness that yogurt is good for digestion and nutrition. Hence, we see a shift from milk beverages to room temperature yogurt (despite the fact that it does not have the same health benefits of chilled yogurt/Greek yogurt).

### 2) **Packaging the gateway of product quality**

Product packaging is key to delivering a good first impression to F&B consumers. A good package can give consumers higher incentive to try products for the first time, especially for products that are new to the marketplace. Three Squirrels and Be & Cheery, for example, have upgraded their packaging in order to make them more convenient and user-friendly. Nongfu Spring and Xiaoming Classmates have changed the shape of their bottles and bottle caps to make their products distinctive from peers.

Also, packaging with small functional improvements can change consumption patterns. One example of this is the moisture adjusted package products used by Zhou Hei Ya (ZHY). This packaging makes it possible to store braised food for up to 7 days, thereby creating more snack demand, rather than dining consumption.

### 3) **Brand associations connects consumers’ loyalty**

In the 2000s, many large F&B companies expanded their sales by extending the size of their distribution networks. Companies like Tingyi and Want Want penetrated into China’s low-tier cities and rural areas with multiple layers of distributors and have established leading market shares in terms of sales volume.

Over the past 15 years or so, companies have sought to win market share by expanding their sales teams and better leveraging distributors. In more recent years, this model has not been functioning as well as before. As the distribution network is widely established and online sales have further lowered the distribution barrier, we believe brand power is becoming increasingly important. Consumers now tend to prefer products with higher brand association, not necessarily premium brands, but brands that can be linked to either product quality (Chu’s Orange, Le Pur) or an impressive/clear brand image (Three Squirrels). For example, with the emergence of Three Squirrels and Be & Cheery, we have seen a quick expansion in the nuts and dried fruits category, and nowadays consumers can easily associate the nuts category with these two brands in China.

### 4) **Addictive tastes spurs repetitive purchases**

Impressive packaging and effective branding can usually drive impulsive consumption. We believe differentiated product taste is critical to ensure repetitive consumer purchases. Products that can offer addictive tastes are able to sustain their popularity in the long run. For example, Lao Gan Ma does not focus on marketing/advertising, but still dominates the chili sauce market through its differentiated and tasty flavor. Le Pur and Nongfu Spring’s Tea Pie have also won over consumers with diversified tastes.



**Exhibit 2: Snapshot of China's 10 hottest F&B brands**












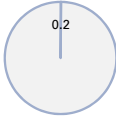
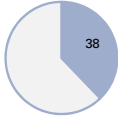

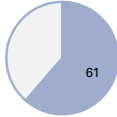





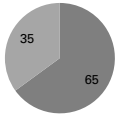
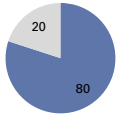
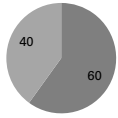
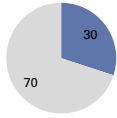
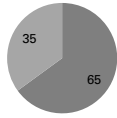
Executive summary table

Company	Three Squirrels (Private)	Hao Xiang Ni (002582 CH)	Zhou Hei Ya (1458 HK)	Shenzhen Mei Xi Xi (Private)	Nongfu Spring (Private)
Logo					
Brand	Three Squirrels	Be & Cheery	Zhou Hei Ya	Heytea	Tea Pie
Picture					
<b>Market information</b>					
Category	Nuts	Nuts	Casual braised food	Fresh milk tea	Soft drinks
Market size (RMB bn)	23.9	23.9	64.2	151.3	103.2
YOY	9%	9%	23%	8%	18%
Market share (%)					
<b>Financial information</b>					
Year of launch	2012	2003	1997	2011	2016
Sales 2016 (RMB bn)	4.4	2.7	2.8	1.0	2.0
YOY	116%	80%	16%	120%	NM
<b>General information</b>					
Target consumers	Millennials	Millennials	Female, millennials	Urban middle	Urban middle/ urban mass
Pricing (1-3 low to high)	 RMB 11 / 205g	 RMB 8.9 / 180g	 RMB 31.9 / 320g	 RMB 20 / 700ml	 RMB 4.5 / 500ml
Supply chain	OEM production	OEM production	Own production	Partial control of R&D	Own production
Marketing	IP of Three Squirrels	Product placement	Social media, ads in transport hubs	Social media (Wechat, Weibo)	Ambassadors
Distribution (%)					
Competitive strengths	Growing category, IP, online channel	Growing category, online, marketing	Better product flavor, packaging, own store	Taste, marketing, experience identity	Less sugar, packaging, marketing

Source: Company data, Goldman Sachs Global Investment Research.







**Exhibit 3: Snapshot of China's 10 hottest F&B brands (continued)**

Executive summary table

Company	Uni-president China (220 HK)	Lechun (Private)	Yili (600887 CH)	Xinping Jintai Fruit (Private)	Lao Gan Ma (Private)
Logo					
Brand	Classmate Xiaoming	Le Pur	Ambrosial	Chu's orange	Lao Gan Ma
Picture					
<b>Market information</b>					
Category	RTD tea	Chilled yogurt	UHT yogurt	Fresh oranges	Chili sauces
Market size (RMB bn)	103.2	55.8	29.6	59.0	5.9
YOY	18%	13%	51%	9%	8%
Market share (%)					
<b>Financial information</b>					
Year of launch	2015	2014	2014	2002	1996
Sales 2016 (RMB bn)	1.6	0.1	11.2	0.3	4.5
YOY	80%	NM	107%	NM	6%
<b>General information</b>					
Target consumers	95s	Young mothers, millennials	Urban mass	Urban middle	Urban mass
Pricing (1-3 low to high)	 RMB 5 / 480ml	 RMB 16 / 135g	 RMB 4 / 205g	 RMB 128-188 / 5kg	 RMB 8.6 / 275g
Supply chain	Own production	Own production	Own production	Own production	Own production
Marketing	Consumer involvement	Social media (Wechat, Weibo)	Show sponsor	Word-of-mouth, founder's mentality	Word-of-mouth
Distribution (%)					
Competitive strengths	Less sugar, packaging, marketing	Various unique flavors, online, marketing	Control of MT / TT, brand building	Taste, brand association, online	Focus, product flavor, competitive pricing

Source: Company data, Goldman Sachs Global Investment Research.

**Exhibit 4: Common factors for top 10 brands: Differentiation, healthy, convenient and brand association most important**

Companies	Brands	2016 Sales (RMB bn)	Healthy Concept	Innovative Packaging	Branding Association	Addictive Tastes
<b>Three Squirrels</b> Private	<b>Three Squirrels</b> 	Nuts 4.4	✓	✓	✓	
<b>Hao Xiang Ni</b> 002582 CH	<b>Be &amp; Cheery</b> 	Nuts 2.7	✓	✓		
<b>Zhou Hei Ya</b> 1458 HK	<b>Zhou Hei Ya</b> 	Casual braised food 2.8		✓		✓
<b>Shenzhen Mei Xi Xi</b> Private	<b>HeekCaa</b> 	Fresh milk tea 1.0	✓		✓	✓
<b>Nongfu Spring</b> Private	<b>Tea Pie</b> 	Soft drinks 2.0	✓	✓	✓	
<b>UPC</b> 0220 HK	<b>Classmate Xiaoming</b> 	RTD tea 1.6	✓	✓		
<b>Lechun</b> Private	<b>Le Pur</b> 	Chilled yogurt 0.1	✓	✓		✓
<b>Yili</b> 600887 CH	<b>Ambrosial</b> 	UHT yogurt 11.2	✓			
<b>Xinping Jintai Fruit</b> Private	<b>Chu's orange</b> 	Fresh oranges 0.3			✓	✓
<b>Lao Gan Ma</b> Private	<b>Lao Gan Ma</b> 	Chili sauces 4.5			✓	✓

Source: Goldman Sachs Global Investment Research.

### Global F&B: Healthier world with small outpace the big incumbents

Across the global F&B sector, we have also seen a broad trend toward healthier options, especially for the sugar-heavy categories.

For beverages, a gradual shift away from carbonated soft drinks (CSD) has taken place in recent years. Probiotic drinks, water or sports drinks have been outperforming CSDs. Also, a number of smaller companies are now taking share over the big incumbents such as Coca-Cola and Pepsi.

Similarly for snacks, we forecast stronger growth for the less-sweetened products as the popularity of sweet foods is fading. We expect energy drinks, fruits and nuts to post relatively fast growth. The popularity of "craft" products is also on the rise, causing large companies to lose market share.



The trend toward healthy products could ease, however, given that our global team sees cyclical factors or the possibility of consumption downgrade if the labor market recovers and disposable income improves.

### **What's in common for China?**

This global trend toward more healthy food has also taken hold in China where we are seeing a more divergent trend of consumer tastes: While sweet/high calorie products are declining, the more savory snacks, some high-calorie nuts, and even room temperature yogurt, which are regarded as "more healthy", are gaining popularity in China.

### **What's different in China?**

In the past, Chinese F&B firms have focused on expanding their distribution networks and are not that experienced in branding. Hence, this leaves more chance for smaller players to take a bigger share in China, especially now as the distribution barriers gradually diminish. We expect more radical changes in Chinese companies' branding initiatives (use of social media, online and interactive marketing) and channel shift (online proliferation, etc.)

## **How China's F&B incumbents can defend share, win over young**

With the key China and global consumer trends in mind, we also explore how China's large incumbent F&B players can defend their market share and win over younger consumers.

### **1. Brand investment**

In the past 15 years, many large F&B companies continued the expansion of their distribution networks and extended their market share. One company can win the market by pushing the same SKU to all tier cities without spending much on advertising/brand building. However, distribution potential is now more limited and lower barriers of distribution from online make brand investment more critical.

Brand investment includes upgrade of product packaging, interactive marketing/advertising and brand image. The good examples would include Nongfu Spring's RTD tea/water products and Yili/Mengniu's dairy premium marketing.

### **2. Innovation - Health concept critical**

The "healthy" concept is also critical to pushing new products. This is especially important for some brands that consumers have already associated with unhealthier products (such as instant noodles). Examples of this include Yili's UHT yogurt, Three Squirrels nuts and Nongfu's water products.

### **3. M&A or organic expansion into high-growth categories**

Another good avenue toward higher growth is expanding into the high-growth categories or acquiring smaller, but faster-growth leaders. Dali, for example, has continuously entered into new categories, such as soy milk in 2017 or sports drinks in 2013 – much faster growth sub-categories vs. the rest of the company's portfolio at the time. In the past, Chinese F&B companies have not engaged in much M&A. However, given that the major players now have sufficient capital and relatively healthy balance sheets, we see room for M&A to increase.

## **How to gain exposure? Buy Yili, Dali Foods, Zhou Hei Ya; Sell WW**

Large F&B incumbents in China have seen divergent performance in past few years. As overall volume growth has slowed and niche players have gained market share, companies that can consistently cater to new consumers with upgraded products are better positioned, in our view.

## Leaders and laggards



### Leaders

#### **Yili (600887.SS, CL-Buy): Faster-growth premium dairy leader**

**Strong premium brand position:** Through years of brand investment, Yili has established a premium positioning in China's dairy market (high end now majority of sales). This has put Yili in a good position as consumers' incomes have risen, contributing to their increased preference for high-quality products.

**New products catering to the 'healthy' concept:** Yili has been pushing new products related to yogurt and organic products category. Even though room temp yogurt is not as healthy as chilled yogurt, consumers still view it as offering health benefits. The new products account for around 20% of Yili's sales every year.

#### **Dali (3799.HK, initiate Buy): Diversified innovative F&B giant**

**Consistent category expansion to offset the declining trend:** Dali has innovated and expanded into new categories over the past 10 years. Every three to four years, Dali has launched a new brand in a different but high-growth category (herbal tea, 2007; sports drink, 2012; soy milk, 2017). The high growth of these new products has offset the slowdown in Dali's existing offering.

**Multiple brand strategy:** Dali uses a different brand name for each category of products and in many cases adopts a different positioning for categories. It adopted a follower strategy in herbal tea and sports drinks, but a more premium position for soy milk. The multiple brand strategy enables Dali to have more flexible positioning vs. single brand.

#### **Zhou Hei Ya (1458.HK, initiate Buy): A growing premium & convenient duck snack**

**Differentiated product taste and premium brand image:** Zhou Hei Ya (ZHY) has successfully differentiated its products from peers by offering a unique sweet-spicy taste, and is also the first mover in creating snack demand through its moisture adjusted packaging. For now, ZHY has established a premium brand image among consumers and consistently maintains high product quality through its directly owned operating model.

**Ample penetration expansion potential:** ZHY has less than 900 stores in China vs. peers' 7K-8K stores. ZHY is also under-exposed in North and East China. We see ample room for ZHY to expand its store count and stimulate snack demand among young consumers.

### Laggards

#### **Want Want (0151.HK, Sell): Brand under-investment has led to declining sales**

**Stale brand positioning:** WW's key milk beverage products have been in the market for more than 20 years. WW has retained its product taste, packaging and pricing through the years. However, the company has been conservative in branding/marketing investment over the past five years, which contrasts with its peers' continued product upgrades and digital marketing efforts.

**Lack of new products:** New products contribute only 2%-3% of sales every year. Although WW launches new SKUs every year, most of them disappear in the market thereafter. We believe this is mainly due to the company's strong focus on margins and limited A&P spending.

#### **Orion (271560.KS, Neutral): Need for change, all eyes on mgmnt's new initiatives**

Take a big hit in 2016, hope for change ahead: In addition to the headwinds from the recent China-Korea geopolitical tensions, Orion is facing inventory/channel issues as one of the major incumbents in the China confectionary space and has been struggling with a lack of

hit products in recent years. Management recently announced future plans for new products (including Turtle Chip launch in 2Q18E), new categories (nuts and meat jerky) and new business initiatives (bottled water business) to reinvigorate growth into its China business, which we view as a strategy into the right direction, but execution would still be a key swing factor.

### Exhibit 5: We analyze four key drivers to identify potential leaders and laggards among domestic players

Stocks related to the theme

Companies	Market cap (US\$ bn)	Sales 16-18E CAGR	Healthy Concept	Innovative Packaging	Branding Association	Addictive Tastes	Comments	Related Research
<b>Potential leaders</b>								
<i>GS Covered</i>								
<b>Yili (CL-Buy)</b> 600887 CH	Dairy 21.8	10.2%	✓		✓		Better positioned, innovative in Yogurt	<a href="#">A faster growth premium leader</a>
<b>Mengniu (Buy)</b> 2319 HK	Dairy 9.8	7.6%	✓		✓		Better positioned, innovative in Yogurt	<a href="#">Milk flowing steadily</a>
<b>Dali Foods (Buy)</b> 3799 HK	Diversified F&B 9.2	12.9%		✓			PET bottles	<a href="#">Diversified, fast-growing F&amp;B giant trading at disc.</a>
<b>Moutai (CL-Buy)</b> 600519 CH	Chinese spirits 92.5	27.4%			✓	✓	Unique flavors, best Chinese spirit brand	<a href="#">Near-term headwinds, but long-term positive</a>
<b>Zhou Hei Ya (Buy)</b> 1458 HK	Savoury Snack 2.2	19.7%		✓		✓	Unique spicy taste, MAP creates snack demand	<a href="#">A compulsively addictive duck snack</a>
<b>UPC (Neutral)</b> 220 HK	Beverages, Noodles 3.7	1.8%		✓			Strong product innovation in beverage	<a href="#">Cost control taking effect, no yet visible in sales growth</a>
<b>H&amp;H (Neutral)</b> 1112 HK	IMF, Vitamins 2.4	10.6%	✓				Ride on healthy demand of vitamin products	<a href="#">2Q acceleration in Baby Nutrition and Swisse</a>
<i>Not covered</i>								
<b>Hao Xiang Ni</b> 002582 CH	Savoury Snack 1.0	NC	✓	✓			Parent of Be & Cheery	
<b>Potential laggards</b>								
<b>WH Group (Buy)</b> 288 HK	Packaged meat 15.3	2.5%	✗				Room temp products less favored by consumers	<a href="#">Solid recovery in China, US steady</a>
<b>Want Want (Sell)</b> 151 HK	Snack, Beverages 8.5	-1.3%	✗		✗		Under investment in branding, sweet products	<a href="#">Margin pressure to persist in 2H17</a>
<b>Tingyi (Neutral)</b> 322 HK	Beverages, Noodles 8.0	3.9%		✗			Limited innovation in products, packaging	<a href="#">Noodles drag, still a bumpy trend ahead</a>
<b>Orion (Neutral)</b> 271560 KS	Snacks 3.2	NM	✗				Sweet products, limited new products & marketing	<a href="#">CEO lays out the blueprint for reinvigorating growth</a>
<b>Glico (Neutral)</b> 2206 JT	Biscuits 3.7	2.7%	✗	✗			Sweet, limited products & packaging innovation	<a href="#">Lower GSe for Asian confectionary business</a>

Companies	Market cap (US\$ bn)	China % of group sales	2Q17 China yoy growth	Market share	Key China brands
<b>Nestle (Buy)</b> NESN VX	Diversified F&B 262.2	Asia: 18.4% <sup>(1)</sup>	Positive growth	Packaged food Soft drinks	3% 2%
<b>Pepsico (Neutral)</b> PEP US	Beverages, Food 163.7	Asia: 9.3% <sup>(2)</sup>	Snack: +hsd Beverage: +lsd	Carbonates Savoury snacks	24% 6%
<b>Mondelez (CL-Buy)</b> MDLZ US	Snacks 61.6	Asia: 15.7% <sup>(3)</sup>	Asia: -0.7%	Biscuits Gum	23% 16%
<b>ABI (CL-Buy)</b> ABI BB	Beer 244.1	APAC: 14.5%	2Q17: 7.2%	Beer	22%
<b>A2 Milk (Neutral)</b> ATM NZ	Infant formula 3.1	China: 16.2%	1H17: 72%	Infant formula	3.5%
<b>Blackmores (Neutral)</b> BKL AT	Vitamins 1.6	China: 19.1%	1H17: 55%	Vitamins	0.4%
<b>Danone (Sell)</b> BN FP	Dairy 53.9	NA	IMF: positive growth Water: decline	Yogurt Bottled water	1.4% 9%

(1) Nestle region refers to Asia, Oceania and sub-Saharan Africa.

(2) Pepsico refers to Asia, Middle East and North Africa, growth refers to volume growth.

(3) Mondelez refers to Asia, Middle East and Africa. Different from other companies, the yoy growth of Mondelez is AMEA region yoy growth.

Source: Company data, Bloomberg, Euromonitor, Nielsen, Goldman Sachs Global Investment Research.

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## China's 10 hottest F&B brands

## The next US\$1bn dollar SKUs

In order to present a full picture of China's F&B industry, in this report we focus in on the 10 hottest brands across a wide range of F&B categories, including snacks, braised foods, yogurt, beverages, fresh food, and sauces.

We built our selection criteria using data on the relative popularity of the brands. Using the Wechat Index, the Baidu Index and the Tmall Index, we picked the top 1 or 2 brands in each of the fast-growing categories. These indices mainly track how frequently consumers look at/purchase products. We also took into account the sales size, market share and growth for each brand (see Exhibits 2-6).

### The 10 brands we highlight share some key features:

- Benefit from a fast-growth industry segment:** Most of the brands belong to industry segments with high-single-digit to double-digit yoy growth.
- Quick expansion of sales size/market share:** Five of the 10 brands enjoyed c.100% yoy growth in 2016 (Three Squirrels, Be & Cheery, Heytea, Le Pur, and Ambrosial) and established market leader positions within their respective segments.
- Potential to grow to US\$1bn brand:** Over the next three to five years, we see potential for all of the 10 brands to grow to as big as US\$1bn in size. As of now, Yili's Ambrosial has already reached this scale; we expect it to post about US\$1.5bn of sales in 2017.

### Exhibit 6: To select China's 10 hottest F&B brands, we took into account market size, two-year CAGR and index rankings

Summary table of high-growth/big categories with hottest brands

Segments	Market (USD bn)	2-year CAGR	Ranking #1	Ranking #2	Ranking #3
<b>Nuts</b>	<b>4</b>	<b>10%</b>	<b>Three Squirrels</b>	<b>Be &amp; Cheery</b>	Liang Pin
Tmall index			4,608,918	3,110,565	2,954,022
Baidu index			5,501	1,847	4,933
Wechat index			139,284	18,057	165,088
<b>Braised food</b>	<b>10</b>	<b>21%</b>	<b>Zhou Hei Ya</b>	Huang Shang Huang	Jue Wei
Baidu index			2,972	2,640	1,545
Wechat index			161,033	126,808	131,430
<b>Milk tea</b>	<b>23</b>	<b>8%</b>	<b>Heekcaa</b>	Yi Dian Dian	Gong Tea
Baidu index			3,299	2,384	1,893
Wechat index			447,655	-	58,368
<b>RTD tea</b>	<b>16</b>	<b>8%</b>	<b>Tea Pie</b>	<b>Classmate Xiaoming</b>	Tingyi Ice Tea
Baidu index			1,404	848	494
Wechat index			16,893	16,009	39,331
<b>Low-temp yogurt</b>	<b>8</b>	<b>12%</b>	<b>Le Pur</b>	Mengniu Guan Yi Ru	Wei Chuan
Baidu index			404	353	349
Wechat index			59,530	1,016	15,084
<b>UHT yogurt</b>	<b>4</b>	<b>57%</b>	<b>Ambrosial</b>	Momchilovtsi	Chun Zhen
Baidu index			1,870	1,211	949
Wechat index			162,742	6,931	43,083
<b>Fresh oranges</b>	<b>9</b>	<b>12%</b>	<b>Chu's orange</b>	Dole	Joyvio
Baidu index			1,058	307	278
Wechat index			46,156	2,588	30,770
<b>Chili sauces</b>	<b>1</b>	<b>8%</b>	<b>Lao Gan Ma</b>	Hai Tian	Lee Kum Kee
Baidu index			2,952	1,294	925
Wechat index			166,132	4,126	53,343

Note: In order to rank brands by popularity ("hotness"), we used the following—Tmall transaction index in March 2017, the Baidu index (average of January 2016-June 2017), and the Wechat index (June 13, 2017). Generally, the three indices provided similar rankings.

Source: Euromonitor, Nielsen, Frost & Sullivan, Baidu Index, Wechat Index, Tmall Index.



# Three Squirrels / Be & Cheery | Nuts

A full suite of products upgrade



## Nuts market leaders with well-received brand images

### Three Squirrels



Established in 2012, Three Squirrels is an ecommerce snack company that offers over 300 SKUs in nuts, dried fruit, tea leaves and other snacks. By 2016, it reached annual sales of Rmb4.4bn, rocketing up to a market share of 13%. The company has differentiated itself by creating a **well-received brand image of three cute squirrels** – with particular emphasis on prompt and friendly customer service. Building on the popularity of its “Three Squirrels” brand image, the company is planning to enhance IP awareness through investing in related cartoons and games, and opening a “City of Squirrel” comprised of an amusement park, retail shops, restaurants and hotels by October 2018. In addition, to strengthen the customer experience, it has opened four offline stores in Suzhou and other areas, and is targeting 100 stores by 2019.

### Be & Cheery

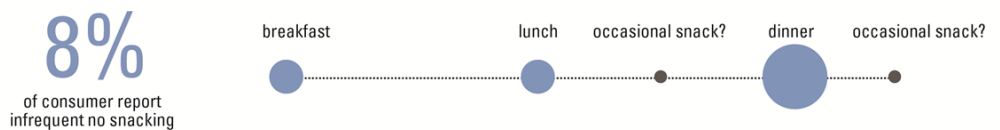


Established in 2003, Be & Cheery remained a regional snacks player until the opening of its Tmall channel in December 2011. It offers a wide selection of nuts, dried fruit, dried meat, and baked goods and is now also available in other major ecommerce platforms such as yhd.com and JD.com. From 1% market share in 2011, Be & Cheery quickly gained in popularity and became one of top-four players with a market share of 5% by 2016 when it was acquired by Hao Xiang Ni (002582.SZ, Not Covered).

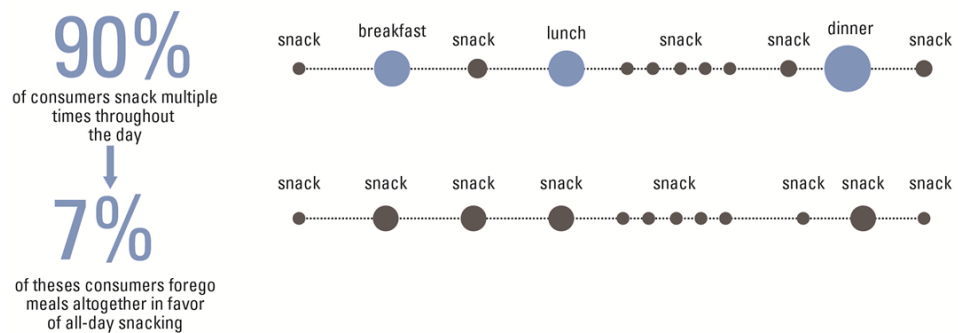
### Exhibit 7: Snacking is becoming an all-day phenomenon

Traditional and modern snacking model

#### TRADITIONAL SNACKING MODEL



#### MODERN SNACKING MODEL



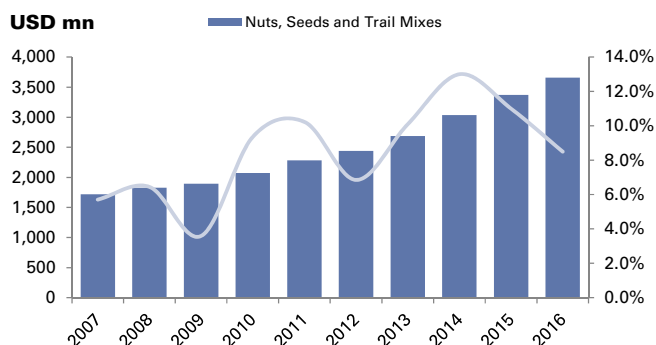
Source: The Hartman Group, Inc.

## Health focus and snacking demand fuels nut industry

Over the past ten years, the market size of the nuts category in China has doubled, with a 2014-2016 CAGR of 10%. This growth has been driven by: 1) an **increasing health consciousness** among consumers; and 2) the rise of **all-day snacking in addition to taking three square meals a day**, further aided by **the trend of eating alone**. According to a survey by Hartman Group, 7% of the respondents **even forego meals in favor of snacking**. In response, Be & Cheery launched “Bao Bao Guo” and “Ren Ren Guo” (details below), partly to satisfy consumer desires for meal alternatives.

**Exhibit 8: Fast-growing category: Sales of packaged nuts have doubled over the past 10 years**

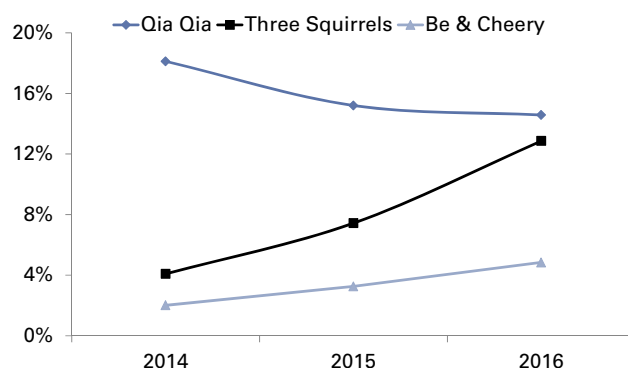
Nuts market size and yoy growth



Source: Euromonitor.

**Exhibit 9: Nuts gaining share over seeds: Three Squirrels gained significant share compared to seed leader Qia Qia**

Market share of nuts segment



Source: Euromonitor, company data.

## Innovative, quality products

### R&D in new products

Last year, Be & Cheery launched “Bao Bao Guo” (which translates to “hugging nuts” and consists of walnuts inside red dates) and “Ren Ren Guo” (a combination of dried fruit and nuts tailored to different types of consumers, such as fitness lovers, students, and white collar workers).

From naming to packaging, this sort of creativity helped drive sales of 10mn packages of “Bao Bao Guo” in the first 18 days post its launch.

**Exhibit 10: Bao Bao Guo and Ren Ren Guo**

Walnuts in red dates and mix of nuts and dried fruit



Source: Company data.

### Quality control

Three Squirrels has developed four criteria to control product quality: safe, fresh, tasty and eye-catching:

- **Safe:** Meets all safety standards; does not contain any harmful additives.
- **Fresh:** Average stock age for consumers is less than 60 days.
- **Tasty:** In blind taste tests of 100 people, 51% or more prefer Three Squirrels brands, with 95% or more of online reviewers leaving positive comments.
- **Eye-catching:** 70% or more of 100+ people rate product more attractive than peers.

In addition, if third-party testing shows that a batch of products is defective, depending on the severity of the issues, related parties are subject to five different levels of remediation from lifelong termination of cooperation and dismissal of the person in charge to free shipping returns/refunds.

### Innovative packaging

**Build a good first impression:** Three Squirrels has created its unique packaging with cute squirrels smiling at you. This packaging helps build a good first impression among consumers, and has been particularly popular among students. Double packaging protects the nuts and reduces the chance of damage when transferring from warehouse to consumers.

**Convenient snacking experience:** Tissues, a moisture-proof clip and a bag for the shells are particularly convenient features for consumers when they are not at home, such as office workers and students, **changing nut snacking from tiresome work to an enjoyable treat.**

**Exhibit 11: Diversified SKU and innovative packaging:**  
300-400 SKUs  
Packaging comparison



Source: Company data, public data.

**Exhibit 12: Functional packaging: detail orientation packaging, bag, moisture-proof clip to make snack experience better**  
Packaging of nuts by Three Squirrels



Source: Company data.

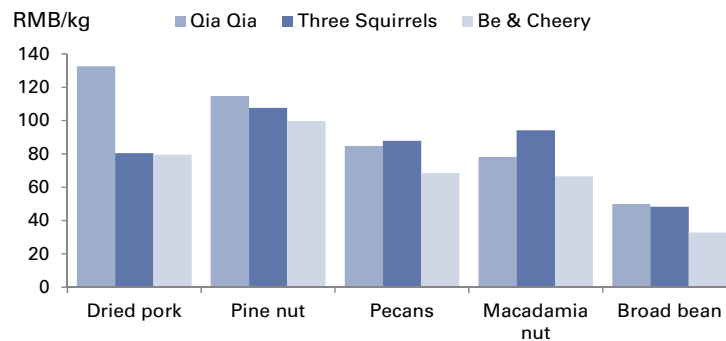
### Affordable pricing

Across different categories, Three Squirrels and Be & Cheery consistently attract consumers through competitive pricing, **at a discount compared to traditional players** such as Qia Qia. Both use OEMs to produce and retain only R&D.

### Multiple SKUs

Nuts (together with big SKUs such as “Bao Bao Guo”) – the low margin business – have helped drive traffic for both Three Squirrels and Be & Cheery, and with the minimum purchase for free delivery, customers combine nuts with other higher-margin categories such as dried fruit, dried meat, etc. Over time, we see a gradual decrease of nuts’ contribution to overall sales, thus improving profitability for the company.

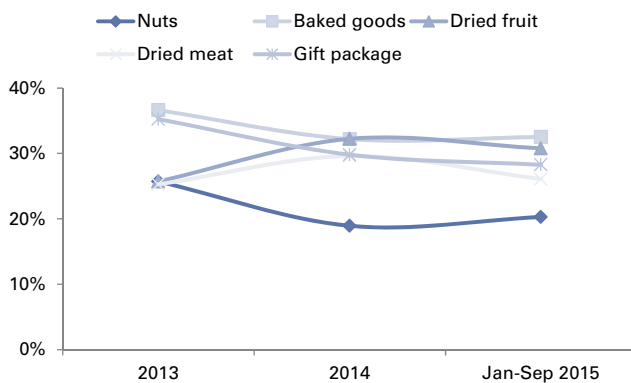
**Exhibit 13: Affordable pricing: Promotional offers are attractive for Three Squirrels and Be & Cheery compared to traditional big player Qia Qia**  
Price comparison



Source: tmall.com.

**Exhibit 14: Brand awareness: quality, cute products in various snack SKUs ...**

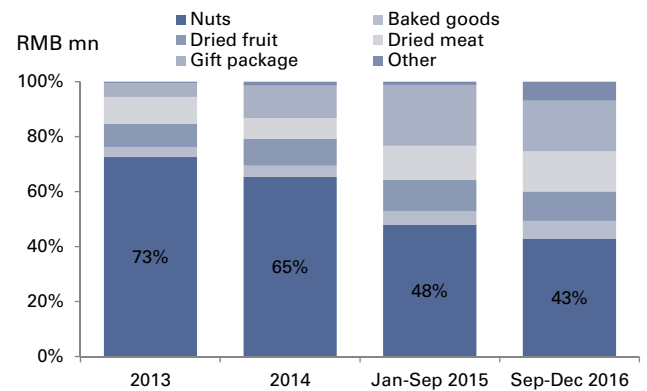
Be & Cheery operating margin by category



Source: Company data.

**Exhibit 15: ...diversify nuts contribution**

Be & Cheery sales contribution by category

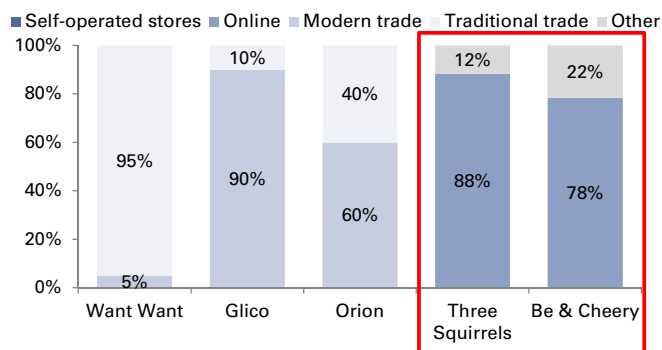


Source: Company data.

### Corner overtaking through online platform

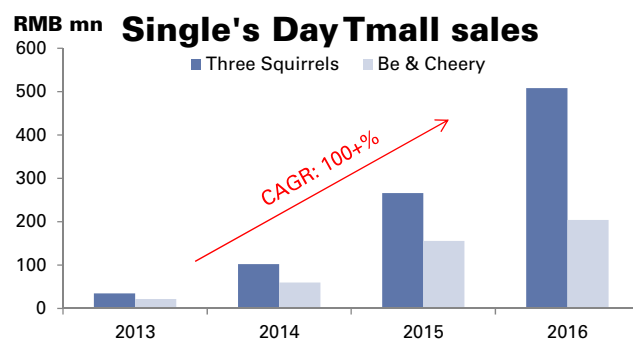
Benefiting from the infinite shelf, Three Squirrels and Be & Cheery bypassed the heavy investments in offline channels, and reach consumers directly through various platforms such as Tmall, JD.com, and yhd.com (in 2016, online sales accounted for 88%/78% of total sales for Three Squirrels/Be & Cheery). At a lower retail price than traditional players such as Qia Qia, online snack players – Three Squirrels and Be & Cheery have **quickly gained in popularity and have accumulated a large user base**. On Single’s Day (November 11) – a festival initially created by Alibaba to boost sales during the off-season and one that is now known for shopping at deep discounts, both Three Squirrels and Be & Cheery enjoyed sales CAGRs of more than 100% in 2013-2016, ranking them No.1 and No. 2 in 2016, respectively, in the snack category. The power of the online channel was further supported by the fact that about 500mn bags of Three Squirrels nuts were sold cumulatively via Tmall and Taobao.

**Exhibit 16: Online expansion: Both companies have enjoyed the benefits of the emergence of online channel**  
Sales breakdown by channel, 2016



Source: Tmall.com

**Exhibit 17: Both Three Squirrels and Be & Cheery posted 100+% CAGRs for Single's Day in 2013-2016**  
Company Tmall sales on Single's Day



Source: Tmall.com

## Building brands through entertainment

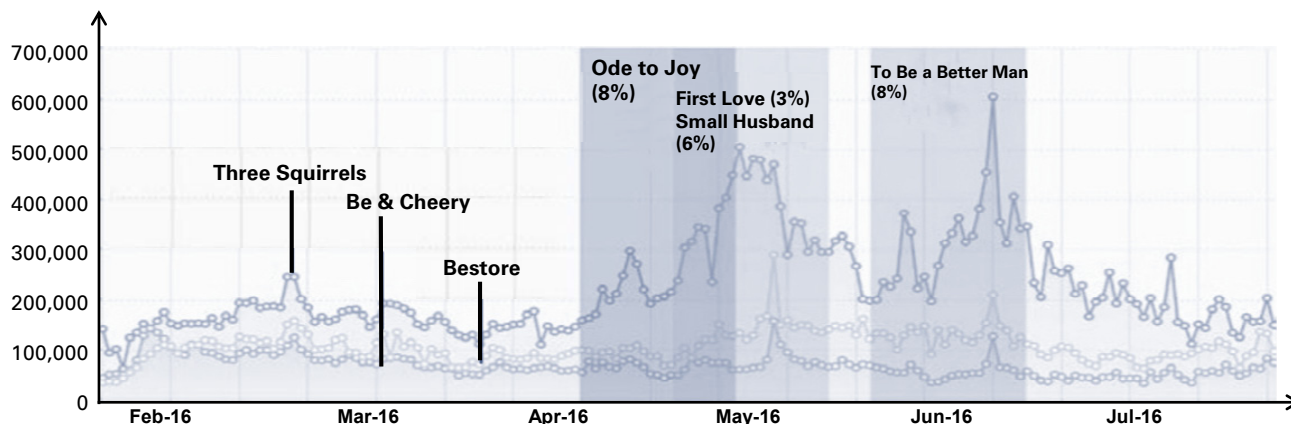
### Product placement

Product placement in TV series has gained popularity, mainly because: 1) along with better network infrastructure, people are increasingly **watching TV series** not just at home, but also **during transit (i.e., on subways, buses)**, so products are exposed to a bigger market. For reference, average daily transit time is c.1.5 hour in Beijing/Shanghai/Guangzhou. 2) The **length of TV series** relative to movies has enhanced the impact of advertisements.

The effectiveness of product placement depends heavily on the **popularity of the TV series, how well the product fits in with the story flows, and how well the product matches the target consumers**. Three Squirrels has built a database of the top 30 hottest TV series every year since 2013, rating them based on directors, scriptwriters, actors, producers, series types, whether the series is adapted from novels, etc. and invested based on standards developed from the database (Qilu News). Such cautious investments have paid off. Along with strong audience share of the TV series, searches of Three Squirrels while the show was being broadcast rose up significantly; in addition, searches for "Three Squirrels" have surpassed searches for "snacks" or "nuts". As a result, it seems reasonable to infer that consumers are increasingly identifying Three Squirrels as their preferred snack brand.

**Exhibit 18: Cautious selection of TV series for product placement has paid off with strong search results**

Baidu Index and TV series (audience share)



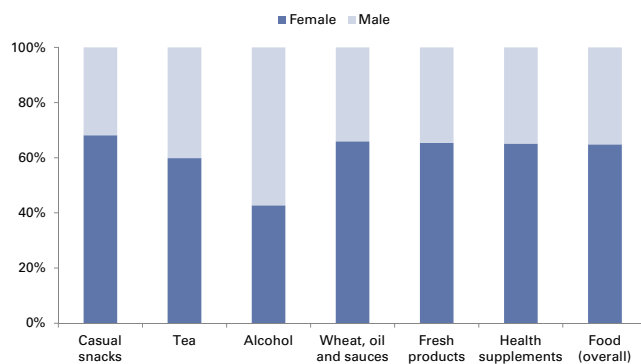
Source: Baidu.com, tvtv.hk.

In another example, Be & Cheery made a successful placement in one of the hottest TV series this year (*Eternal Love*). The product placement earned high scores under the three criteria below, and the company estimates it resulted in sales that were four times higher than they would have been without the cooperation with *Eternal Love*.

1. **Popularity of the TV series:** Within 48 hours, *Eternal Love* was viewed 1bn times, and 10bn times after three weeks (Qilu News).
2. **Fits with the story flows:** Consumers increasingly **prefer to eat snacks while watching TV series** at home; as the Be & Cheery brand (百草味) is associated with the ancient Chinese legend of the Yan Emperor, who **tasted hundreds of herbs** and developed medicines to subdue plagues, it fits in well with this TV series set in ancient China.
3. **Match of target consumers:** According to the Baidu Index, c.80% of searches of *Eternal Love* were by people born in the 1980s or later and 72% were female; 65% of casual snacks were consumed by females, and consumers aged below 35 are major drivers. Women born in the 1990s tend to prefer nuts, baked goods and dried fruit/meat (CBNData).

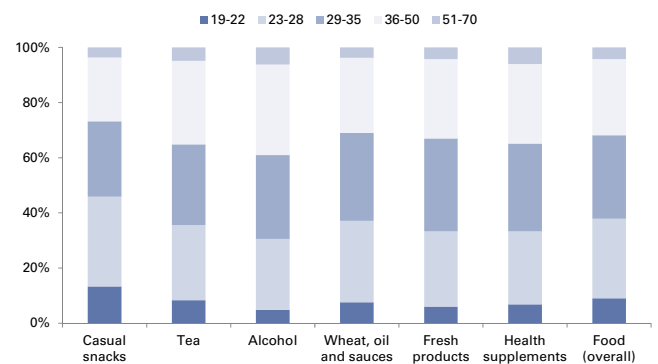
**Corresponding marketing campaigns and customized product offerings** further improve translation from popularity to sales. For example, Be & Cheery has launched limited offering “glutinous rice dumplings” using the nickname of a main character in the series.

**Exhibit 19: Women tend to consume more casual snacks**  
Online food spending by gender in 2015Q1-Q3



Source: CBNData.

**Exhibit 20: People aged 35 or below are major consumers of casual snacks online**  
Online food spending by age in 2015Q1-Q3



Source: CBNData.

## Interacting with consumers

### Utilizing celebrities in creative ways

**Three Squirrels:** During Single’s Day, celebrities in a reality show became temporary customer service staff for Three Squirrels. The interactive and creative entertainment generated over Rmb250mn of sales in 24 hours.

**Be & Cheery:** Yang Yang, one of the most famous celebrities in China and ambassador of Be & Cheery, was the host on the Tmall live streaming platform to launch Be & Cheery’s “Ren Ren Guo” in October of last year, bringing over 100,000 viewers and over 30mn “likes” in an hour and breaking the record for Tmall live streaming.

**Offline store as showcase:** Three Squirrels has opened four offline stores in Suzhou and other regions, and Be & Cheery cooperated with 200+ distributors to open one store in each city as an experience center. Both aim to improve brand recognition and finally translate to online sales.



**Customers are “masters”:** Three Squirrels puts an emphasis on customer service (in line with the Western saying that “the customer is always right”) and trains staff to respond to customer questions in a prompt, helpful and cute way. As a result, Three Squirrels has earned a customer rating that is 20% above the industry average.

### IP awareness through investment in cartoon movie

Three Squirrels has plans to crystalize its IP in a number of ways. For example, it is due to release a cartoon series based on the Three Squirrels, and it is planning to build a “City of Squirrels” comprised of an amusement park, retail shops, restaurants and hotels.

**Exhibit 21: Three Squirrels has invested in cartoon movies to enhance IP awareness...**



Source: Company data.

**Exhibit 22: ...while Be & Cheery has made product placements in TV series in creative ways**  
Product placement in hottest TV series



Source: Company data.

## Risks

1. **Quality concerns over outsourced manufacturing:** Using OEMs provides flexibility, low capex and high ROE, but they can also sometimes attract negative customer feedback on issues like mouldy products or raw materials that are not cleaned carefully enough. Both Three Squirrels and Be & Cheery have adopted measures to reduce the likelihood of this sort of thing happening, including: 1) setting up high entry requirements for suppliers and regularly checking qualifications, monitoring the manufacturing environment and conducting sample testing; 2) tracing customer feedback issues to suppliers and addressing it with a variety of remedial steps, depending on the severity of the issues; 3) supporting suppliers via training on food safety and aligning the interests of suppliers through proper incentives based on the quality of products.
2. **Over-reliance on Tmall platform:** The key to maintaining strong sales growth on an ecommerce platform is the acquisition and maintenance of traffic. On the one hand, reliance on Tmall entails a significant marketing budget while companies suffer from higher acquisition cost per user; on the other hand, lack of diversification also means low bargaining power against the platform, and increased likelihood of bottlenecks. To counter this potential weakness, both companies have opened their offline stores to drive online traffic and expanded into other online channels such as JD.com.
3. **Innovative products easy to be replicated in a short time:** Given the low barriers in terms of technology and infrastructure, once a company introduces a product that is well-received by consumers, it is highly likely that competitors will be able to replicate them in a short period of time utilizing the flexibility of OEMs.
4. **Brand equity:** Three Squirrels has successfully built its IP through its packaging and its strong focus on customer service. However, as the company grows larger, it will get increasingly difficult to maintain this service culture across a wider group of new employees. Nevertheless, this is critical for the delivery of the consumer experience, the core of the brand equity.

# Zhou Hei Ya | Duck

An addictive, spicy and convenient snack



## A black spicy duck snack from Central China



Established in the late 1990s, Zhou Hei Ya (ZHY) started out as a duck processing company in Wuhan, Central China. The company’s name is translated as “Zhou black duck” and it is known for its spicy black duck products. The company’s founder spent years working on product taste and developed the unique spicy taste of the company (which is a little sweet as well). In the past 10 years, the company has expanded across the rest of China through its directly owned operating model. It now earns almost Rmb3bn in sales, making it China’s No. 2 savory duck snack company and its most profitable one.

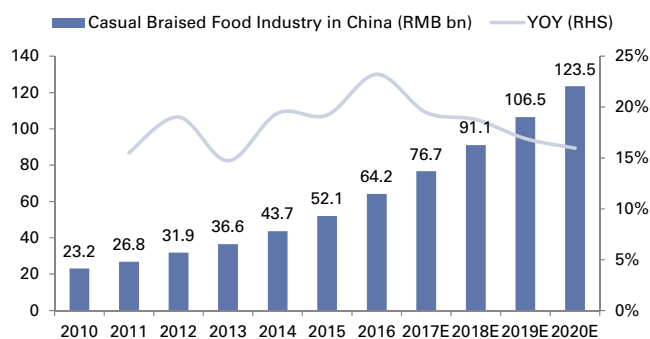
## Creating duck snack demand

### Innovative packaging

In the past, due to its short expiry date and status as an unpackaged product, savory duck was mostly consumed at home or in restaurants. ZHY was the first company to introduce moisture adjusted packaging, which makes it possible for products to be stored in a chilled environment for as long as seven days.

In this case, ZHY overcame the difficulty of storage for these products, thereby creating significant snack demand.

**Exhibit 23: Create duck snack demand: Casual braised food industry has grown by double digits...**  
Industry size and yoy growth



Source: Frost and Sullivan.

**Exhibit 24: ...and ZHY has enjoyed its highest sales growth over the past three years**  
Sales and yoy growth



Source: Company data.

**Exhibit 25: Innovative packaging to serve snack demand: longer expiry date, wider distribution, safer food, from dining table to snacking**  
Packaging comparison



Source: Company data.





**Exhibit 26: Differentiated taste: ZHY’s unique, spicy taste**  
Number of SKUs

Brand	Original flavor	SKUs
Zhou Hei Ya	Sweet and spicy	131
Jue Wei	Spicy	39
Huang Shang Huang	Spicy	74

Source: tmall.com

**Exhibit 27: From meals to snacks: Packaging makes the difference: People accept a 20%-30% premium for impulse purchases, food safety, and premium branding**

ZHY's product timeline from 2002 to 2015

2002	2009	2012	2015
<b>Unpackaged products</b>	<b>Vacuum packaged products</b>	<b>MAP products</b>	<b>Fixed-weighted MAP and individually-packed vacuum products</b>
			

Source: Company data.

**Differentiated, addictive taste**

ZHY has been strong at innovating and differentiating its products. Over the years, it has developed a unique sweet-spicy taste by pairing duck with a variety of ingredients. Compared to peers, ZHY contains higher sugar content and hence tastes sweeter than Jue Wei's hot spicy taste. In China, like the rest of the world, spicy foods tend to be addictive, and this has been reflected in recent culinary trends. For example, hotpots and Sichuan dishes, which are known for being spicy, have gained popularity across various regions of China, including in places where local consumers have traditionally not eaten spicy food.

**Exhibit 28: ZHY products are relatively higher in sugar and have a sweet and spicy taste**

ZHY and Juewei comparison

Brand	Ingredients	Taste	Calories (kJ)	Protein (g)	Fat (g)	Carbonhydrate (g)	Na (mg)
Zhou Hei Ya	Duck neck, sugar, aginomoto, chicken powder, salt, spicy ingredients, white spirits, soy sauce	Sweet spicy	892	28.8	5.2	4.4	1439
Jue Wei	Duck neck, sugar, salt, aginomoto, chicken powder, white spirits, vegetable oil, chili, pepper, ginger, other spicy ingredients	Hot spicy	724	32.9	3.5	2.3	1300

Source: Goldman Sachs Global Investment Research.

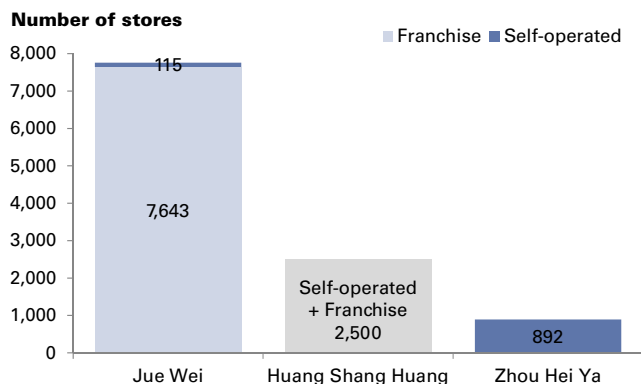
**Self-operated store to ensure premium quality**

ZHY has adopted a 100% self-operated model and opens about 200 new stores every year. Although at a slower pace vs. other peers who use a franchise model, ZHY's self-operated model has enabled it to ensure the high quality of its products, store account and customer service. Hence, the company has successfully established a premium branding and strong pricing power.

**High store productivity from transport hub stores:** About 50% of ZHY's stores are located in transportation hubs including airports, train stations and MRT stations. This gives the store high exposure to traffic and also stimulates consumer's repetitive demand. Thus, ZHY's stores have very high productivity vs. peers and high profit margin as well.

**Exhibit 29: Better branding on self-operated stores: ZHY adopted a different model compared to peers**

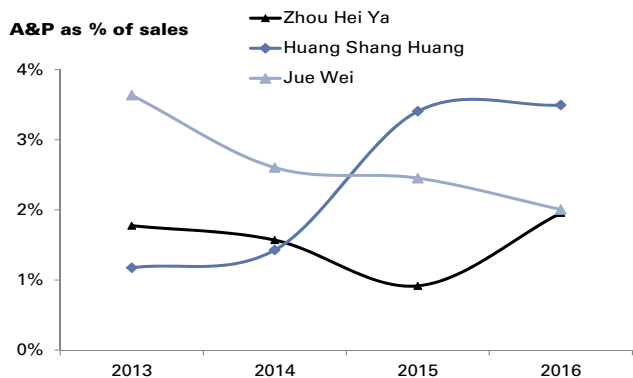
Store number and model comparison



Source: Company data.

**Exhibit 31: Word of mouth marketing: Rather than spending significantly on advertisements, ZHY's marketing centers on free trials of its products and store locations**

A&P as % of sales



Source: Company data.

**Exhibit 30: High-traffic locations incur high rental costs in transport hub/shopping mall stores to drive traffic, enhance store productivity and build brand recognition**

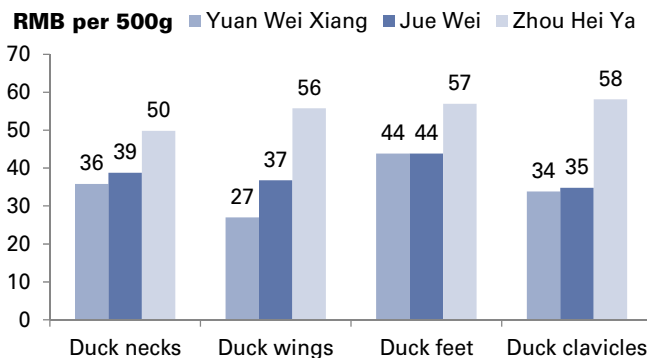
Store design comparison



Source: Company data.

**Exhibit 32: Premium pricing: Location, packaging, flavor and branding have allowed ZHY to charge premium prices**

Price check among different braised food brands



Source: Company data.

**Risks: Competition, weather, balance on expansion/store quality**

- Food safety** should be reduced, but not eliminated, by the shift from unpackaged to moisture adjusted packaging as well as an improved production/logistics/storage environment, and thus any failure to handle potential food safety issues may affect the brand image and subsequently the financial performance of the company.
- Competition for/unable to secure transport hub stores** that may slow down sales growth/drive down margins.
- Different taste across different parts of China:** Central China stores are more than twice as productive as stores in other parts of China. However, consumers from ex-Central China may not be accustomed to the spicy products or prefer different tastes. As a result, productivity per store may not improve as much as we expect.
- Raw material price fluctuation** may put pressure on GPM, and the company generally does not enter into long-term supply agreements at fixed prices.

# Heytea | Fresh Tea

A Chinese tea version of “Starbucks”?



## Heytea: a young disruptor in an “old” tea industry

Originated from China, tea became popular in western countries by adding sugar and milk; milk tea was then localized by people in Hong Kong and Taiwan; after entering mainland China, Hong-Kong style tea and Taiwan bubble tea quickly became popular. Initially the raw material used was milk-tea powder, later tea powder and non-dairy creamer, followed by fresh milk and real tea after adverse publicity on non-dairy creamer and plasticizer.

Traditional key players such as Da Ka Si, Coco, Happy Lemon, etc. evolved in the early 2000s. They typically adopt a **franchise model** with centralized raw material provision, use a similar and standardized menu – mainly milk tea with add-ons such as bubbles/grass jelly. Consumers are able to choose different sugar and ice levels in their **take-away** only stores.

HeyTea, one of the hottest tea brands among Chinese millennials, opened its first outlet in Jiangmen, a third-tier city, in 2012, and it has led the trend of cheese milk foam. With over 60 stores, it offers 30+ SKUs, including tea with cheese milk foam, fruit tea, mix tea, milk tea, pure tea, coffee and desserts. Its direct competitors include Yi Dian Dian, inWE, Nesno, and etc., which invest heavily in product quality, experience and marketing.

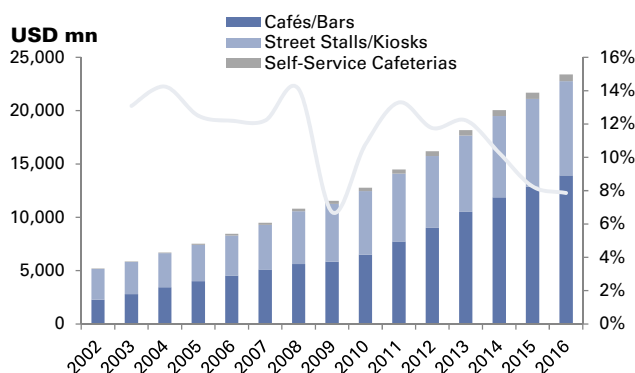
Following the first opening of Heytea in Shanghai last year, **customers spent more than six hours waiting for a cup of tea**. In addition, Heytea has achieved surprisingly **high store productivity**: We estimate that each of its stores can generate Rmb19mn of sales on average, which is 6.8 times the productivity of a normal milk tea store in China.

We see potential in the fresh tea market mainly from: 1) penetration growth (1.04kg/year per capita tea consumption nationwide in 2013, tripling from 2011 vs. 2kg/year in Guangdong); 2) a shift from substitutes (e.g., bubble tea/RTD drinks/coffee with high sugar content, instant coffee/tea bag of inferior flavors); and 3) tea drinkers looking for more convenient options (500mn total consumers, with 254mn of them in urban areas, from Research Office of National Tea Technology System).

We believe **product innovation, own store model, and competitive pricing** form the basis for Heytea’s success.

**Exhibit 33: In China, cafés and street stalls have grown by the high single digits in recent years**

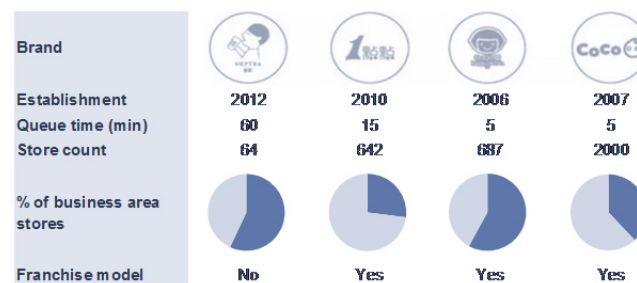
Market size and yoy growth



Source: Euromonitor.

**Exhibit 34: Heytea has the longest queues among well-known milk tea brands**

Brand comparison



Source: Company data, CBN Weekly, dianping.com, Rising Lab database, Goldman Sachs Global Investment Research.



## 360-degree product upgrade

### Innovating new flavors

We believe Heytea's leadership in innovation (e.g., cheese milk foam) is key to the popularity of its products. Through **exclusive agreements with tea houses to improve soil, planting and tea processing**, it differentiates its products from the very beginning – offering tea bases unavailable in the market. In addition, **experiments** on the roast blend of tea and other ingredients, brewing temperature, timing and attenuation has also aided Heytea's success in new products. such as the latest **seasonal offerings** – mango/strawberry with cheese milk foam.

### Natural, fresh and diversified ingredients

Heytea is sourcing the most suitable ingredients around the world, e.g. Australian cheese, European fresh milk, and high-quality teas discovered from Taiwan Ali Mountain, etc., which contrasts with the typical low-priced milk tea store using milk powder with basic green/black tea.

### Package upgrade

Aesthetic packaging makes consumers more likely to take photos of the product and share with friends; moreover, the bottle plug and drinking tips provided have enhanced consumer satisfaction.

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#### Exhibit 35: Packaging comparison with traditional milk tea stores



Source: Company data.

## Value added from branding and experience

### Employee training

Heytea employees differ from peers in terms of **process standardization and service quality**.

1. Each store typically has c.10 employees to prepare milk tea, each performing a single function (e.g., preparing fruit, making cheese milk foam, and packaging), which has helped to maintain quality consistency and production efficiency. We believe **process standardization enables faster and consistent product delivery and facilitates store expansion with minimal employee training**.
2. **Services help improve customer satisfaction**. Mindful of the relatively long waiting time for its customers (usually at least 15 minutes), Heytea tries to cater to customers waiting on long queues by keeping the queue orderly, taking orders before customers reach the counter, and offering information about how and when to enjoy their products.



### Own store model

Different from the traditional franchise model, Heytea operates through 64 own stores. We believe this is a better model for **product innovation, location selection, and employee training.**

1. **Employee training:** We believe an own-store model is superior to franchising when it comes to transferring good practices on process standardization and service quality.
2. **Product innovation:** As a direct-to-consumer model, the brand owner is more incentivized to continuously develop new products and also has easier access to information on consumer preferences.
3. **Location selection and investment in interior design:** While some inexperienced or underfunded franchisees may opt for sub-optimal locations with low rents, Heytea has sufficient financial resources to **open stores in areas with a high density of urban middle consumers**, particularly shopping malls and office buildings such as Mixc in Shenzhen and Taikoo Li Sanlitun in Beijing. Spending on the interior design of stores is not viewed as a waste, but as an investment to create a better consumer experience.

### Creating brand association

Heytea has tried to build a premium brand perception using package design, creative flavors and fresh ingredients, and also focusing on flagship store location and decoration. This has allowed it to create a casual environment for rest and social gatherings, which further strengthens its brand.

1. **Flagship store location and decoration:** Heytea opens stores on the first floors of premium shopping malls that attract wealthy/young consumers (for example, Heytea has an outlet in the Mixc shopping mall that is located next to a Prada outlet). Heytea also aims to reinforce its premium image via attractive interior design elements that emphasize clean lines and utilize large windows; this has allowed Heytea to create casual and social spaces that are on par with the decor of Starbucks outlets.
2. **Picture sharing elevates product popularity:** Heytea’s attractive packaging makes it more likely that its customers will post photos of Heytea’s products to their social networks, such as via Wechat moment or Weibo. This is an effective marketing strategy given that people tend to be heavily influenced by close friends and key opinion leaders.

**Exhibit 36: Heytea employs attractive interior design to reinforce its premium positioning**

Heytea store photos



Source: Company data.

**Exhibit 37: Different from take-away milk tea stores, Heytea benchmarks against Starbucks**

Starbucks and traditional milk tea store photos



Source: Company data.

### Competitive pricing with offerings comparable to Starbucks

At a price of c.Rmb20 per cup (US\$2.90), Heytea’s products are sold at a 40% discount to Starbucks coffee (US\$4.30) and a 100% premium to a typical milk tea store. Given our estimate that the urban middle in China earned an average of US\$13,000 in 2016, or US\$6.50/hour, we believe that such pricing is making the enjoyment of upgraded milk teas more affordable.

**Exhibit 38: China urban middle class earned c.US\$13,000 in 2016, or US\$6.50 per hour**  
China consumer cohort

Working Population:	Average income per capita in 2016E (US\$):	Average hourly earning in 2016E (US\$):		(% of working population)	(% of aggregate income)	Aggregate income in 2016 (US\$bn)
1.6mn	500,000	250.0	The Affluent	(0.2%)	(15%)	820
72mn	14,091	7.1	Government /SOE staff	(9%)	(18%)	1,016
100mn	12,203	6.1	Urban white collar/SME owners	(13%)	(22%)	1,215
70mn	7,834	3.9	Urban blue collar workers	(9%)	(10%)	546
170mn	6,143	3.1	Migrant workers	(22%)	(19%)	1,044
363mn	2,482	1.2	Rural	(47%)	(16%)	901
<b>Total : 776mn</b>	<b>US\$7,142</b>					

← Working population avg per capita income  
← China nominal GDP per capita

Source: CEIC, Euromonitor, Goldman Sachs Global Investment Research.

**Exhibit 39: Our hours worked affordability test suggests Heytea is an affordable enjoyment for China’s urban middle**

Our "hours worked" affordability test				
Average hourly earning (US\$)		"Urban middle" (China)	Hong Kong	Taiwan
		6.5	17.9	7.1
Product	Price (US\$)	No. of working hours needed		
Starbucks Grande Latte (Mainland China)	4.3	0.67	0.24	0.62
Starbucks Grande Latte (Taiwan)	3.7	0.57	0.21	0.53
Starbucks Grande Latte (Hong Kong)	4.9	0.75	0.27	0.69
Heekcaa Tea King	2.2	0.33	0.23	0.58
Starbucks Venti Caramel Macchiato (Mainland China)	5.4	0.82	0.30	0.76
Starbucks Venti Matcha Cream Frappuccino (Taiwan)	5.1	0.79	0.28	0.72
Starbucks Venti Matcha Earl Grey Jelly (Hong Kong)	6.4	0.99	0.36	0.91
Heekcaa Cheese Strawberries	4.1	0.62	0.27	0.69

Source: Company data, Euromonitor, Goldman Sachs Global Investment Research.

### Risks

- Relatively low entry barrier:** The market is crowded with traditional players like Coco and new entrants (Yi Dian Dian, inWE, Nesno, etc.). Severe competition may hurt traffic and profitability.
- Long time queuing:** Experience is key to premium pricing; excessive queuing time may irritate first-time consumers and also deter repeat customers.

**Ability to innovate and lead the trends:** Consumers are looking for new products and surprises; companies failing to meet their desires will lose the market over time.

# Nongfu Spring | RTD Tea/Water

Traditional company in a new style




## Nongfu Spring: Traditional beverage leader since the 1990s

Nongfu Spring, whose major business consists of water, ready to drink (RTD) tea and juice, is a **national leader in the bottled water market** with a market share of 22%, and it **has increased its share in RTD tea significantly** from 1.6% in 2015 to 13.7% in 1H17, according to Nielsen. In addition, over time it has launched energy drinks, vitamin water and room-temperature not-from-concentrate juice. By entering these new and growing beverage sub-sectors, Nongfu was able to post annual sales of Rmb15bn by 2016, with a four-year CAGR of 11%. In addition, the company has become famous for using advertisements to **narrate the stories** behind how their employees devote themselves to bringing safe and high-quality products to consumers. It is also the first company in China that pays for online video viewers to skip their ads after five seconds.

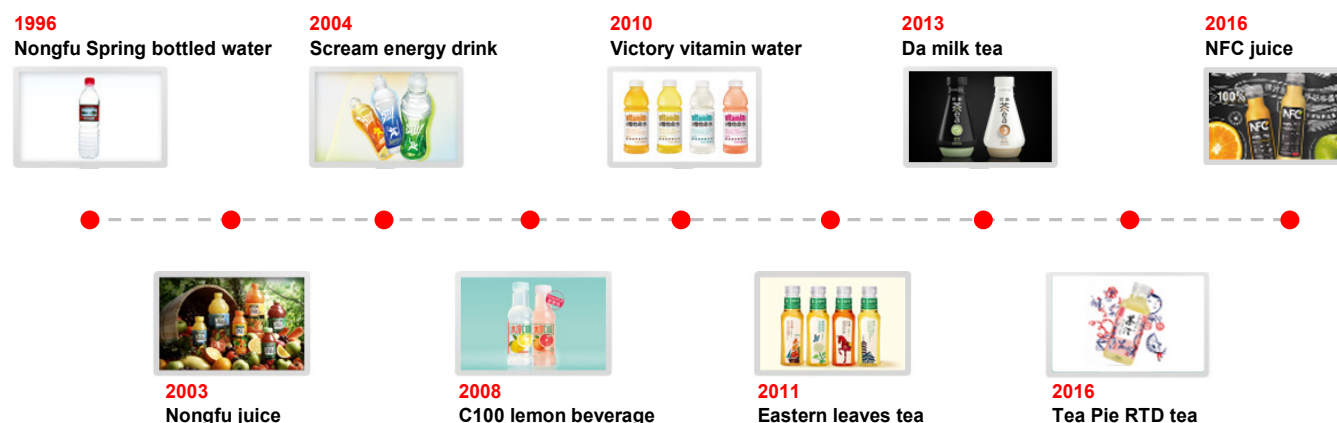
**Tea Pie**, launched in 2016, has chosen Big Bang (a popular band in Asia) to be the brand’s ambassador. Big Bang made a two-minute ad to communicate how their efforts make their music dreams come true, thereby establishing a connection with the brand– “sticking to your own identity”.

In contrast to the disappointing sales of mainstream products, **Tea Pie has experienced remarkable growth, reaching Rmb2bn in annual sales.**

We view **innovation in growth categories, consistent quality delivery, packaging upgrade, and branding & targeted marketing** as critical for the success of Nongfu Spring.

### Exhibit 40: As one of the leaders in beverages and water, Nongfu Spring continues to grow quickly through product innovation

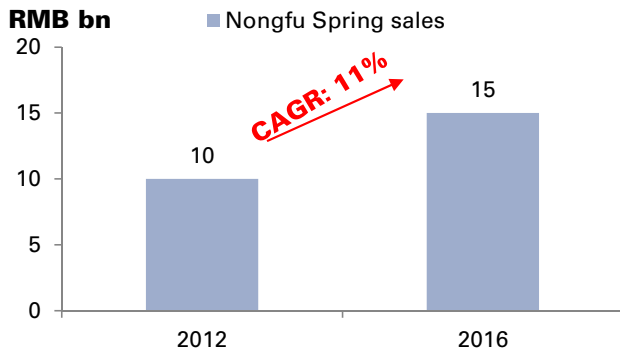
Major product launches and Nongfu Spring sales



Source: Company data.

**Exhibit 41: Nongfu Spring grew at an 11% CAGR in 2012-2016**

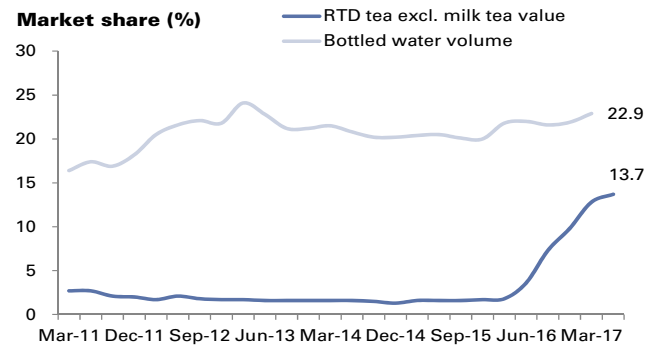
Nongfu Spring sales



Source: Company data.

**Exhibit 42: Nongfu Spring is No.1 in the water segment and has gained share from other players in RTD tea**

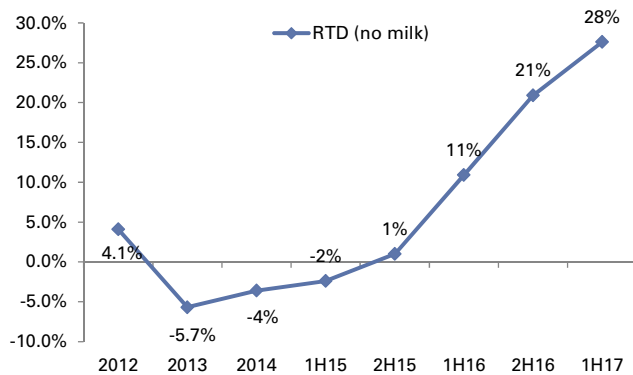
Market share of bottled water and RTD tea



Source: Nielsen.

**Exhibit 43: RTD tea faced a slowdown in 2015, but thanks to Tea Pei and Classmate Xiaoming, the popularity of tea has rebounded**

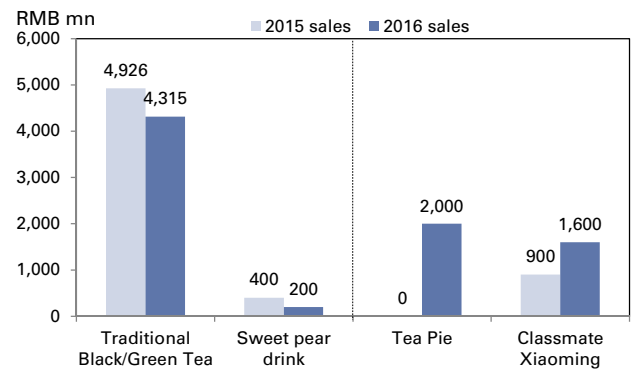
Sales yoy of RTD segment



Source: Nielsen.

**Exhibit 44: Tea Pie and Classmate Xiaoming are gaining sales momentum**

Sales comparison among key RTD products



Source: Company data, Goldman Sachs Global Investment Research.

### Product innovation on growth, healthy categories





Focus investment and innovation in key growth categories has helped Nongfu Spring to fuel growth even though it is a market leader (e.g., Screaming energy drink in 2004, Liliangdi vitamin water in 2010, 17.5° NFC juice and Tea Pie (reduced sugar tea) in 2016).

**Low-sugar content:** With stronger health awareness and a consumer shift to low sugar content, Coca-Cola and Tingyi Ice Tea have seen declining sales in recent years, each with a sugar content of 10.6g and 9.7g per 100ml respectively. In contrast, Tea Pie and Classmate Xiaoming, at c.6-7g per 100ml respectively, since their launch, have quickly gained popularity.

**Control of strategic assets:** As the leader in the water segment, Nongfu Spring has invested in discovering new water sources and established eight water bases across China including Qiandao Lake in Zhejiang province, Changbai Mountains in Jilin province, and Manasi in Xinjiang province. Nongfu’s control of sources of unpolluted water with natural mineral composition has helped differentiate it from most Chinese players that produce purified water. Further, its marketing has educated consumers about the health benefits of mineral water. Its premium water launched in 2015 uses water from Moya Spring, Changbai Mountai, one of the best water sources in China (according to the company), with a unique and healthy mineral composition – low sodium and rich metasilicic acid.

### Exhibit 45: Consumer preferences have shifted to low sugar content and low-calorie products

Summary of product comparison

Brand	Coca Cola	Tingyi Ice Tea	Classmate Xiaoming	Tea Pie
Product				
Year of launch in China	1978	1996	2015	2016
Sales (2016, RMB mn)		2767	1600	2000
2015-2016 sales growth	-4%	-3%	78%	
Sugar content (g/100 ml)	10.6	9.7	6.7	6
Calories (per 100 ml)	43	37	33	33

Source: Euromonitor, company data, Goldman Sachs Global Investment Research.

### Packaging makes a good first impression

**Premiumization from packaging:** Nongfu Spring also launched its premium water lines with glass packaging. The design has won five international awards including awards by D&AD, The Dieline, and Pentawards. With the choice of sparkling and still natural water, it caters to demand from premium restaurants and business meetings.

### Brand acceptance via consistent & personalized messages

**Tea Pie's marketing is** differentiated from that of peers in a number of interesting ways:

- Option to close its ad:** Non-VIPs have to watch ads for 75+ seconds before every video on online platforms. Nongfu Spring uses two-minute ads that viewers can close after five seconds. According to Youku (an online video platform), 70% of viewers chose to watch 30+ seconds.
- Brand identity** consistent with young people fighting for their dreams: Tea Pie has signed up Big Bang as its ambassador. Rather than purely advertising how tasty Tea Pie's products are, the members of Big Bang shares stories behind their success, and these stories are resonant with the Tea Pie's emphasis on "sticking to your own identity". This appeals not only to fans of Big Bang, but also to young people in the early stages of life, who often have dreams and aspirations that are not understood by their parents or sometimes even their friends.

**Exhibit 46: Snapshot of marketing and packaging initiatives**

<p><b>Creative ads</b></p>  <ul style="list-style-type: none"> <li>• <b>Water for cooking</b> An interesting ad to additional create water demand</li> <li>• <b>Open bottles easily</b> Collaborating with TV series <i>Nothing Gold Can Stay</i>, actors played arm wrestling and opened bottle with one hand</li> </ul>	<p><b>Customized packaging</b></p>  <ul style="list-style-type: none"> <li>• <b>Onmyouji package</b> for fans of this game (top 10 games in iOS store worldwide)</li> <li>• <b>Music package</b> of Nongfu's water cites 30 best comments with QR code for related music from Netease Cloud Music (3+mn users)</li> </ul>
<p><b>Title sponsorship</b></p> <ul style="list-style-type: none"> <li>• <b>Sponsored</b> <i>the Rap of China</i> produced by iQIYI at RMB 120mn for Victory, Nongfu's vitamin water</li> </ul> 	<p><b>Event advertising</b></p> <ul style="list-style-type: none"> <li>• <b>Dedicated water</b> for high-end meetings such as BRICS business forum and G20 Hangzhou Summit</li> <li>• <b>Special edition</b> of bottles with Chinese zodiac animal during Chinese new year in early 2017</li> </ul> 

Source: Company data.

**Risks**

1. Is Nongfu Spring able to **protect the intellectual property of its packaging**? The copying of packaging from competitors, especially by small players, has the potential to erode Tea Pie's market share due to a lack of awareness among consumers. This can ultimately hurt the brand image of the company.



## Classmate Xiaoming | RTD Tea

Ride on the 95s diversity wave



### Classmate Xiaoming

In 2015, Uni-President China introduced Classmate Xiaoming (a line of RTD drinks with four flavors – lemon, black tea, jasmine tea, and yogurt). Classmate Xiaoming is differentiated from the company's other offerings by the use of funny faces on the bottle, which is consistent with younger consumers' willingness to make jokes and have fun.

In contrast to the disappointing sales of mainstream products, **Classmate Xiaoming recorded strong growth, reaching sales of Rmb1.6bn.** We attribute this success to **advances in healthier products with less sugar, innovative packaging and targeted marketing.**

### Packaging the gateway to quality

**First and most prolonged advertisement:** A survey by UPC showed that 50% of consumers were aware of Classmate Xiaoming because of its packaging. Traditional packaging typically emphasizes information – from brand name, product category to the key features of products. However, when most brands on the shelf have established their reputation for flavor, differentiated packaging has helped Classmate Xiaoming stand out.

**Targeting consumers through packaging:** The cartoon figures on Classmate Xiaoming appeal primarily to students who are amused by funny faces; the aesthetic packaging of Tea Pie attracts young people that appreciate beauty and are keen to share photos of their preferred drinks.

### Effective marketing to enhance brand awareness

Marketing campaigns of **Classmate Xiaoming** show the effectiveness of **integrated and targeted marketing.**

1. **Brand recognition - sponsorship** of reality TV show "Going to School" **targeting consumers born after 1995 (95s):** The show followed popular celebrities (such as Lu Han and Zhang Danfeng) as they went back to high schools and experienced life with high school students. The first two episodes on the iQIYI online platform reached 1bn+ views and an audience share of 3%-4% according to CSM.
2. **Brand association - creative slogan** "be serious, we are making jokes" with **consistent** messages from ads: consumers, particularly those born after 1995, known as "95s", view their identity as consistent with Classmate Xiaoming's playful approach.
3. **Brand loyalty - interaction with consumers:** Through cooperation with Miaopai, an online streaming platform, Classmate Xiaoming invited consumers to imitate the funny but not pretentious expressions and tones of the character, share in Weibo and earn gifts. Involvement and sharing not only increased brand exposure at a low cost but also enhanced brand affiliation.

**Exhibit 47: Packaging usually offers the first – and longest-lasting – impression to consumers**  
UPC product type progress



Source: Company data.

**Exhibit 48: Cooperation with Miaopai to invite consumers to imitate the funny expressions and tones of Xiaoming**  
Xiaoming branding



Source: Company data.

# Le Pur | Greek Yogurt

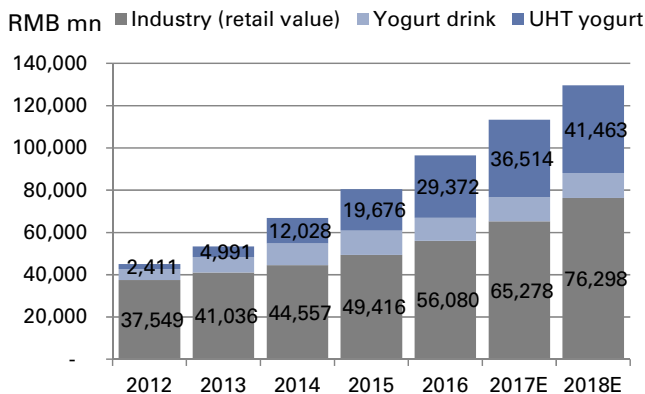
Chinese Chobani? Innovative taste in a growing category




## Le Pur: Aiming for the best-quality yogurt

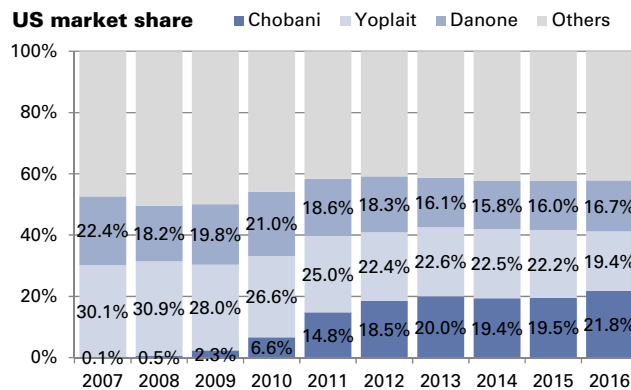
In 2014, Zhang Nannan graduated from Le Cordon Bleu with 500,000+ followers in Weibo, experimented for half a year and finally developed a yogurt named “Le Pur”. The name means “pure and natural”, as the product is made from high-quality fresh milk and lactic acid bacteria, without any additives such as essence or thickening agent. Denny Liu, with the recipe from Zhang, set up the company in 2015, and did two things to win consumer trust: 1) He has **made the recipe** that Zhang developed **public**, allowing everyone interested in the products to make them by themselves. 2) He opened the first store in Sanlitun with a mini-factory inside, where **consumers can walk by and observe the process of Le Pur yogurt production** from beginning to the end. Such differentiated approaches, together with novel flavors (such as coconut, rose, and hazelnut) have quickly won over yogurt lovers. Recently, monthly sales have exceeded Rmb10mn. We believe the **market cultivation, consumer centered innovations in new products and flavors** as well as **targeted marketing** are the engines of the company’s growth.

**Exhibit 49: Low-temp yogurt is expanding remarkably**  
Breakdown of yogurt market in China



Source: Euromonitor, Goldman Sachs Global Investment Research.

**Exhibit 50: Chobani’s Greek yogurt brand has grown from 0 to No.1 within 10 years in the US**  
US yogurt market share breakdown



Source: Euromonitor.

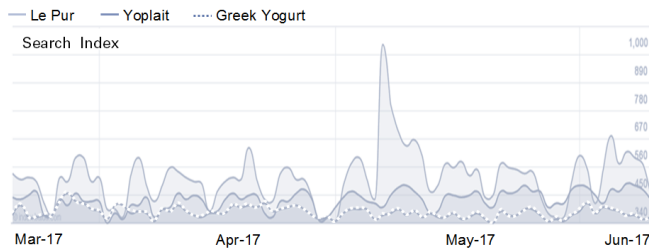
## Cultivating demand for the Greek yogurt category

In the past 10 years, strained yogurt (commonly called Greek yogurt) has gained momentum in the United States, Korea and Singapore. A Greek yogurt company, Chobani, founded in 2005, has surpassed large yogurt players in the United States over the past 10 years and has become the no.1 player. According to Statista, Greek yogurt held a c.50% share of the US yogurt market, up from 4% in 2008. The introduction of Greek yogurt has changed American tastes in yogurt, and its large consumer acceptance helped increase the pie of the yogurt category.

In China, we expect that: 1) **Low temp yogurt will grow at a CAGR of 17%** in 2016-2018E; and 2) among low temp yogurt, we expect **Greek yogurt will become the preferred choice over time just as in other countries**, as Greek yogurt contains more natural ingredients and

higher protein, in line with people’s desire for health. Brands such as Le Pur and Yoplait are building consumer understanding and interest in Greek yogurt. According to the Baidu Index, weekly numbers of searches in Le Pur and Yoplait are highly correlated to consumer curiosity about Greek yogurt. The investment on consumer education has turned yogurt into not only a **beverage but also a breakfast essential and an ingredient in a variety of dishes**. In line with delivery coverage and income level, early adopters are most likely from tier-1 cities and coastal areas, as suggested by the Baidu Index.

**Exhibit 51: Le Pur and other famous brands are cultivating consumer interest in Greek yogurt**  
Baidu index



Source: Baidu.com.

**Exhibit 52: Beijing, Shanghai and Guangzhou are showing the highest interest in Le Pur**  
Baidu index



Source: Baidu.com.

**Consumer focus: New flavors every month with pursuit of quality**

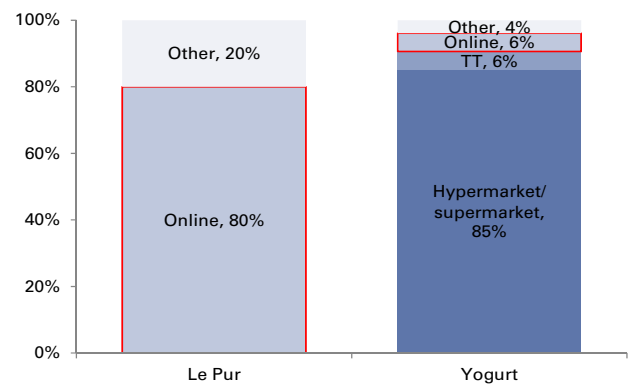
Every month, consumers will have a chance to try a new flavor. So far, Le Pur has launched 15 flavors in total. Some of them are exclusively available from Le Pur, such as rum and red grape, durian, rose and coconut. While traditional yogurt companies typically launch a new product/flavor every 6-9 months, Le Pur surprises its consumers almost every month. Such fast execution depends heavily on its unique distribution model – **80% sales from online channel vs. the industry average of only 6%**. Without the transfer time from producers to distributors to supermarkets, Le Pur yogurts are available to consumers in its Wechat or Tmall stores immediately after their introduction. Further, the purchasing behavior, consumer graphing and continuous sales data can provide support for the development of new flavors and the reasoning behind which flavors to maintain or remove, thereby building the ground for fast execution that a traditional player is unable to achieve.

**Exhibit 53: Le Pur offers a variety of differentiated flavors with aesthetic packaging**



Source: Company data.

**Exhibit 54: 80% of sales from online channel provide the foundation for fast execution and targeted marketing**  
Distribution channel breakdown



Source: Euromonitor, company data.

### Social media building consumer awareness and high-end hotels a window of product positioning

We believe an integrated marketing approach has helped make Le Pur one of the most famous yogurt brands in China.

**Effective social media marketing** is a powerful and cost-effective way to acquire new customers. Through tracking key criteria such as acquisition cost per user and ARPU, the marketing campaigns have been consumer centered, cost effective and powerful. For example, the first ad was to share the story behind Le Pur yogurt by highlighting Zhang’s devotion to improving its recipe for half a year and how its R&D team recruited 3,000 fans to engage in taste tests and provide feedback on ways to improve the product. The ad attracted 100,000+ readers in less than 24 hours, showing the power of sharing, initially from its fans, who spread it to a much wider and deeper audience. Another marketing campaign on Mother’s Day was to invite 12 groups of mothers and children to enjoy dinners made from Le Pur yogurt in five-star hotels; this ad reached 50,000+ readers in a day.

**Own store as a showcase and experience center:** When Le Pur opened its first store, it boosted consumer confidence in the quality and safety of its products—by allowing consumers to observe the yogurt-making process and speak directly with employees.

**High-end hotels** such as Peninsula and Waldorf Astoria also started to use their products. While it might not be a significant sales contribution, this serves as a **window of product positioning - premium, natural, high-quality Greek yogurt.**

### Risks

- Cold-chain accessibility:** Despite its popularity, the cold-chain infrastructure is only limited to mostly tier-1 and tier-2 cities; as a result, it is inherently difficult for Le Pur to penetrate a bigger consumer base. However, given its premium pricing, people with the purchasing power are mostly concentrated in higher-tier cities.
- Ability to innovate continuously:** Consumers are looking for new products and surprises, companies failing to meet their desires will lose the market over time.

# Yili Ambrosial | UHT yogurt

US\$1bn brand in 2.5yrs

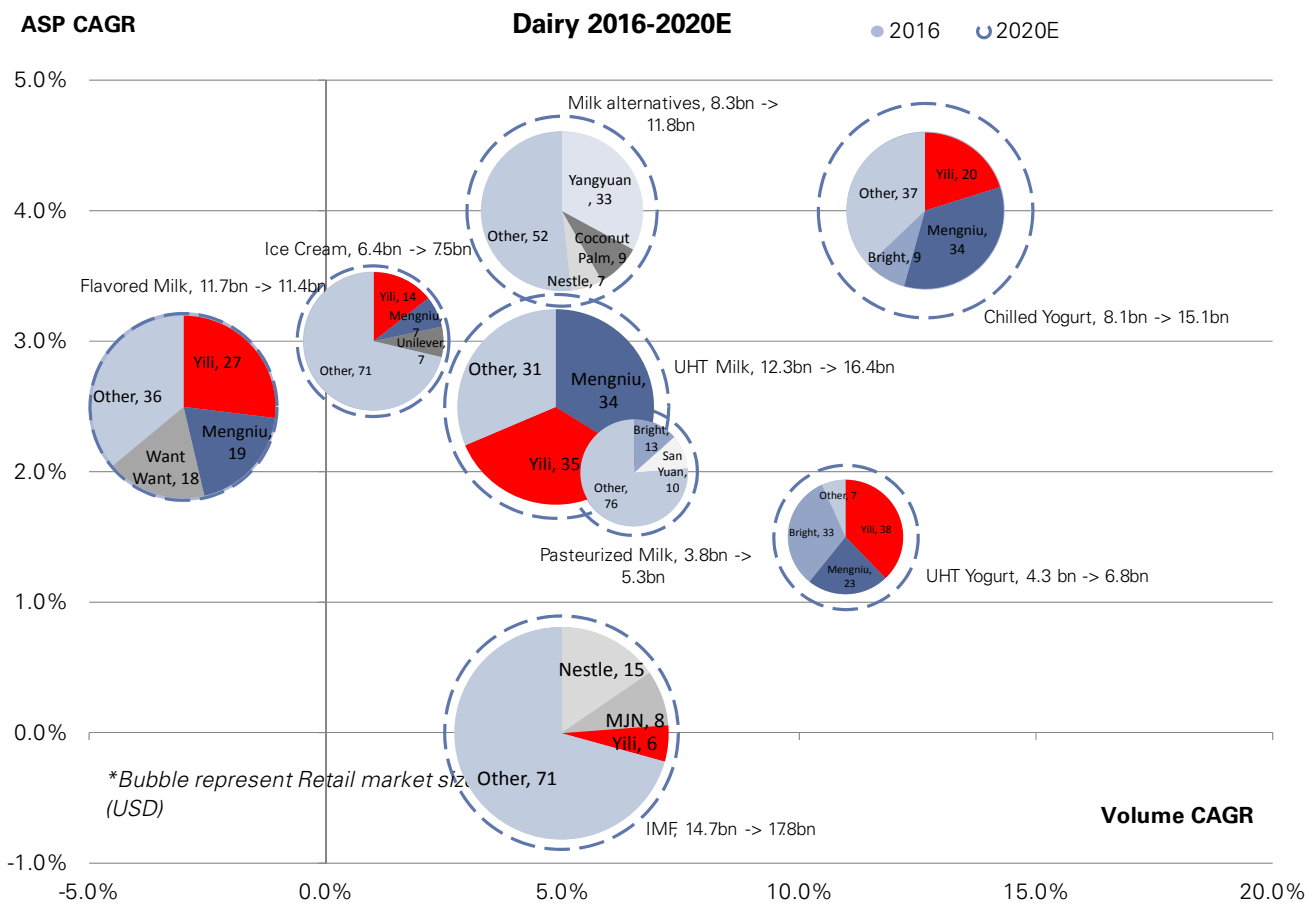



## Ambrosial: Bestselling SKU in Yili's portfolio

As the largest dairy company in China, Yili has proven its expertise in chasing high-growth categories and product innovation. Its latest new products include lactose free milk, red date flavored chilled yogurt, yogurt ice cream, etc. The UHT yogurt category was first created by Yili's competitor – Bright Dairy in 2009, through the launch of Momchilovtsi. From 2014, Yili, Mengniu and a few dairy companies entered this new and high-growth category. Benefiting from a comprehensive sales network in lower-tier cities and strong marketing support, Yili's Ambrosial surpassed Momchilovtsi in 1Q16 and has maintained its leadership position.

**Exhibit 55: Yili has dominant position in the yogurt, UHT milk, and IMF segments**

Dairy in a glance



Source: Euromonitor, Goldman Sachs Global Investment Research.

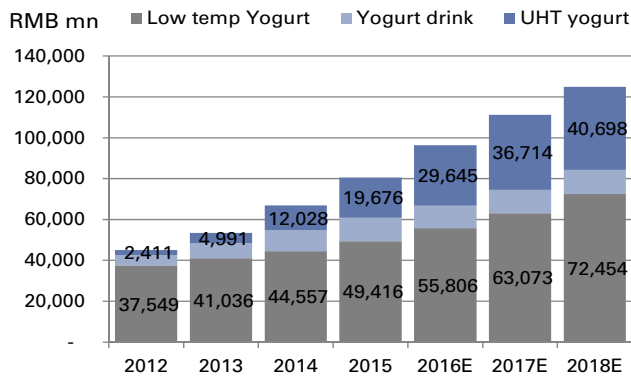
### Category growth from desire to taste yogurt in low-tier cities

The innovation of UHT yogurt has a few benefits: 1) **market penetration**: Limited by the development of cold-chain infrastructure, low-temp yogurt primarily serves tier-1 and tier-2 cities. UHT yogurt provides a much longer quality guarantee period, a wider transport radius, and simpler transport and storing condition. As a result, lower-tier cities and rural consumers are provided with a beverage alternative to carbonates, bottled teas and UHT milk. 2) **Nutrition**: Despite the lack of live acid bacteria, it provides the same benefits as milk does – relatively high protein (3.1g/100g for Ambrosial) and calcium content. 3) **Wider consumer group**: It provides an alternative for people with lactose intolerance.

Considering these benefits and the continued infrastructure limitation, we expect sales of UHT yogurt to reach Rmb41bn with a CAGR of 17% in 2016-2018E. Over time, Ambrosial has gained share significantly from Momchilovtsi, rising from 9% in 2014 to 38% in 2016.

**Exhibit 56: We expect the UHT yogurt segment to grow 24% yoy in 2017**

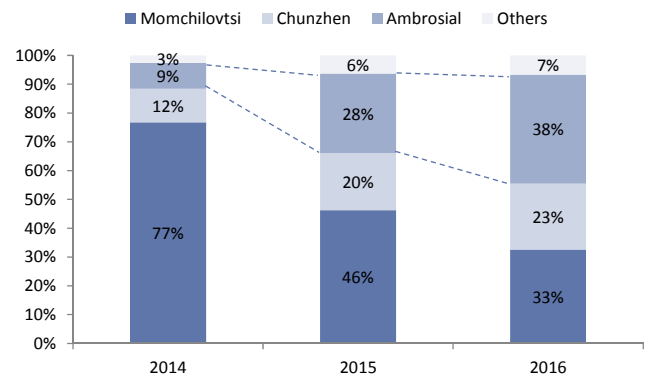
Yogurt market size 2012-2018E



Source: Company data, Goldman Sachs Global Investment Research.

**Exhibit 57: Ambrosial has gained share significantly over its competitors**

Market share breakdown of UHT yogurt



Source: Company data.

### Control of distribution channel

#### Greater presence in lower-tier cities

Yili has more than 8,000 distributors, whereas Mengniu and other peers have less than 5,000. With its wider distribution system, Yili has a greater presence in lower-tier cities and traditional channels than its peers.

#### Up-to-date consumer information

Yili has a flat distribution network and better control of the retail end. Yili employs a lot more sales people than its peers (30% more than Mengniu), as it has a flat one-tier distribution network. Its sales people contact their tier 1 distributor and then the distributor directly reaches out to the retail end. Under this network, Yili will be able to more efficiently adapt to the changes at the retail end and get up-to-date information from consumers.

#### Large-scale marketing in TV shows targeting mass market

Yili has invested heavily and effectively in marketing, typically spending on programs with wide reach and strong popularity among mass market / young consumers. In addition to product placement in TV series like *Growing Up*, movies like *Somewhere Only We Know*, Yili has sponsored the *Running Man China* TV series; the show gained an audience share of 15% in 2015/2016, and helped Yili establish its brand among mass market consumers.



Beyond lending their name recognition to the Ambrosial brand, celebrities are shown using Ambrosial as their “energy drink” during *Running Man China*. In an episode released on July 1, 2016 that was set in the Yili factory in Hohhot, Angelababy, Li Chen, and other celebrities needed to cooperate with Yili employees to complete tasks. In addition, Angelebaby and Li Chen were contracted to become ambassadors, further enhancing Ambrosial’s brand image, establishing the association between Ambrosial and tasty, healthy UHT yogurt.

**Exhibit 58: Ambrosial sponsors *Running Man China*, with an audience share of c.15% in 2015/2016**  
2017 key sponsorship

2017 Key Sponsorship					
Company	2017 TV Shows	Date	Brand	Expense (rmb mn)	Avg. Rating
Yili	中国新歌声 2 (China's New Voice 2)	1H17	Satine		
	我是歌手第五季 (I am Singer 5)	1H17		700	
	孤芳不自赏 (General and I)	1H17			1.72
	奔跑吧 (Running Man 5)	Apr-17	Ambrosial	500	
	我们相爱吧 (Let us date)	May-17	Chang Qing	150	
<b>Yili Total</b>				<b>1,350</b>	<b>1.72</b>

Source: Company data, 36Kr.com

**Exhibit 59: Angelababy and Li Chen, two celebrities that appear in *Running Man China*, are Ambrosial ambassadors**



Source: Company data.

## Risks

- Higher spend on A&P and price rebates driving down margin:** Effective use of marketing expense in, for instance, TV show naming is important. Failure to predict which name will win the heart of the mass consumer market will drive down margin without improving sales.
- Weaker-than-expected sales due to competition:** With limited product differentiation among major UHT yogurt products, other major players such as Bright Dairy and Mengniu may potentially grasp market share from Yili if marketing spending is insufficient or ineffective.

## Chu's Orange | Fruits

A simple product with a “founder’s premium?”



### A 90-year-old' man's orange dream

As the **biggest market and second-biggest country of origin**, China consumed 5.9mn tons and produced 6.2mn of fresh oranges in 2016 (USDA), or 12%/21%, respectively, of global consumption and production. When oranges are ready for the market, distributors buy from farmers at the market price, package and sell them to secondary distributors, and finally they reach consumers through mostly small grocery stores. As fragmented as the market is, **there is no established brand**; people distinguish the quality of oranges through place of origin, including Jiangxi Ganzhou and Hunan Hongjiang.

In 2002, at the age of 74, Chu Shijian contracted 2,400 acres in Yunnan Ailao Mountain to plant oranges. After years of devotion to improving the yield and taste, through cooperation with benlai.com (an ecommerce website focusing on fresh products), it quickly became popular from Yunnan province to Beijing and later nationwide because of both the story behind Chu Shijian and the taste of the oranges. People named it “Chu’s Orange” and called Mr. Chu “the king of oranges”. Along with robust demand, the **retail price** of Chu’s Orange went up significantly, and **was in parallel with imported premium brand Sunkist oranges in 2016** at Rmb158 every 5 kilograms on average. Inventory was typically cleared within a few days. We believe the success of Chu’s orange is due to **control of strategic assets, pursuit of excellence through experimentation, adoption of scientific findings and appropriate incentives for stakeholders**, as well as **brand association with Chu Shijian**.

**Exhibit 60: The logo clearly differentiates Chu's orange from other orange products in the market**  
Chu's orange logo



Source: Company data.

**Exhibit 61: The packaging is aesthetic, consistent with the premium positioning and suitable for gifting**  
Chu's orange packaging



Source: Company data.

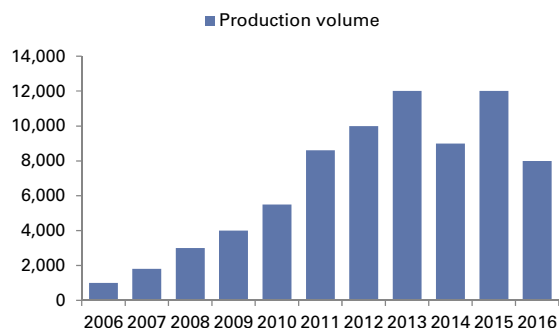
### Control of strategic assets – natural environment

**Unique natural environment:** Chu’s Orange contracted the Ailao Mountain for 30 years from the government, and as Exhibit 63 summarizes, it has one of the most suitable environments in which to grow oranges in terms of temperature, sunlight, climate, etc. In addition, through investment in water supply, the company has created favorable conditions for growing oranges.

**Investment in water supply:** The Ailao Mountain lacked water, resulting in a soil crust. Mr. Chu addressed this by investing millions to erect a 19km pipe and draw water from unpolluted Nanen Falls to the orchard. In addition to ensuring consistent water supplies in different seasons, he contracted nearby fishponds as a reservoir for the orchard.

**Exhibit 62: Devotion to improving taste, consistency of quality, even at the expense of production volume**

Annual production volume (tons)



Source: Company data.

**Exhibit 63: Control of strategic assets: Ailao Mountain's natural environment is among the most suitable to grow oranges****Ailao Mountain natural environment**

2,000+ AMSL, relative difference of height reaching 2.5 km  
 2,000 hours of sunlight  
 1,200mm of annual rainfall  
 Valley climate, 21 celcius degree in average  
 Built the infrastructure to obtain water from waterfall to grow plants

Source: Company data.

**Pursuit of improving quality and yield****Challenging tradition, experimenting and devotion to better taste**

**Challenging tradition brings higher yield:** Under the traditional approach, 146 orange trees were planted per acre in Yunnan. However, each tree produced only 3-4 kg of fruit in 2006. Mr. Chu investigated with experts, developed his hypothesis that the trees were too densely planted to obtain sufficient nutrition, and insisted on testing his hypothesis by cutting the number of trees planted to 80 per acre. In 2015, the amount of fruit each tree reached 40-50kg, with the per-acre amount reaching 4-5 tons vs. 3 tons in the United States and Australia.

**Experiments on fertilizer structure:** To improve the flavor of its oranges, the company set up a few pilot sites to test the effects of different fertilizers; the results were analyzed and compared. Subsequently, tobacco stalks and turf were added to the soil to improve its organic content. As a result, the organic matter in soil rose to 3% in 2015, compared to less than 1% in 2002.

**Devotion to better flavors:** To ensure quality and branding of Chu's oranges, the company cut 50% of tree branches and 30,000 trees in 2016, thus reducing supply by 4,000 tons without raising the price. In addition, the product is only introduced to the market when soil, leaves and sugar-acid ratio checks have reached the corporate standards.

**Incentive alignment with farmers**

Farmers' basic concerns about living are addressed, and Mr. Chu also uses proper incentives to enhance farmers' initiative and ensure the adoption of best practices.

- 1. Work without concern of living:** Every family is provided with houses and 1-2 acres of vegetable patch.
- 2. Income in correlation with product volume and quality:** Mr. Chu has also adopted a system that pays farmers a prepaid income of Rmb2,000 every month, calculates the actual income based on the volume and orange quality at the end of year, and pays back farmers the amount in excess of the prepaid income.
- 3. Penalties to ensure research findings are adopted:** To educate and incentivize farmers, Mr. Chu has developed a **comprehensive and numerical work plan covering every aspect of the business such as pruning, row spacing and spraying of chemical pesticides**, along with penalties for incomplete tasks: e.g., for every 50 oranges that drop to the ground, the farmer's prepaid income will be reduced by Rmb20; for every five oranges discovered not to be packaged properly in paper, the prepaid income will be reduced by Rmb5.

### Protecting the interests of retailers

To ensure the freshness of products reaching consumers, the company decided not to sell to distributors. During early meetings with the mass market in 2009, retailers were concerned about sales; these concerns were addressed in the following three ways:

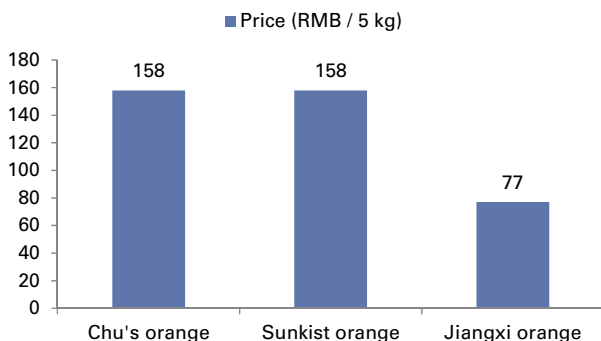
1. **Strong profit incentives:** The company sold to retailers at Rmb20/5kg whereas the retail price was Rmb50/5 kg.
2. **Unconstrained cash:** The company received money after the oranges were sold.
3. **Protective mechanism for retailer profit:** If the fruits were unsold for too long, the company would pay a 5% fee to retailers as a compensation for wear and tear.

### Traffic from brand association with Chu Shijian

**Brand association with one of the most controversial businessmen in China:** Chu Shijian turned a loss-making tobacco factory operation into one of the worlds’ five largest, creating Rmb99.1bn in tax revenue vs. his own income of less than Rmb1mn in 10 years. However, he was subsequently accused of corruption and sentenced to life imprisonment. At 74, following a medical parole, he decided to plant oranges. **The association with such a unique figure has been a valuable intangible asset**, differentiating the company’s oranges from all fresh products, which are mostly unbranded.

**Exhibit 64: Chu’s Orange is priced in parallel with imported brands, 2X the price of local unbranded oranges**

Price comparison



Source: benlai.com, tmall.com.

**Exhibit 65: Social media sharing: Chu’s Orange has a controversial story behind it that has attracted the public’s attention**

Year	Chu Shijian History
1979	Director of Yuxi Tobacco Factory
1995	Letter of accusation on Chu bribery, daughter and wife in prison
1996	Daughter committed suicide in prison
1997	Yuxi factory became the biggest in Asia, creating tax revenue of <b>RMB 99.1bn</b> vs his personal income only <b>0.6mn</b> over 18 years
1999	Chu received life imprisonment
2002	Chu (75 years old) got medical parole
2011	Chu rented 2,400 acres to plant oranges in Ailao Mountain
2011	The farm earned RMB 30mn+ a year, with FA RMB 80mn+ a year

Source: Company data.

**Online channel fueling its success:** In 2012, benlai.com, a startup of fresh product ecommerce, sold Chu’s oranges in Beijing. The company’s CEO, an ex-media professional, wrote a few articles describing the stories behind the orange and created an easy-to-remember slogan – “there are ups and downs in life, while spirits can pass on”, in which orange is homophonic of the last character. This turned out to be a great success: even priced at Rmb128-148/5 kg (premium lines), 200 tons were sold out in less than 10 days in 2012 and 1,500 tons were sold in the subsequent year through the ecommerce platform.

### Risks

1. **Ability to find new areas suitable to plant oranges:** Given a stable pricing strategy, scale matters for revenue growth. However, a few question marks exist, such as: how many more plants with suitable conditions can the company find and how many can it get the permit to use?
2. **Ability to maintain good practices and high standards:** While the standard is set up to be high, execution matters, which depends on company profitability, consumers’ continued preference for Chu’s orange, regular training, consistent delivery of proper incentive mechanism, management practices, etc.

# Lao Gan Ma | Sauces

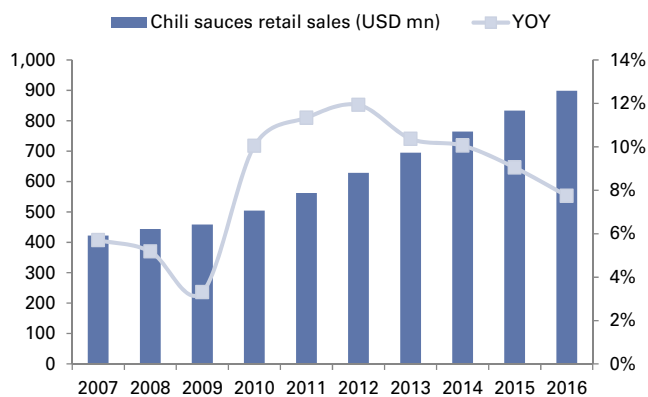
A spicy SKU through the cycles




## China’s best-selling chili sauce for over 10 years

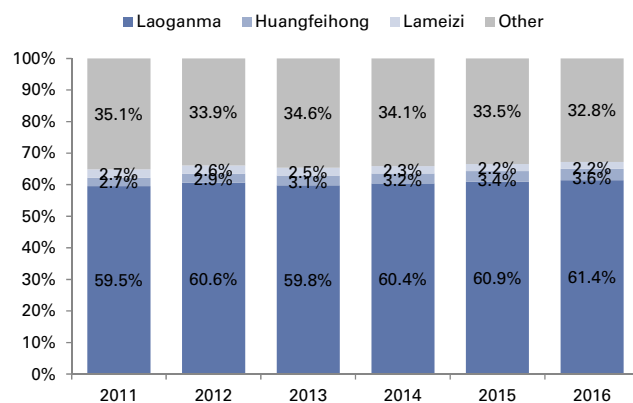
Tao Huabi, or Lao Gan Ma, initially started out as a simple restaurant selling rice tofu and noodles, and provided chili sauces for free. The chili sauces turned out to be so popular that customers were willing to buy it and take it back home. In 1994, when a highway was built next to the restaurant, truck drivers became the main consumers of the restaurants. Ms. Tao gave them chili sauce as gifts. As the truck drivers travelled to different parts of China and broadcast Lao Gan Ma through word of mouth, it has gradually established its reputation. With over 13 different types of chili sauce priced at c. Rm9/ 210g, Lao Gan Ma **consistently maintained a market share of c.60% in China in 2007-2016**. At such a stable market share, it has generally grown in line with the market by the high-single-digits in recent years. We believe **differentiated and consistent flavor** and a **competitive pricing strategy** are the key reasons for its success.

**Exhibit 66: Chili sauce still enjoys healthy demand in China, growing by the high single digits**  
Chili sauce market and yoy growth



Source: Euromonitor.

**Exhibit 67: Laoganma has consistently dominated the market, with a market share of 62% in China**  
Market share of chili sauce



Source: Euromonitor.

## Differentiated and consistent flavor

In 2015, *The Los Angeles Times* held a blind testing of a number of hot sauces such as Tabasco, Sriracha, Cholula, and Lao Gan Ma. Two chefs and a restaurant critic were judges, made Lao Gan Ma the winner and described the experience of tasting the sauce as “a three-course meal in a spoon” as “it has sweetness, heat, fermented complexity and a deep toasted-onion flavor”.

**Word of mouth has been key:** Consumers are voluntarily sharing ways to use Lao Gan Ma. Typical dishes include braised eggplants, dry-fried French beans with minced pork, etc. Western consumers also developed many more creative ways to use it as sauces to match with mashed potatoes, salad, and even ice cream.

**Exhibit 68: The unique and rich flavor made Lao Gan Ma the winner in a hot sauce blind taste test...**



Source: LA Times.

**Exhibit 69: ... and attracted consumers to share different creative ways to use Laoganma voluntarily**



Source: Goldman Sachs Global Investment Research.

### Competitive pricing to maintain monopoly in China

Targeting the mass market, chili sauces are developed to be acceptable for even people who typically do not use chili as condiment. Consistently, pricing strategy has reflected its mass market positioning. At a lower price compared to almost all of its peers, it helps to maintain the dominant position in China. With economies of scale, Lao Gan Ma has been able to **enjoy lower unit production and procurement cost**, thus enhancing profitability without the need to raise ASP. When entering overseas markets, Lao Gan Ma continues to target the mass market, making it an affordable condiment through a pricing strategy comparable to other hot sauces.

**Exhibit 70: Lao Gan Ma has maintained competitive pricing to dominate the market**

Brand	Lao Gan Ma	Run Ge Fang	Xiao Kang	Lee Kum Kee
Price RMB/kg	31.0	36.4	38.9	52.4
Price	8.7	10.2	10.9	17.8
Size (kg)	0.28	0.28	0.28	0.34

Source: Tmall.com.

### Brand association – “flavor of home” for overseas dwellers

Lao Gan Ma has been sold to 30+ countries and regions, and has been named the “flavor of home” by overseas dwellers and students. Overseas dwellers also have limited access to other domestic chili sauce brands and not all are knowledgeable and have time to make chili sauces by themselves. Lao Gan Ma has been a convenient way for them to enjoy the “flavor of home”. Besides, when young students go abroad, many have not developed strong cooking skills. Lao Gan Ma serves as the best choice to improve the flavor of dishes.

### Risks

Change in taste of the young consumers relative to older generation, desire for diversified hot sauces, and other international hot sauces entering China may potentially affect Lao Gan Ma’s business in a negative way.



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## Four key trends

# 1. Health is the new wealth

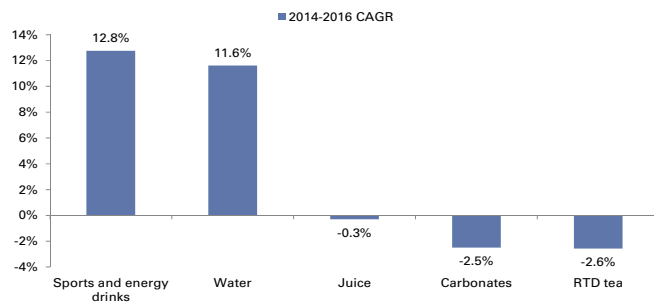
## “Healthy” concept now more critical, especially for sugary categories

As volume penetration has gradually increased in past years, Chinese consumers now prefer quality rather than quantity, and we have seen a general trend toward healthier products or healthier concept products.

There are a number of healthy trends happening in the China beverage segment: Beverages with less sugar content, such as water or sports drinks, have gained strong momentum in China, vs. the decline of carbonated soft drinks or low content juice drinks. More young consumer now prefer less sweet products but want more function in the soft drinks.

Also, room temp yogurt (yogurt with high temp sterilization) is gaining popularity in China in the past three years due to consumer’s increasing awareness that yogurt is good for digestion and nutritious. We believe Yili’s single SKU can grow as big as US\$1bn sales in two and a half years. Hence, we see a shift from milk beverage to room temp yogurt, despite the fact that it may as has much health benefits as chilled yogurt/Greek yogurt.

**Exhibit 71: Beverages considered healthy have seen strong growth**  
Beverage subcategory growth



Source: Euromonitor.

**Exhibit 72: Difference between perceived and actual healthiness**  
Fresh milk tea calorie, fat and sugar content

Per cup	Fresh milk tea 500 ml	Coke 330 ml
Product		
Calories	289	142
Sugar	34	35
Fat	32 (milk foam) 14 (milk tea)	0

Source: Shanghai Consumer Council.

**Exhibit 73: UHT yogurt was perceived as “healthy” in China and soared in past 3 years**

**Milk: Shift to high protein, functional and fresh products**

Avg Content (per 100g)	Yogurt Products				Liquid Milk	
	Yogurt Drinks	UHT Yogurt	Low Temp Yogurt	Greek Yogurt	Milk Beverage	UHT Milk
Protein	1.1g	2.2g	2.9g	4.1g	2.4g	3.3g
Sugar	15g	12.7g	12.3g	5.5g	10g	5.1g
Calories	70	90	90	77	78	75
ASP (Rmb per pack)	Rmb 6.5 (340ml)	Rmb 5.8 (200g)	Rmb 6.7 (250ml)	8.7	Rmb 4.1 (125ml)	Rmb 6.5 (250ml)
Main Brands	MaiYiTian (Yili) YouYiC (Mangniu) Yakult	Ambrosial(Yili) Just Milk (Mangniu) Mornshilovtsi (Bright)	ChengQing (Yili) GuanYiRu (Mangniu) BiYou (Danone)	Rushi (Bright)	WangZai (Want Want) QQ Star (Yili) Futura Star (Mangniu)	Satina (Yili), Milk Deluxe (Mangniu)
2012-16 Sales CAGR	23%	88%	10%		3%	7%
2016-20 Sales CAGR	2%	13%	17%		-1%	8%
Product Picture						

Source: Company data, Goldman Sachs Global Investment Research.

## 2. Packaging spurs impulsive consumption

### Packaging: First impression can spur impulsive consumption

F&B products' packaging delivers the first message to consumers, and is an important way to attract new consumers. An appealing or very differentiated package can attract younger consumers more easily and spur impulsive purchases. Three Squirrels or Be & Cheery have succeeded in the market by upgrading their packaging with more interactive, cartoon features. Nongfu Spring and Classmate Xiaoming have changed the shape of their bottle and bottle cap, so their products are very distinctive from peers.

### Packaging convey the message of branding and product quality

Also, the packaging material and product pictures of the package can often affect the quality of the brands. For example, Nongfu Spring's bottled water products have a variety of packaging designs corresponding to the seasons of the year, which leaves consumer with a positive perception of its natural water source and taste quality.

**Exhibit 74: Consumer preferences, packaging and differentiated marketing approaches helped the success of Classmate Xiaoming and Tea Pie**



Source: company data.

### Packaging can create more purchase occasions

Also, packaging with small functional improvements can change consumption patterns and create additional purchase occasions.

For example, the moisture adjusted packaging that ZHY uses for its products makes it possible for braised food to be stored up to seven days in a chilled environment, and this has helped to fuel more snack demand vs. the past when dining consumption was the norm.

**Exhibit 75: longer expiry date, wider distribution, safer food, from dining table to snacking**  
Packaging comparison



Source: Company data.

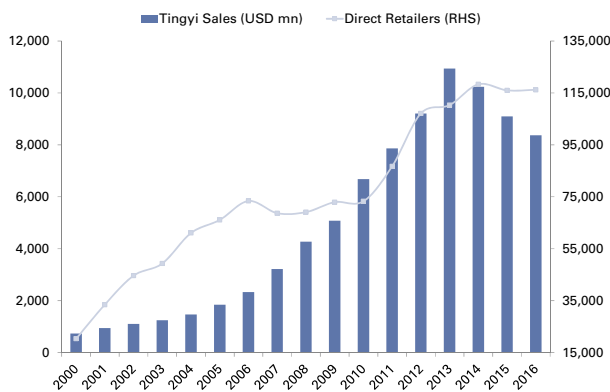
### 3. Brand association: Buying is about feeling

#### Distribution barriers diminish rapidly as online/CVS proliferates

In the 2000s, many large F&B companies expanded their distribution networks. Companies like Tingyi and Want Want penetrated into low tier cities and rural China with multiple layers of distributors and established leading market shares in term of sales volume.

If in the past 15 years, companies have succeeded in the market by expanding their sales teams, better leveraging distributors and squeezing out other peers. However, in recent years this model has not been functioning as good as before.

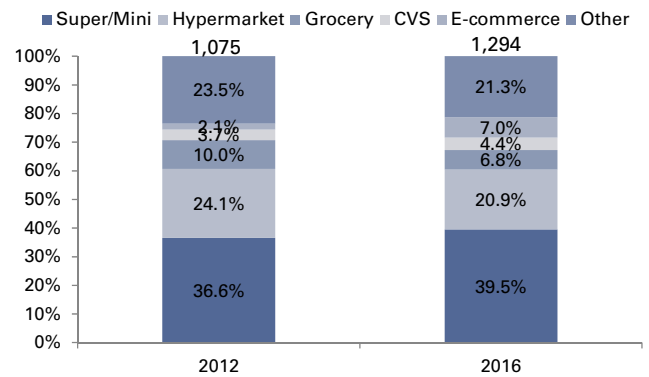
**Exhibit 76: Tingyi POS more than 8X over 2000-2013, benefiting strong sales growth**  
Tingyi sales and POS



Source: Company data.

**Exhibit 77: Online penetration growing 50% every year in staples sector**

Online penetration of Staples in China



Source: KantarWorldpanel.

#### Branding now more important, creating emotional connection with consumers

As distribution barriers diminish, branding becomes more important. What consumers purchase now is what they feel and perceive for the products. We believe consumers now prefer products with higher brand connection – not necessarily the premium brand, but brands that have a clear image or linkage to product features.
















Out of the 10 hottest brands, we see a majority of them have strong brand linkage to product quality (Chu Orange, Le Pur), fashion or cartoon (Heytea, Three Squirrels) or an addictive taste (ZHY, Lao Gan Ma). Below are a few examples:

**Chu’s Orange:** Company’s founder has a strong mentality and unique experience in the past. He is very dedicated and persistent in his work and spends almost five years building/growing the orange plants. With no aggressive advertising or promotion, Chu’s Orange has established a strong connection with high product quality, as consumers trust in its founder’s mentality and are touched by his personal experience.

**Three Squirrels:** Company has successfully established its cute “Three Squirrels” cartoon figures and presents these cartoon images on its product packaging, online platforms and interaction with customer services. Hence, now consumers can easily connect Three Squirrels with the cartoon image and perceive them as a representative of the nuts category. Going forward, the company can also leverage the Three Squirrels as intellectual property and apply to other product categories and derivative products (such as toys, souvenirs, etc.)

**Heytea:** It labels its products as natural and tasty, and has rapidly become fashionable in tier 1 cities, mainly through social media marketing and word-of-mouth.

**Exhibit 78: These brands have established differentiated associations among consumers**  
 Brand association summary

Brands	Association		Comments
	1	2	
<b>Three Squirrels</b> 			Cute squirrels, healthy nuts
<b>Zhou Hei Ya</b> 			Spicy duck neck, tasty and addictive
<b>Nongfu Spring</b> 			Natural water, aesthetic package
<b>HeekCaa</b> 			Tasty, photo sharing, long queue
<b>Chu's orange</b> 			Chu Shijian, quality oranges

Source: Goldman Sachs Global Investment Research.



## 4. Addictive tastes ensure repeat purchases

### Consistent delivery of quality products with differentiated tastes

Tastes and flavors are always the top of Chinese consumers’ minds. Brands that offer products with consistent, balanced and differentiated flavors have established themselves over time.

Duck neck company ZHY has developed its unique sweet-spicy taste, a mix of duck with spicy ingredients. Compared to peers, ZHY contains higher sugar content and hence tastes sweeter than Jue Wei’s hot spicy taste.

Lao Gan Ma, a Chinese well-established hot sauce brand, has gained popularity not only with Chinese consumers (evidenced by 60+% market share for 10 years) but also among chefs and restaurant critics in a hot sauce blind testing organized by the *Los Angeles Times*, which described the experience of tasting it as “a three-course meal in a spoon – sweetness, heat, fermented complexity and a deep toasted-onion flavor”.

Balanced flavor between sourness and sweetness has helped grow the reputation of Chu’s Orange, and allow it to sell at a price twice as expensive as its local peers.

**Exhibit 79: ZHY products contain higher sugar and therefore have a sweet-spicy taste**  
ZHY ingredients vs Jue Wei

Brand	Ingredients	Taste
Zhou Hei Ya	Duck neck, sugar, aginomoto, chicken powder, salt, spicy ingredients, white spirits, soy sauce	Sweet spicy
Jue Wei	Duck neck, sugar, salt, aginomoto, chicken powder, white spirits, vegetable oil, chili, pepper, ginger, other spicy ingredients	Hot spicy

Source: Goldman Sachs Global Investment Research.

**Exhibit 80: The unique and rich flavor made Lao Gan Ma the winner in a hot sauce blind test**  
Lao Gan Ma blind test



Source: LA Times.

### Tempting regular customers with speedy and innovative offerings

Heytea and Le Pur also realize a high retention rate – not through an unchanged formula, but through innovations or ongoing launch of refreshed flavors.

Heytea established itself through innovation of cheese milk foam. Since then, it has continued to work on improving the product quality and portfolio through: **1) tea base unavailable in markets; 2) seasonal offerings; and 3) experimenting on a roast blend of teas, attenuation, etc.** Such efforts have paid off – Heytea has achieved surprisingly high store productivity, 6.8 times the productivity of a normal milk tea store in China.

Le Pur, a Greek yogurt start-up in China, satisfies consumer desires for a feeling of freshness. Compared with a typical yogurt brand with generally 3-5 flavors (e.g., original, blackberry and mango), Le Pur has provided **exclusive flavors such as tiramisu, durian, rose and coconut, and etc.**, and continues to **surprise its customers with a new flavor almost every month.**

**Exhibit 81: Heytea tries to provide fresh and innovative milk tea choices to drive repetitive consumption**  
 Heytea product differentiation



Source: Company data.

**Exhibit 82: Le Pur continues to launch differentiated flavors with aesthetic packaging**  
 Le Pur Greek yogurt flavors



Source: Company data.

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## Key industry themes

# Venture capital working in China F&B: Crowded in “healthy” space

## RELATED REPORT

### VENTURE CAPITAL HORIZONS

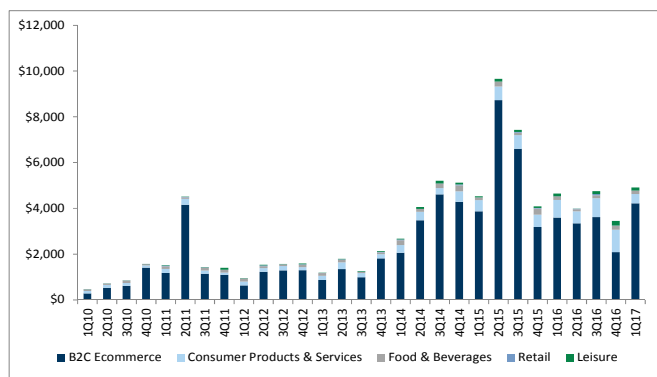
[Consumer Edition: The Sustaining Power of LOHAS](#)

## Global perspective: Focus on consumer & LOHAS

Globally, the venture environment for consumer has outperformed total VC investment on average, growing at a CAGR of 29% since 2010 vs. total VC funding growth of 23%. The Consumer sector includes a diverse set of industries such as Consumer Packaged Goods (CPG), B2C ecommerce, consumer services, retail, F&B, restaurants, travel, lodging, entertainment, and sports & recreation. Lifestyles of Health and Sustainability (LOHAS) have been a key growing influence for the overall space.

**Exhibit 83: VC funding for consumers accelerating recently and B2C is the majority**

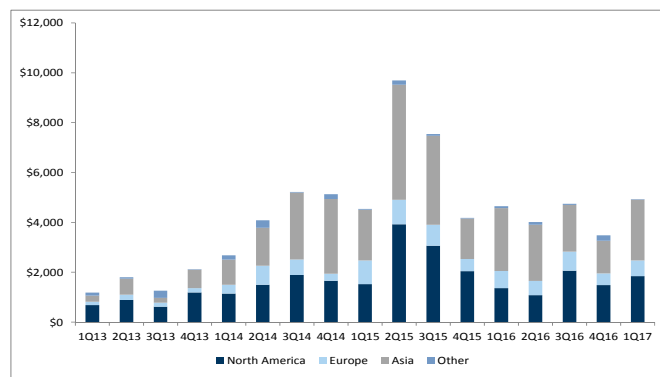
Consumer VC by category



Source: Company data.

**Exhibit 84: Asia VC investments account for 46% of global funding (mostly driven by Chinese start-ups)**

VC Investments in Consumer by Region



Source: Company data.

**Exhibit 85: Where the dollars are going in global consumer space**

**Global VC Snapshot - 1Q17**

<p><b>Deal volume</b> <b>3,526</b> (+7% yoy)</p>	<p><b>Investment</b> <b>\$27BN</b> (-7% yoy)</p>	<p><b>VC funding growth by sector</b></p> <ul style="list-style-type: none"> <li>• Technology -3% yoy</li> <li>• Consumer (ex-ecommerce) -31% yoy</li> <li>• Healthcare +12% yoy</li> <li>• Industrials +161% yoy</li> <li>• Financials/FinTech -53% yoy</li> <li>• Energy -33% yoy</li> </ul>
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**Where the Dollars Are Going in...Consumer**

We use our vertical analysis framework to highlight subsector opportunities and representative companies across the VC funding spectrum.

**Stage 1**  
Rapidly growing on both a dollar and deal count basis; low capital base

**Pet Products**  
PetNet  
Nullo  
Ollie

**Household**  
Coravin  
Vestaron

**Stage 2**  
Faster growing verticals on a larger capital base

**Ecommerce Enablement**  
Wynd  
BigCommerce  
Tradesty

**Health & Wellness**  
Bigfoot Biomedical  
Habit  
Imsignal

**Stage 3**  
Modest growth within large investment verticals

**Consumer Electronics**  
Thalamic Labs  
Devialet  
UBTECH Robotics

**Restaurants**  
Philz Coffee  
Sweetgreen  
Cava Group

**Stage 4**  
Declining growth off a large capital base

**Non-alcoholic Beverages**  
ALOHA  
Ripple Foods  
REBBL

**Online Food & Grocery**  
Deliveroo  
Yiguo

**VC Funding Growth** (y-axis) vs **VC Capital Base** (x-axis)

Source: Goldman Sachs Global Investment Research.

### China: “Healthy” concept a key attraction

This growth for smaller players in China has been greatly helped in recent years by increasing investment from venture capital (VC) and private equity (PE) funds. The majority of the 10 brands we explore in this report have been backed by VC/PE investment. We also looked at the overall China F&B space investment track record, and found that investments in the F&B space have centered on two key trends – a focus on healthy foods and premium products.

This ties to global consumer stage 3 and 4 as beverage, food grocery and restaurants are among the hottest funds for now.

Fresh tea has been a hot investment topic for VC/PE over the past three years, with a number of companies – including Heytea – labeling themselves as offering more natural tea, with less added sugar/ingredients, or with fresh fruit mixed in. Around 5-10 similar fresh tea companies have attracted VC/PE investment, and this has helped the expansion of the industry.

Similarly in packaged food, we see the healthier nuts, salads or yogurt categories have attracted more VC/PE funding in the past few years.

### China: “Out of home” consumption growing quickly

Foodservice has consistently delivered 20%+ growth over the past three years, and a number of popular restaurants or chains have emerged. Although this could potentially be a competitive industry with constantly changing consumer taste/brand preference, many VC/PE have funded companies with differentiation or upgraded food service.

### Exhibit 86: F&B startups that meet the desire of healthy concept, premiumization and convenience have been well received by primary market in China

Example of investments in F&B space by venture capital and private equity funds

Brand	Round	Funds	Funding (Rmb)
<b>Packaged food</b>			
Three Squirrels	D round	Li Feng, IDG Capital, Capital Today, FreeS Capital	0.1-1bn
Be & Cheery	Acquired	Hao Xiang Ni	0.1-1bn
Le Pur	A round	IDG Capital, Zhao Zhiyuan	10-100mn
Guan Tea	Pre-A round	FreeS Capital, Li Kanglin	10-100mn
Xiao Xian Dun	A round	Angel Plus, 36Kr, Zhou Hongwei, Chen Shu, Moonycherry Group	10-100mn
Yan Xiao Mai	Angel	Undisclosed	10-100mn
Sonetto	Pre-A round	Dan Ke Capital, Win-Light Investments	10-100mn
With Wheat	A round	Light-up Capital, Sinovation Ventures	10-100mn
<b>Beverages</b>			
Panda Brew	A round	Tang Binsen, Hua Tong Group	0.1-1bn
Penguin Group	A round	Qing Cong Capital, Zhen Fund, PreAngel, Galileo Ventures	10-100mn
Jiuhuar.com	Pre-A round	Tisiwi	10-100mn
<b>Fresh milk tea/coffee</b>			
HeekCaa	A round	IDG, Capital Today, He Boquan	0.1-1bn
inWE	A round	Liu Qiangdong	0.1-1bn
Mattburg	Angel	Liu Ting Capital	0.1-1bn
Jie Xiang Beverages	Pre-B round	Shengjing Group	10-100mn
Lai Bei Ka Fei	Pre-A round	Yongche.com, Plum Ventures, K2 VC, Zhen Fund, Cyanhill Capital	10-100mn
Wing Café	NEEQ	Zhen Fund	10-100mn
Xiao Guan Tea	A round	Jian Kun Investments	10-100mn
Seesaw Coffee	A round	Hony Capital	10-100mn
<b>Salad</b>			
Sagreen	A round	Lightspeed China Partners, Light-up Capital	10-100mn
Sexy salad	B round	IDG Capital, Wang Juanshu, NextBig, FreeS Capital and etc.	10-100mn
<b>Foodservice</b>			
Yum China	Strategic investment	Primavera, Ant Financial	US\$ 460mn
He He Gu	Acquired	Hony Capital	0.1-1bn
Spice Spirit	A round	N5 Capital, Plum Ventures	10-100mn
Alati	A round	SR Capital	10-100mn
Xiao Wei Yang	NEEQ	CSC Group, Jundefu Ventures	10-100mn
Xi Xiang	A round	Zhejiang Jinkong Assets Venture Investment, Newslon Venture Capital	10-100mn
Xiao Mian	A round	Hony Capital	10-100mn
Pho Norm	A round	Hony Capital, Baifu Group	10-100mn
<b>Foodservice lifestyle/media</b>			
Amanda Tastes	Pre-A round	Clear And Logical Fund, Hexiang Co. Ltd.	10-100mn
Penguin Guide	A round	Bertelsmann Asia Investments, Ping'an Innovation Investment Fund	10-100mn

Source: itjuzi.com, company data.



**Exhibit 87: Five of the 10 hot brands we explore in this report are from smaller players and have secured VC/PE funding in the past five years**

Funding history of the 10 hot F&B brands in this report

Round	A	B	C	D
Three Squirrels	Mar-12 USD 1.5mn IDG Capital	Jun-13 USD 6mn IDG Capital, Capital Today	Mar-14 RMB 120mn IDG Capital, Capital Today	Sep-15 RMB 300mn FreeS Capital
	May-11 RMB 10mn NA	Feb-16 RMB 960mn Acquired by Hao Xiang Ni		
HeekCaa	Aug-16 RMB 100mn IDG Capital, Capital Today			
Le Pur	Aug-15 USD several mn IDG Capital			
Zhou Hei Ya	Nov-11 RMB 60mn Tiantu Xingsheng	Jul-12 RMB 150mn IDG Capital, Tiantu Capital		

Source: Company data, Goldman Sachs Global Investment Research.

## Global perspective: A healthier world with small outpacing the big

Health and wellness has become a global topic in the past few years, with reduced sugar drinks and savoury snacks gaining in popularity vs. carbonated soft drinks or sugary snacks. In addition, premiumization continues to be a trend as consumers are willing to trade up and pay for differentiated products.

On the company level, our global analysts also see the “craft” phenomenon gaining further momentum in the F&B space, with small companies rising up and grabbing market share from the large incumbents.

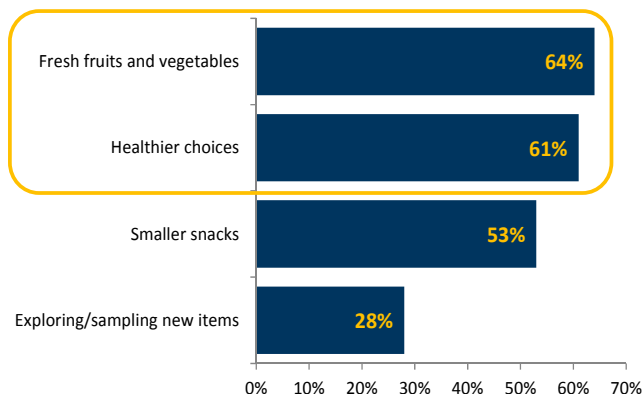
On the flipside, it is still debatable whether the “health” drivers are more cyclical or sustainable, given that some prepared food categories (desserts, crisps) are also outpacing overall growth.

We believe this could apply to a similar pattern in China, and we have started to see a more divergent trend of consumers: some sweet/high calorie products are declining, while lower-calorie water, salads, and probiotic drinks are increasing share. At the same time, the more savory snacks, and some high-calorie nuts, even room temp yogurt, which are regarded as more healthy, are also becoming popular in China now.

### The rise of health and premiumization are key consumer trends globally

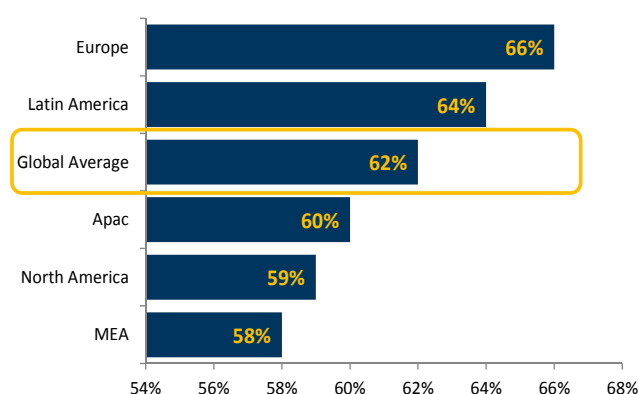
The focus on healthy eating has become a global phenomenon with most consumers now indicating they prefer low-sugar or healthier options. This trend is also reflected in growth rates for healthier food categories (such as nuts and fruit snacks), which are outpacing growth rates for sugary foods.

**Exhibit 88: Consumers opting for more healthy snacks: How has your snacking changed in the past five years?**  
What snack foods are consumers having more often?



Source: The Hartman Group, Inc.

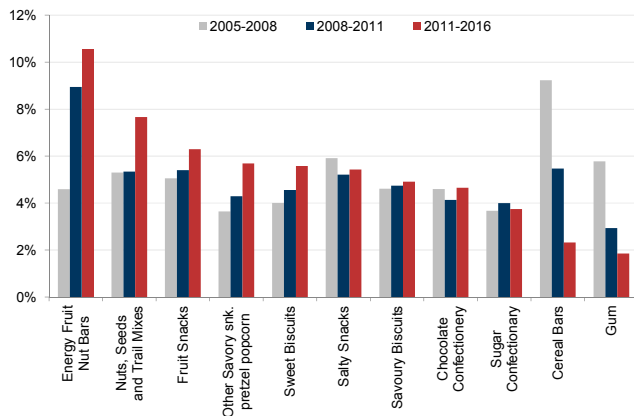
**Exhibit 89: What ways are consumers changing diets to lose weight? – cutting down on chocolate, sugar etc.**  
Percentage of consumers aiming for “low sugar” in diet



Source: The Nielsen Company

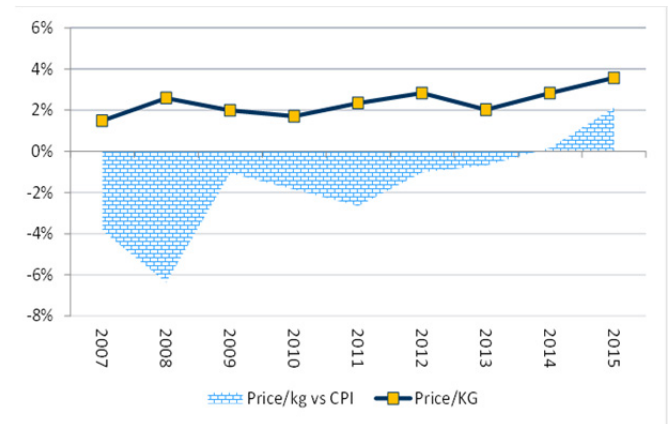
**Premiumization trend:** Consumers are increasingly showing a willingness to trade up to differentiated and unique premium offerings, as demonstrated by the outsized global price/mix inflation in global snacking. Mainstream mass-market oriented brands are lagging as a result.

**Exhibit 90: We see more natural, less-processed categories posting the most robust growth, while sugary snacks (e.g., cereal bars and gum) are fading**  
Snacking subcategory sales CAGR (Global)



Source: Euromonitor, Goldman Sachs Global Investment Research.

**Exhibit 91: Premiumization continues to be topical as global pricing vs. CPI gap increases and acceleration in price/kg remains solid**  
Price/kg vs CPI (globally) YoY, Price/KG (YoY)



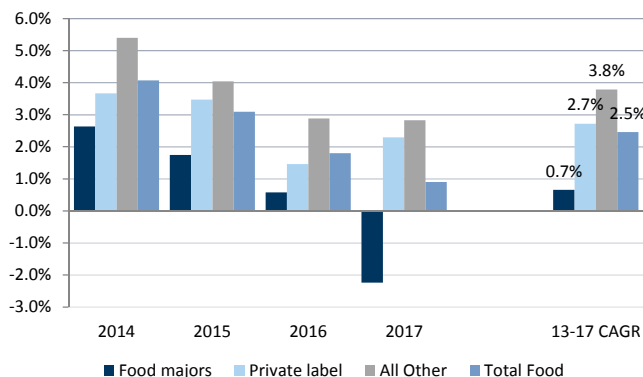
Source: Woldbank, Euromonitor, Goldman Sachs Global Investment Research

**Small brands rise up in both snack and beverage**

As the distribution barriers for brands are fading and branding awareness can be enhanced through more digital platforms, we see the smaller brands continuing to make inroads and outpacing both industry and private labels brand growth.

This is happening in both the snack and beverage categories where the big incumbents have lost share in past years.

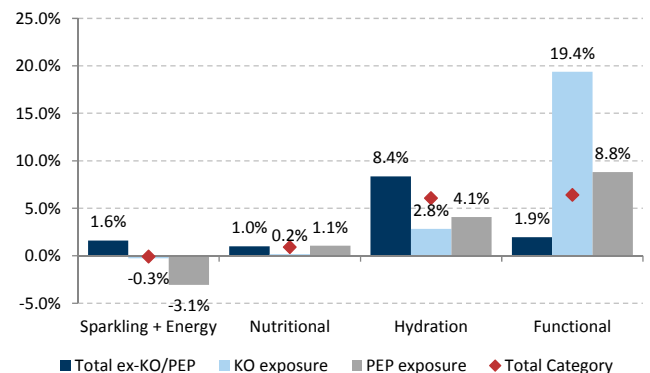
**Exhibit 92: Share losses have come as a proliferation of assortment at food retailers persists with smaller branded companies the primary gainers**  
YoY Average items per store, 52 wk periods ending March



Note: Food majors include CAG, CPB, GIS, HSY, SJM, K, KHC, MDLZ, Mars, Nestle, PF

Source: The Nielsen Company, Goldman Sachs Global Investment Research.

**Exhibit 93: Non-KO/PEP sales are growing faster in most beverage category clusters**  
2016 sales growth by LRB consumer vertical



Note: (1) does not include not-fully owned brands; (2) MNST is not included for Coca-Cola (KO); (3) Lipton/Starbucks partnerships and KeVita (PF2016) added for Pepsi (PEP).

Source: The Nielsen Company, Goldman Sachs Global Investment Research.

## How can incumbents strike back? Expand category, focus on innovation and M&A

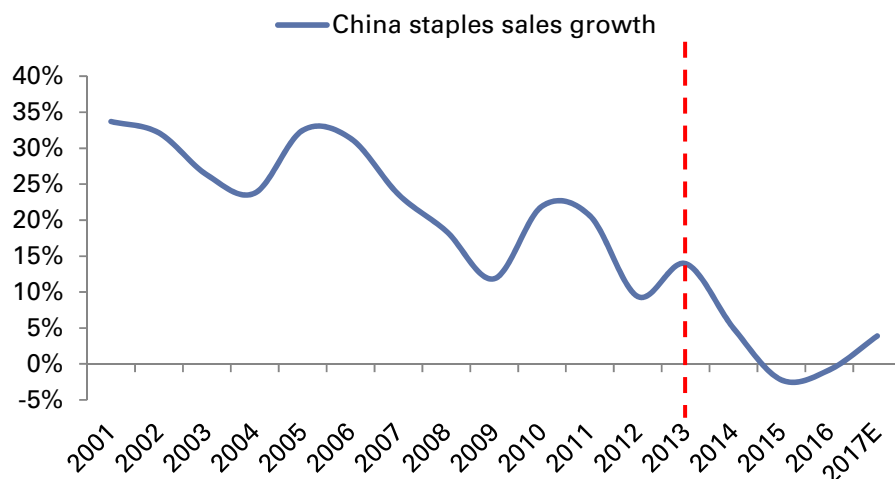
### Incumbents: Growth under pressure, divergent performance

Many of the large Chinese F&B players have seen slowing or even declining growth over the past three years. In 2000-2013, we saw generally strong growth for most of the listed players as volume penetration in China continued to improve. However, over the last three years, we have begun to see more divergent performance between the large incumbents.

The dairy companies, including Yili and Mengniu, have recovered well from the milk safety scandal that roiled the industry in 2008, and have maintained topline growth in the high single digits to the low teens since 2013. However, companies such as WW and Tingyi continue to see challenged growth.

#### Exhibit 94: Staples have reached a mature stage with low-single-digit growth going forward, significantly lower than the double-digit growth seen in 2001-2009

Sales performance (2000-2013) vs. 2013-2017E



Source: Company data, Goldman Sachs Global Investment Research.

#### Sales benefit from distribution expansion in the 2000s, but now more difficult

We view the growth in the early 2000s as due to both the volume penetration growth and the expansion of company distribution networks. Large F&B companies such as Tingyi and WW have expanded their point of sales (POS) by c.8X since 2000, and saw a stable market share gain during the period.

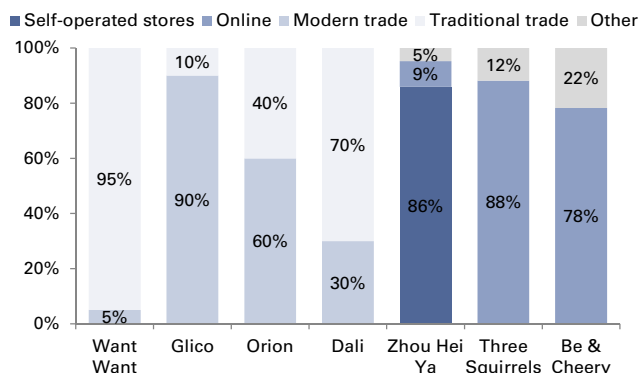
However, in the past few years, on the one hand we saw that Chinese FMCG's volume penetration has reached closed to the Japan/Korea level, and meanwhile there is less distribution expansion potential for the big incumbents. As a result, competition for market share has increased, and it is more difficult to push sales by simply selling to the distributors.

#### Online an inevitable channel, albeit not necessarily margin accretive

Even for FMCG categories, online has now reached 7% of total sales overall vs. only 2% five years ago. Taken together, convenience stores and online now account for c.12% of total sales and are posting the fastest growth. On the back of online proliferation, we have

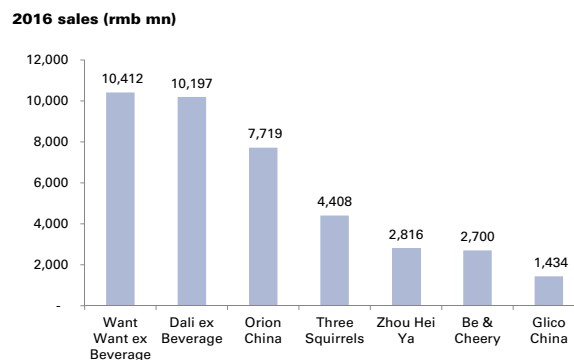
begun to see some almost purely online F&B brands emerging in China, such as Three Squirrels and Be & Cheery. More than 80% of their products are sold online, and they have reached a meaningful size vs. large offline F&B incumbents.

**Exhibit 95: Online-driven brands obtain 80% of sales from ecommerce channel**  
Channel split for snack brands



Source: Company data.

**Exhibit 96: Niche brands have reached a meaningful scale vs. the large players**  
Sales comparison



\*WW, Glico, Orion and Dali is ex-factory level. Be & Cheery is estimated.

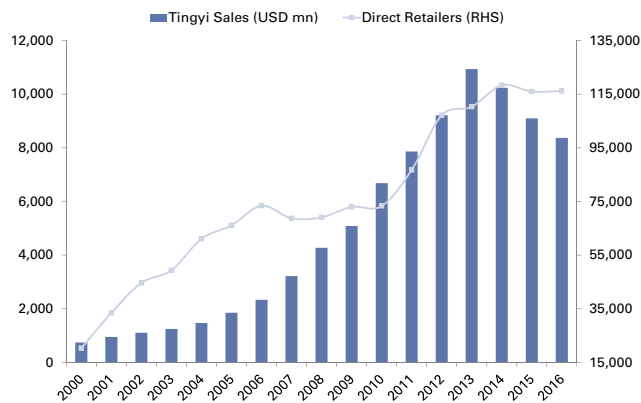
Source: Company data.

Using the online channel allows niche players to forgo the multiple layers associated with offline distribution, thereby reducing their distribution costs. Although brand owners can enjoy the full benefit of a direct channel, their online sales margin is not necessarily high vs. offline given the high traffic procurement cost on the ecommerce platform and the relatively cheaper selling expenses. For example, Three Squirrels has an operating profit margin of about 10% and ZHY's is about 18%-19% online. This compares to 29% for ZHY in offline self-operating stores and 21%-24% for other snack companies such as Dali/WW in the traditional channel.

Hence, we believe some large F&B companies with strong presences in offline channels have less incentive to expand into online channels given its negative margin mix. However, we believe online channels are a must-have for F&B companies as it also offers them the ability to directly connect with consumers and collect product feedback. For the niche players, online is also a great platform to establish a lively brand image.

### Exhibit 97: In 2000-2013, Tingyi expanded its direct POS by 8X

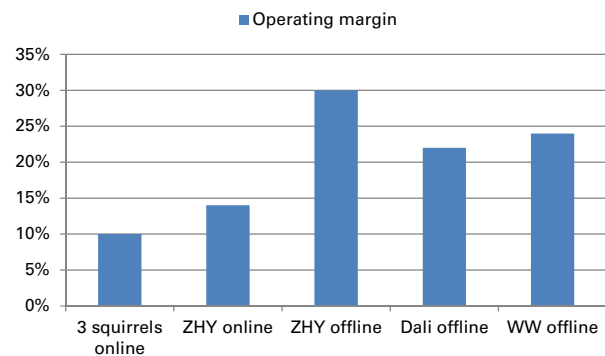
Distribution expansion



Source: Company data.

### Exhibit 98: Online snacks usually fetch lower margins than offline snacks

Margin comparison of various channels



Source: Company data.

### Brand fatigue is another issue

We believe some incumbents have been unable to avoid brand fatigue, especially among younger consumers. Although some brands (such as Wang Zi, Master Kong, etc.) were introduced into China around 15-20 years ago, they have not yet changed their product taste, packaging, or pricing. However, as consumers nowadays have become more diversified and are willing to try new products, we believe they may start to view these established products as either out of date brands from the previous generation or as mainstream brands rather than premium brands. When these companies want to launch new products using their existing brands, it is very hard for them to achieve premium brand positioning.

### Rising niche brands: What's different from incumbents?

#### Changing adoption path

**From advanced to developing regions historically:** In previous decades, it has generally been the case that brands have established their existence in Beijing, Shanghai, and Guangzhou first, then penetrated into tier-2 cities and later lower-tier cities. Such a pattern has been due to affordability, population density, and infrastructure. In addition, limited by information accessibility, the perception of good products is determined by the origin of the products as well as store location and decoration. MNCs generally **enjoy a substantial premium** relative to domestic brands. Citizens from lower-tier cities and rural areas understand what is good through observing what is **only** available in top-tier cities.

**The opposite way works:** The pattern described above has gradually diminished over time. With China's internet users reaching 751mn, online mobile penetration at 96.3% in June 2017, and the strong readership among key opinion leaders in their respective areas, information on good brands is now widely available in the market. In the past three years, the income of urban and rural citizens has grown at CAGRs of 8% and 9% to Rmb33,616 and Rmb12,363, respectively, generally eliminating the affordability issues of particularly small-ticket items nationwide. As a result, people are more likely to pay for what is perceived and tasted to be good, which is not necessarily those products that are advertised to be good. Consequently, we have seen the rise of Heytea from Jiangmen, Chu's Orange from Yunnan, and Lao Gan Ma from Guizhou. All of these brands were established in cities that were tier-3 or below, but they made their way to top-tier cities and became highly popular.

## Consumer orientation

### No longer one formula for everyone

**Customer segmentation:** Mass market products have increasingly shown weakness given increasingly individualized and diversified consumer tastes. Successful new brands are those that identify their target consumer group and cater to a variety of consumer preferences arrayed across a variety of occasions and timing. Classmate Xiaoming targets consumers born after 1995 (Generation Z), Three Squirrels primarily targets white collar workers and students, whereas ZHY focuses primarily on females and younger customers.

**In the shoes of target consumers:** Three Squirrels, to improve the snacking experience of white collar workers and students when eating their nuts, began providing tissues, moisture-proof clips and bags for shells. ZHY was the first to offer moisture adjusted packaging for braised products, satisfying young customers’ desire to eat snacks anywhere anytime.

### Getting closer and faster to consumers

**Channel shifts:** ZHY and Heytea have adopted an own-store model, and Three Squirrels, Be & Cheery, Le Pur sell most of their products online. As a result, these companies are getting increasingly closer to consumers.

**Data analytics:** Rising players are attempting to affect customer behavior via the creation of membership databases, which enable personalized pricing, product recommendations and effective marketing campaigns.

**Accelerated product iteration** based on consumer consumption patterns has become possible. Le Pur has typically introduced a new flavor of Greek yogurt every month (traditional dairy companies typically take 3-6 months. Companies adjust production based on consumer purchasing behavior, which is readily available every day, while traditional players need to spend time trying to understand the inventory of each product they have in each layer of distribution.

**Value of money:** Consumers typically enjoy products either of better quality or of lower cost. For instance, Three Squirrels and Be & Cheery are able to offer more competitive price points relative to offline traditional players. Chu’s Orange limits the layers of distribution (e.g., selling directly to retail stores in Yunnan province), which ensures that its oranges are fresh and tasty when they get to customers. By adopting a factory to consumer model that eliminates distributor profit entirely, NetEase’s Yanxuan platform has recorded healthy growth as suggested by the company.

**Exhibit 99: Incumbents are still the most popular brands in China**

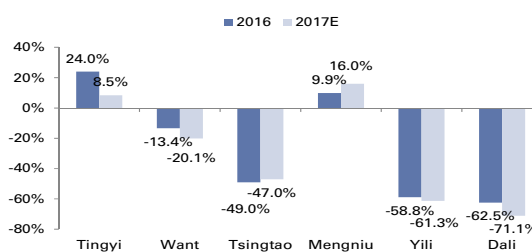
Kantar consumer survey

2016 Rank	Brand	Company	Penetration (mn times)	Penetration (%)	Avg times / person
1	Yili	Yili	1140	88.2	7.8
2	Mengniu	Mengniu	1043.2	86.8	7.2
3	Master Kong	Tingyi	922.1	83	6.7
4	Want Want	Want Want	519.7	67.7	4.6
5	Haitian	Haitian	495.9	70.2	4.2
6	Bright Dairy	Bright Dairy	467.6	44.2	6.3
7	UPC	UPC	449.2	63.6	4.2
8	Shuanghui	Shuanghui	446.7	60	4.5
9	Libai	Libai	379.8	66.1	3.4
10	Mind Act Upon Mind	Hengan	358.3	58.6	3.7

Source: [kantarworldpanel.com](http://kantarworldpanel.com).

**Exhibit 100: Incumbents have sufficient capital for marketing budgets**

Net gearing ratio for large China consumer companies



Source: Company data, Goldman Sachs Global Investment Research.



### Incumbents' advantage: Widest consumer reach, growing domestic brand trust, sufficient marketing budget

Despite the slowing growth, we believe the incumbents have multiple opportunities to win over new consumers:

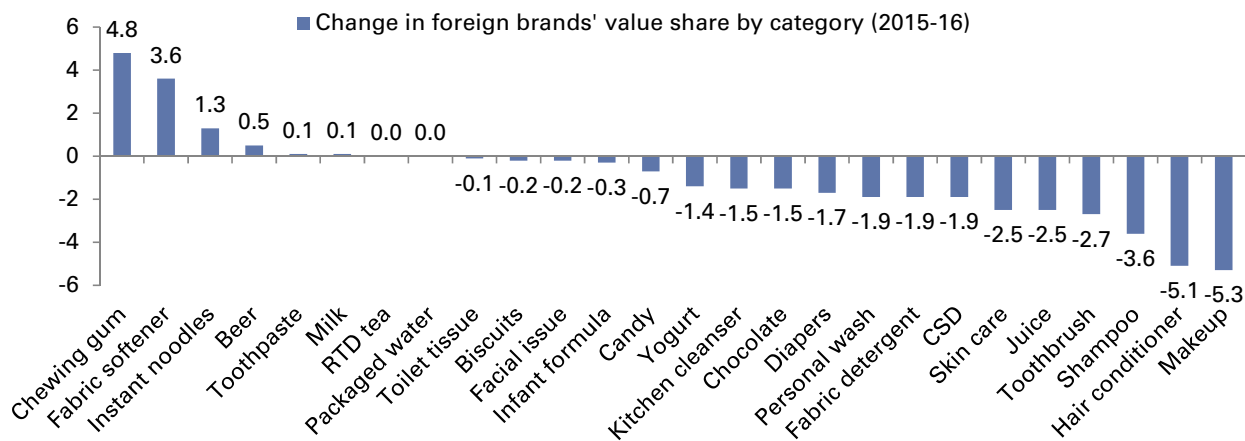
**Still the most popular brands among consumers:** According to a survey by Kantar, the large incumbents – such as Tingyi, WW, Mengniu, and Yili – are among the top 10 companies with the widest consumer reach in China, i.e. their brand names are the most popular, and their products retain a significant profile among Chinese consumers.

**Domestic brands gaining share over MNC:** Despite the premiumization trend in China FMCG, local consumers are gradually building up trust in and preference for domestic brands, according to the Kantar survey. In many key categories, domestic have consistently gained market share from the MNCs over the past three years.

**Sufficient capital advantage:** Another advantage for incumbents is their relatively large marketing budgets. Many incumbents are in cash-generative businesses and have net cash positions, so they are able to launch national marketing campaigns, etc. (for example, in 2016 Yili spent Rmb600-700mn to sponsor *Running Man*, the popular TV series, in China.

**Exhibit 101: Domestic brands are taking share from MNCs**

Domestic vs. foreign brand share



Source: Kantar.com.

### How to re-battle: Innovation and branding

In order for incumbents to maintain their market share, we believe they will need to upgrade their branding image, continue innovation and carry out more M&A.

#### Branding – product packaging, marketing, brand image

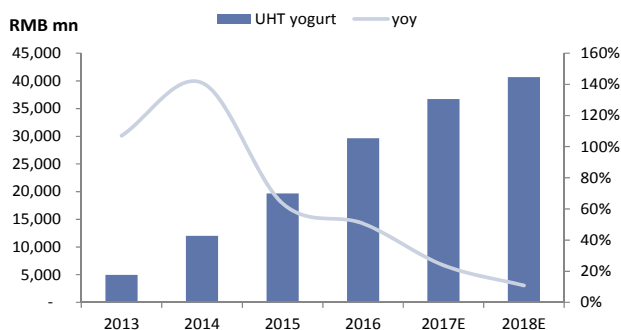
Given that consumers now have multiple options as niche and smaller players are entering the market, we believe it is important for the large players to upgrade their brands. Steps they should take include upgrading their product packaging, boosting their marketing activities and improving their brand image.

Given that some consumers may become fatigued with older products, we believe incumbents need to boost the quality of their product packaging and make it more interactive. This would help support marketing focused on younger consumers, which represent a key source of new customers. For example, Nongfu Spring has upgraded its

water bottles to incorporate a more premium bottle shape and packaging, and gain stable market share in the competitive beverage market. UPC has also launched RTD-tea products, but with a completely different brand name and with packaging that features cartoon images, which makes it less likely that consumers will connect the new products with UPC’s mainstream products and old brand image.

**Exhibit 102: Aided by the focus on healthy eating, UHT yogurt posted double-digit growth in 2016**

UHT yogurt market growth



Source: Company data.

**Exhibit 103: The differentiation of packaging has helped Haizhiyan and Classmate Xiaoming stand out**

UPC product package upgrade



Source: Company data.

**Innovation – “healthy” concept, new categories**

The large incumbents consistently push new products every year, but only a few stand out enough to contribute meaningfully to top-line growth. Looking back, products with a healthy or premium concept have been more likely to post strong growth. Consumers are now more health conscious, and they are willing to pay a premium for the products they believe will benefit their health (for example, UHT yogurt, packaged water, and vitamin drinks).

Another way to innovate is to enter into new product categories or related categories. The good example would include Dali Foods: the company entered a new category every three to four years to offset the slower growth of existing categories. Back in 2013, they launched the sports drink (now still growing 30%-40% yoy in 2017) and in 2017 they entered the soy milk categories with a large-scale marketing campaign.

**M&A another source for growth**

Chinese large F&B companies have not entered into many M&A deals in the past. As they have relatively strong balance sheets and a high base of organic volume, we expect M&A to become an increasingly important source of growth for large incumbents.

## Leaders and laggards

# Dali Foods: Innovative F&B giant trading at a discount; initiate Buy

## Source of opportunity

We expect Dali, leveraging its status as a diversified F&B company, to continue innovating into faster-growth product categories, while also defending its market share in existing businesses from high competition. Dali trades at a 25% discount to listed F&B peers in HK, mainly, we believe, due to concerns on the sustainability of its high margins. However, we expect Dali to maintain its 20%+ op. margin given its shift to higher-margin products and its strong hold on traditional channels. We expect double-digit growth in sales and EPS over the next two years to drive a rerating of the shares. With 21% upside to our 12-month TP of HK\$6.40, we initiate at Buy.

## Catalyst

**1) Soy milk/energy drinks the key growth drivers:** We expect Dali's newly launched soy milk products to benefit from growth in the packaged soy milk market and contribute 12% of profits in 2018. Also, we expect its Hi-Tiger energy drink brand to keep its strong momentum with 34%/22% growth in 2H17/2018, gaining share from Red Bull. **2) GPM uplift to offset opex pressure in 2018:** Dali is fast expanding into modern trade (35% of sales) and upgrading its brand positioning. Although we see higher associated opex over the next two years, it will likely be offset by Dali's shift to higher ASP and better product mix. **3) 17% EPS growth in 2H17, among fastest in staples coverage:** We expect 90bps yoy gross margin expansion in 2H on higher growth of energy drinks/soy milk and the full-year effect of a food price hike in March. We expect soy milk to be profit-making in 2H17.

## Valuation

Given Dali's high earnings and cash returns vs. peers (we see ROE and cash returns of 23%-25% from 2016), we apply a target multiple of 19X (15X/21X averages for Dali/peers) to 2018E EPS to find our 12-month TP of HK\$6.40.

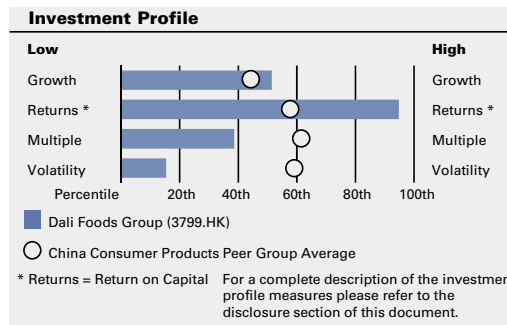
## Key risks

Weaker-than-expected energy drink/chips sales, slower soy milk roll-out, lower margin from cost pressure and higher opex on channel expansion.

**For further details, see our companion report, *Dali Foods Group (3799.HK) Buy: Diversified, fast-growing F&B giant trading at discount; initiate at Buy*, published September 18, 2017.**

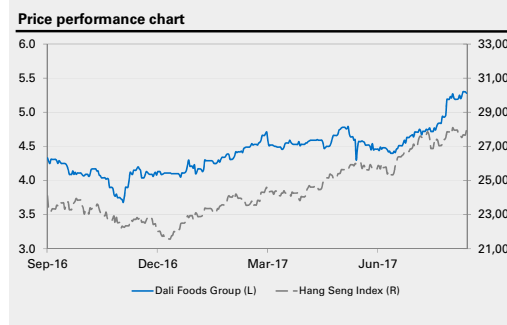
**INVESTMENT LIST MEMBERSHIP**  
Asia Pacific Buy list

**Coverage View: Neutral**



Key data	Current
Price (HK\$)	5.28
12 month price target (HK\$)	6.40
Market cap (HK\$ mn / US\$ mn)	72,304.3 / 9,255.9
Foreign ownership (%)	--

	12/16	12/17E	12/18E	12/19E
EPS (Rmb)	0.23	0.26	0.29	0.32
EPS growth (%)	(5.0)	11.7	13.7	10.5
EPS (diluted) (Rmb)	0.23	0.26	0.29	0.32
EPS (basic pre-ex) (Rmb)	0.23	0.26	0.29	0.32
P/E (X)	15.9	17.2	15.2	13.7
P/B (X)	3.6	4.0	3.6	3.3
EV/EBITDA (X)	9.1	10.4	8.9	7.9
Dividend yield (%)	4.4	4.1	4.6	5.1
ROE (%)	24.3	24.1	25.0	25.1
CROCI (%)	23.8	22.6	23.0	22.9



Share price performance (%)	3 month	6 month	12 month
Absolute	15.5	16.6	21.9
Rel. to Hang Seng Index	7.6	(1.7)	5.1

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 9/11/2017 close.

# Zhou Hei Ya: An addictive, impulsive duck snack; initiate at Buy

## Source of opportunity

We expect Zhou Hei Ya (ZHY), a braised food company in China, to benefit from changing consumer trends: **1) Packaging creates snack demand:** The moisture adjusted packaging that ZHY uses creates more snacking occasions for braised duck products, rather than just home dining. **2) Unique spicy taste a barrier:** ZHY differentiates itself from peers with its popular sweet and spicy product taste, which drives repeat consumption; **3) Self-operated traffic stores attract impulsive consumption:** ZHY fully owns its stores in key transport locations, which tend to stimulate more impulsive and less price-sensitive consumption. Given these positives, and the 32% upside to our 12-month target price of HK\$9.60, we initiate on a ZHY with a Buy rating.

## Catalyst

**1) Store expansion driving 20% sales CAGR:** We see ample potential for ZHY to expand its store footprint in tier 1/2 cities, especially in East, South, and North China. We expect 200-240 gross stores opening over the next three years with a focus on the transport hub areas (where ZHY now has only c.15% penetration). Therefore, we expect ZHY will maintain its strong store productivity given high traffic.

**2) Faster growth from 2H17:** We expect ZHY to see accelerating high-teen earnings growth from 2H17, driven by fast store expansion and ramp-up of new store productivity. In 1H17, we expect ZHY to be impacted by higher A&P expenses and the low cost base in 1H16. However, we believe ZHY's structural growth is intact, and we forecast EPS growth of 10%/19% in 2017/18E. We would view any pullback in the share price as resulting in even more upside to our target price.

## Valuation

We value ZHY based on its earnings growth and cash return. In 2017-2019E, ZHY posted one of the fastest EPS growth rates in our coverage (17%) and among the highest rates of cash return (22%). We derive our 12-month target price of HK\$9.60 by applying a P/E of 22X to our 2018E EPS. ZHY is now trading at a 12-month forward P/E of 19X, a slight discount to the China consumer staples average.

## Key risks

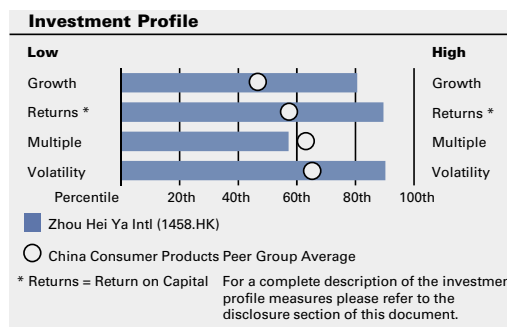
Competition over the key store locations and higher rental cost, consumer preference change, unfavorable duck cost trend.

**For further details, see our companion report, *Zhou Hei Ya Intl (1458.HK) Buy: A compulsively addictive duck snack; initiate at Buy*, published September 18, 2017.**

## INVESTMENT LIST MEMBERSHIP

Asia Pacific Buy list

**Coverage View: Neutral**



Key data	Current
Price (HK\$)	7.20
12 month price target (HK\$)	9.60
Market cap (HK\$ mn / US\$ mn)	17,158.6 / 2,196.5
Foreign ownership (%)	--

	12/16	12/17E	12/18E	12/19E
EPS (Rmb)	0.30	0.33	0.38	0.45
EPS growth (%)	3.2	9.7	15.7	16.9
EPS (diluted) (Rmb)	0.30	0.33	0.38	0.45
EPS (basic pre-ex) (Rmb)	0.30	0.33	0.38	0.45
P/E (X)	20.2	18.2	15.7	13.5
P/B (X)	4.0	3.4	3.0	2.5
EV/EBITDA (X)	12.5	11.7	9.7	7.9
Dividend yield (%)	1.5	1.6	1.9	2.2
ROE (%)	36.0	20.3	20.2	20.3
CROCI (%)	39.2	22.1	22.0	21.9

Share price performance (%)	3 month	6 month	12 month
Absolute	(7.8)	(7.6)	--
Rel. to Hang Seng Index	(14.2)	(22.1)	--

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 9/11/2017 close.

# Yili: A faster growth premium leader; reiterate CL-Buy

## Source of opportunity

We expect Yili to further strengthen its leading position in dairy post its 2Q17 results, and we believe it is now set to deliver sustained faster sales growth with an upgraded product mix over the next two years. After the recent share price rally, we expect further upside to come from lower pricing promotions and expense ratio. We believe Yili is well on track to deliver its high-single-digit topline target in 2017, and we expect it will likely be less keen to push further price promotions in 2H17, especially now that its peer Mengniu has tapered off promotions and is focused on profitability. Given these positives and the 18% upside to our 12-month target price of Rmb27.50, we reiterate our Buy rating (on CL).

## Catalyst

**1. Double-digit sales growth in 2H17:** Following 2Q17's 20% growth, Yili gained 210bps of liquid milk market share yoy in 1H. We expect Yili to further gain share and steadily deliver double-digit 12% sales growth in the next two quarters. We expect this growth to be driven by stronger overall milk demand, Yili's strong premium products in UHT yogurt and premium UHT milk, and a fast recovery of basic milk products in lower-tier cities. IMF business is likely to continue to recover in 2H as it benefits from lower-tier cities and Mom&Baby stores.

**2. Further 70bps OPM expansion in 2H:** It appears investors are still concerned about whether Yili will increase its selling expense ratio in 2H17. With a more balanced supply and demand environment for the industry and a lower likelihood that peers will pursue aggressive price competition, we expect Yili will likely contain its selling expense ratio and promotion activities in 2H17. In 1H17, its selling expense ratio was down 70bps yoy. We expect 24% OP growth in 2H17 and 2018 yoy and forecast a two-year EPS CAGR of 16%.

## Valuation

Our 12-month target price remains Rmb27.50, based on 2018-19E EV/GCI vs. CROCI/WACC (using an unchanged sector cash return multiple of 0.9X and a 10% premium reflecting its high cash return). Our target price implies a 2018E P/E of 21X.

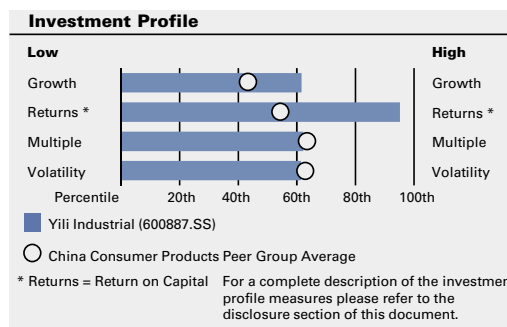
## Key risks

Higher spending on A&P and price rebates driving down margins, weaker-than-expected liquid milk sales from competition, and unfavorable M&A.

### INVESTMENT LIST MEMBERSHIP

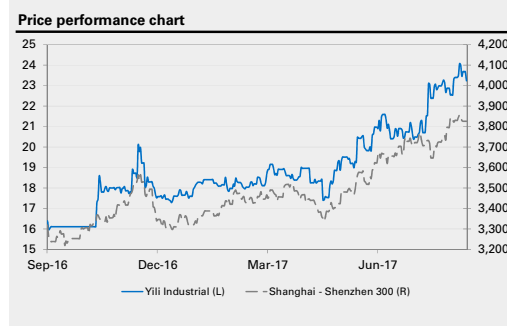
Asia Pacific Buy list  
Asia Pacific Conviction Buy list

Coverage View: Neutral



Key data	Current
Price (Rmb)	23.24
12 month price target (Rmb)	27.50
Market cap (Rmb mn / US\$ mn)	140,946.0 / 21,604.9
Foreign ownership (%)	--

	12/16	12/17E	12/18E	12/19E
EPS (Rmb)	0.93	1.02	1.24	1.44
EPS growth (%)	22.2	9.0	21.7	16.0
EPS (diluted) (Rmb)	0.93	1.02	1.24	1.44
EPS (basic pre-ex) (Rmb)	0.93	1.02	1.24	1.44
P/E (X)	17.3	22.8	18.8	16.2
P/B (X)	4.2	5.6	5.0	4.5
EV/EBITDA (X)	12.5	15.8	12.9	11.1
Dividend yield (%)	3.7	2.8	3.4	4.0
ROE (%)	26.3	25.5	28.2	29.5
CROCI (%)	26.9	29.0	30.5	30.5



Share price performance (%)	3 month	6 month	12 month
Absolute	13.8	27.7	41.8
Rel. to Shanghai - Shenzhen 300	6.3	14.4	23.0

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 9/11/2017 close.

# Want Want: Not yet turning the corner; reiterate Sell

## What's changed

Over the next two years, we expect Want Want (WW) could still be challenged to balance its high margin and sales recovery. With years of brand under investment and distribution focus on traditional trade channels, we expect it will take time for WW to turn the corner and see sustained sales growth. For 2H17, we expect:

**1) Margin still under pressure in 2H17:** Higher raw material costs are the main drag for 1H17 margin, and we see continued unfavorable cost pressure from high-cost imported milk powder in 2H. The company further reduced its selling expenses, but we see less room to cut as WW has added sales representatives to support the retail channels. In 2H17, we expect another 380bps OPM decline and a 16% decline in EPS.

**2) Better sequential sales trend, but more from distribution expansion:** The company posted an improved sales trend for 2Q17 and positive sales growth for 3Q to date, especially for "Hot Kid" milk products (up by mid-single-digits yoy). However, we believe this recovery is more from points of sale expansion in lower-tier cities, together with better industry demand over this summer. Competition in milk beverage and snacks is still intense.

**3) Limited new products contribution:** For 1H17, WW's new products roughly contributed 2%-3% of sales (UHT yogurt, premium UHT, etc.). The company plans to launch pre-mixed cocktails in 2018, but we see limited upside given the competitive market and volatile demand. WW is changing its fiscal year end to March from end-December, which will enable it to avoid the reported earnings volatility from the Chinese New Year in January-February.

## Implications

Reiterate Sell. We now expect a 15%/4% EPS decline for 2017/18E.

## Valuation

We continue to value WW on a 2018-19E EV/GCI vs. CROCI/WACC framework (using an unchanged sector cash return multiple of 0.9X). Our 12-month target price of HK\$4.3/share implies a 2018E P/E of 16.4X.

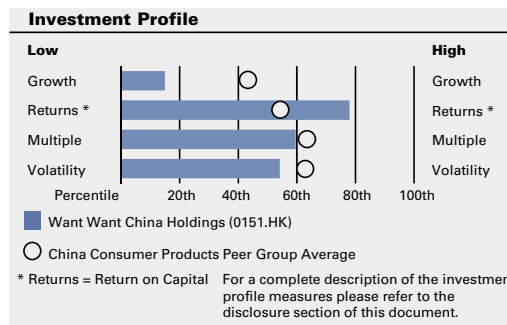
## Key risks

Stronger-than-expected milk beverage/snack sales, higher profit margin.

### INVESTMENT LIST MEMBERSHIP

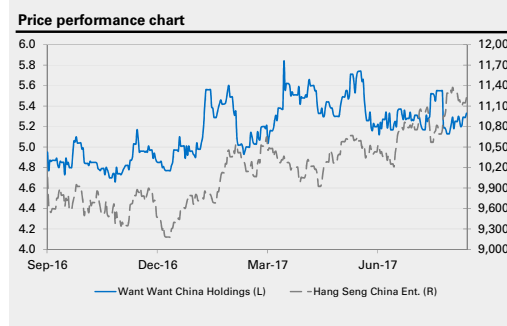
Asia Pacific Sell list

Coverage View: Neutral



Key data	Current
Price (HK\$)	5.33
12 month price target (HK\$)	4.30
Market cap (HK\$ mn / US\$ mn)	68,511.8 / 8,770.4
Foreign ownership (%)	--

	12/16	12/17E	12/18E	12/19E
EPS (Rmb)	0.28	0.24	0.23	0.24
EPS growth (%)	7.3	(12.9)	(2.9)	4.1
EPS (diluted) (Rmb)	0.28	0.24	0.23	0.24
EPS (basic pre-ex) (Rmb)	0.28	0.24	0.23	0.24
P/E (X)	16.2	18.4	19.0	18.2
P/B (X)	4.6	4.3	3.9	3.6
EV/EBITDA (X)	9.7	10.7	10.7	10.1
Dividend yield (%)	2.7	2.7	2.9	3.0
ROE (%)	28.9	24.1	21.7	20.4
CROCI (%)	37.0	18.2	16.2	15.1



Share price performance (%)	3 month	6 month	12 month
Absolute	(7.1)	6.0	7.7
Rel. to Hang Seng China Ent.	(12.3)	(4.9)	(3.5)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 9/11/2017 close.



# Ezaki Glico: Lower GSe for Asian confectionery business and TP, down to Neutral

## What happened

We maintain our bullish stance in anticipation of high growth driven by the Pocky brand across Asia and a margin boost from restructuring the Japan operations. However, we lower our outlook for the Asia confectionery business amid stiffer competition in China and a slow recovery in SE Asia consumer spending. We cut FY3/18-3/20E OP by 2%. Our new estimates are below consensus, and upside from our new 12m TP of ¥6,600 (14%) is the smallest within our consumer products coverage. On this basis, we downgrade the stock to Neutral from Buy. The shares are +15% since we initiated at Buy (on CL) on April 2, 2015 (TOPIX: +5%, coverage: +16%).

## Current view

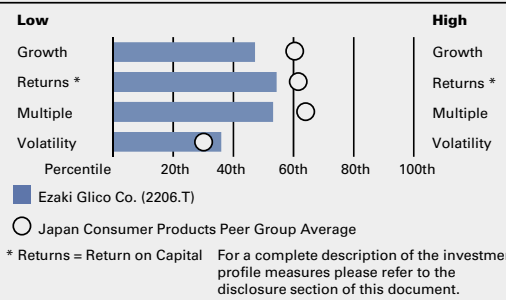
The confectionery market in China has been affected by increased health awareness, diversifying tastes and dramatic shifts in sales channels. We had already lowered our forecasts for the China business' growth rate and profit margins, but we now revise our outlook for the confectionery market in China as competition intensifies further, and as Korean rivals target renewed expansion; we thus believe Ezaki Glico will need to spend more to keep sales on a growth trajectory (see our September 18, 2017, report, A New Taste of China). In the SE Asia business, sales in the core Thai market are rising in both the modern and the traditional trade channels, but so too is the ratio of promotional spend to sales. In Indonesia, a key destination for exports, sluggish growth in the minimum wage has seen Ezaki Glico struggle to grow shipments of Pocky. The Asia business' growth potential has long been the company's greatest source of investment appeal, but it seems that restoring that potential will take some time, in view of which we lower our estimates and downgrade our rating to Neutral. We lower our 12-month target price by 4% to ¥6,600 to reflect our revised forecasts and a reduction in our FY3/22E EV/NOPAT multiple to 14X from 14.5X, amid lower share prices within our coverage over the past few months. Risks include swings in key currencies/input prices, rapid deterioration in weather/other external factors, a major slowdown or recovery in consumption in China/Thailand and stiffer competition.

## INVESTMENT LIST MEMBERSHIP

Neutral

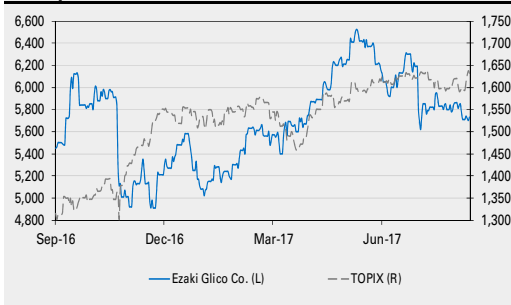
Coverage View: Neutral

## Investment Profile



Key data	Current			
Price (¥)	5,730			
12 month price target (¥)	6,600			
Market cap (¥bn)	397.8			
<b>Local GAAP (¥bn)</b>	<b>3/17</b>	<b>3/18E</b>	<b>3/19E</b>	<b>3/20E</b>
Revenue New	353.2	358.7	369.4	382.2
Op. profit New	24.3	25.0	27.2	28.7
Op. profit Old	24.3	25.5	27.7	29.2
Op. profit CoE New	22.5	25.0	--	--
Op. profit CoE Old	22.5	25.0	--	--
<b>EPS(¥) New</b>	<b>276.2</b>	<b>272.3</b>	<b>298.1</b>	<b>316.4</b>
yoy % chg.	30.3	(1.4)	9.5	6.1
EPS (¥) Old	276.2	278.3	304.2	322.4
P/E (X)	20.3	21.0	19.2	18.1
P/B (X)	2.0	1.9	1.8	1.7
EV/EBITDA (X)	9.5	8.7	7.9	7.3
CROCI (%)	11.2	11.5	12.1	12.4
EV/GCI (X)	1.1	1.1	1.1	1.0

## Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	(9.9)	1.6	5.1
Rel. to TOPIX	(12.1)	(2.0)	(15.3)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 9/14/2017 close.

# Appendix

# China F&B overview (who is growing, who is declining, and why)

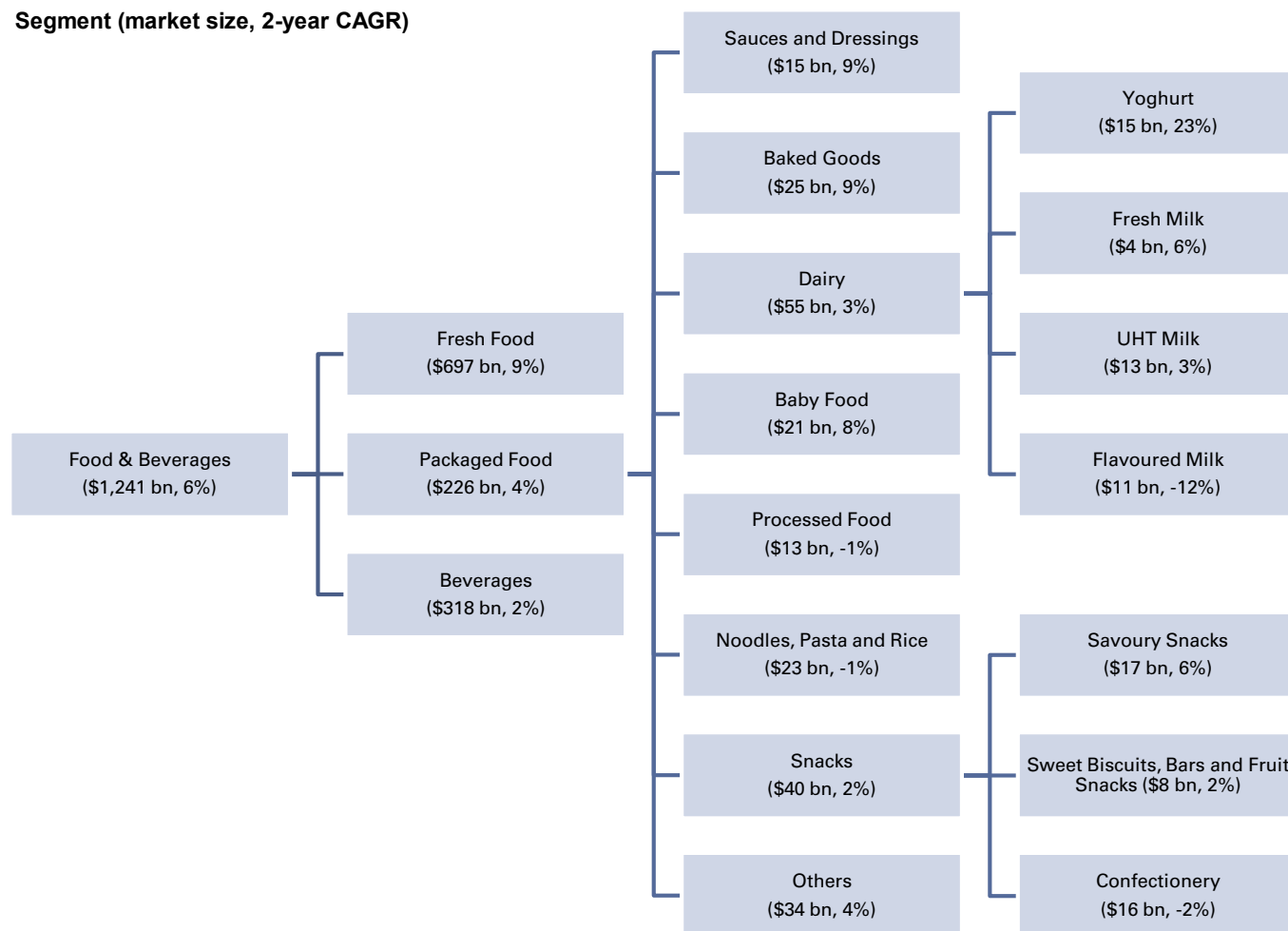
China’s F&B market size is US\$1,241bn and can be broken down into fresh food (US\$697bn), packaged food (US\$226bn) and beverages (US\$318bn).

## Packaged food: Healthy concept and convenience matter

Within the packaged food segment, yogurt, savory snacks and baked goods are the bright spots, whereas confectionery and flavored milk have suffered from negative growth, as consumers are **more conscious of sugar consumption and prefer products with healthy concepts**; we also see penetration growth potential in processed meat and ready meals consistent with the phenomenon of **“paying for time” and convenience**, particularly among urban consumers.

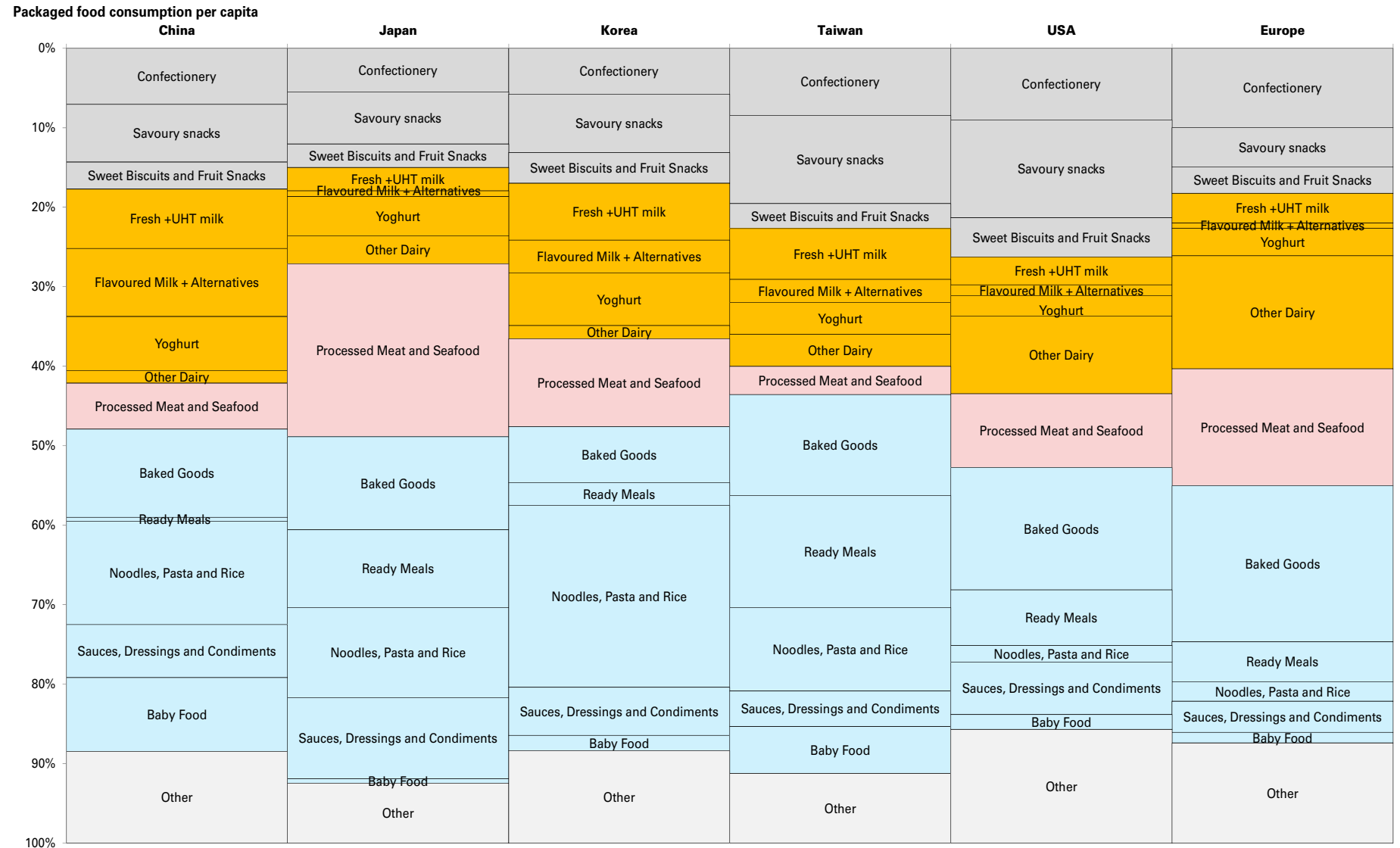
**Exhibit 104: Packaged food US\$230bn – yogurt, savory snacks, baked goods the bright spots**  
Retail market size and 2014-2016 CAGR

Segment (market size, 2-year CAGR)



Source: Euromonitor.

**Exhibit 105: F&B country comparison – China’s ready meal, processed meat under indexed**  
 Per capita packaged food consumption breakdown - comparison across regions



Source: Euromonitor.

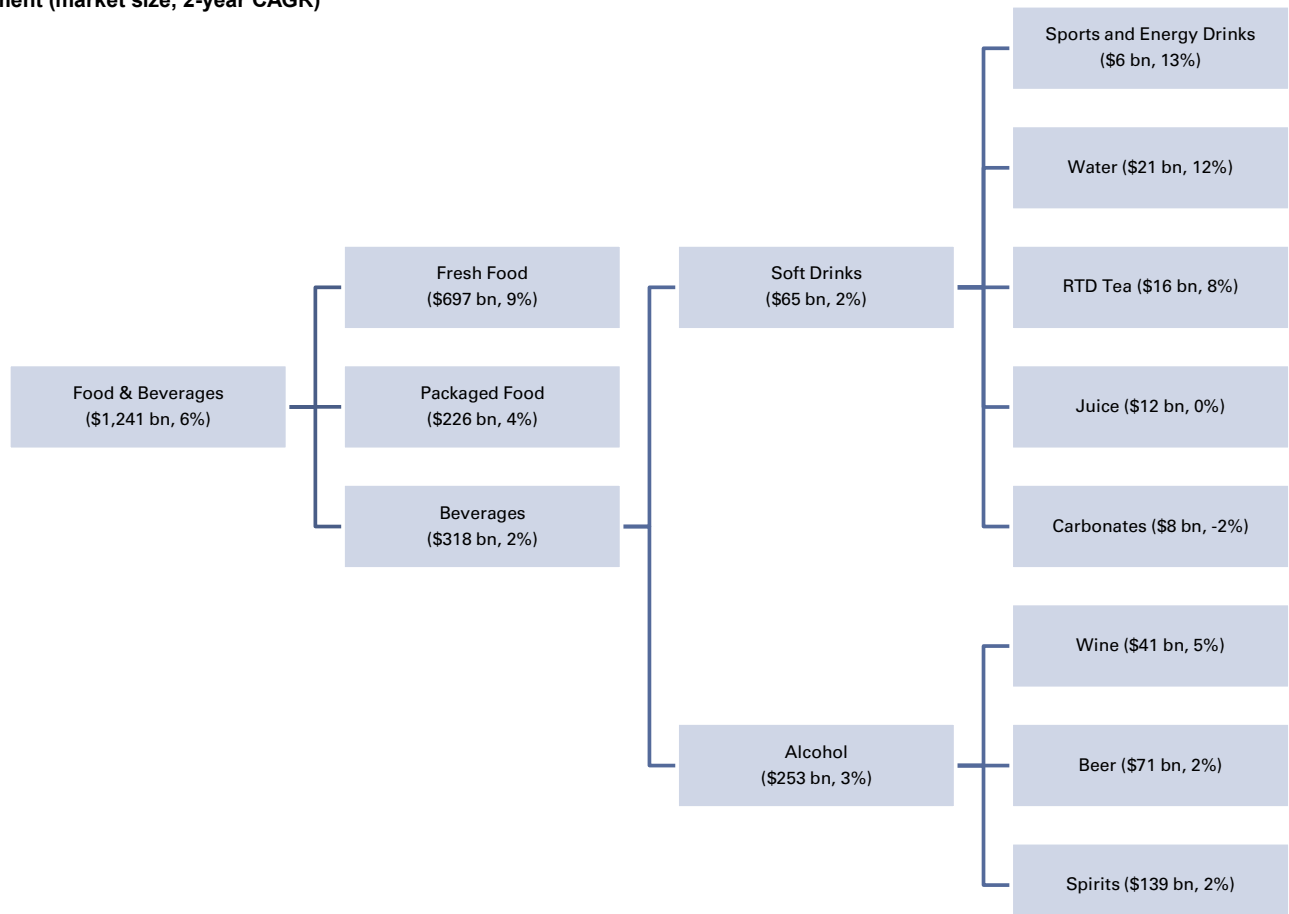
### Beverages: Innovation and health awareness drives growth

China’s beverage market size is US\$318bn, and we see sports and energy drinks, water, RTD tea and wine as the bright spots, with 2014-2016 CAGRs of 13%, 12%, 8% and 5%, respectively. While we see more penetration potential for wine as young consumers are exposed to western culture, desire for drinks suitable for sports activities and living a healthy life have driven the growth of sports and energy drinks as well as water. Although RTD tea faced a slowdown in 2015, the popularity of tea has rebounded along with efforts by Tea Pei and Classmate Xiaoming’s introduction of products with less sugar content, new flavors and distinguished packaging.

**Exhibit 106: A US\$318bn beverage market – water, energy drinks, RTD tea, wine the bright spots**

Segment market size and 2014-2016 CAGR

Segment (market size, 2-year CAGR)



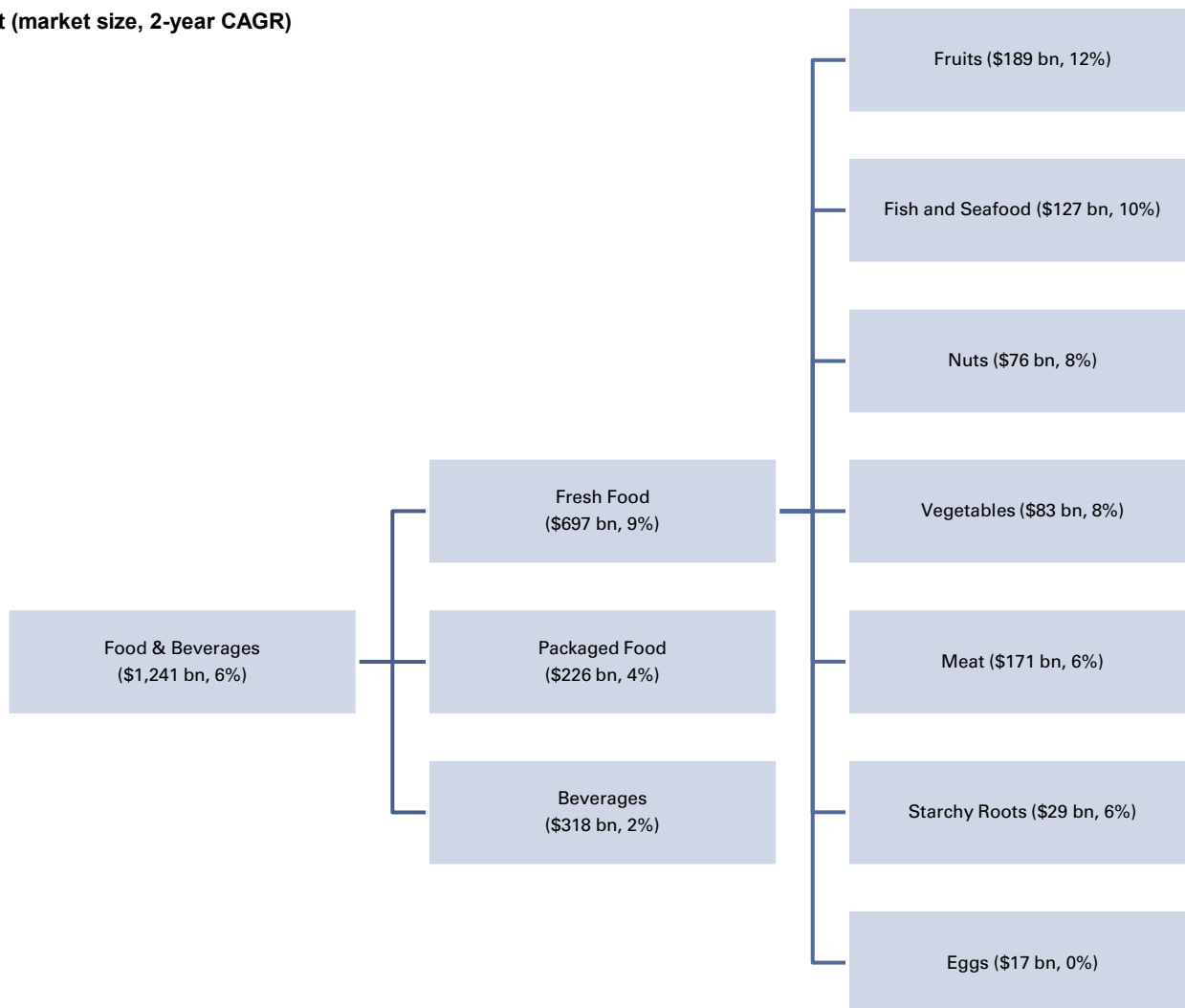
Source: Euromonitor, Nielsen.

### Fresh food: Dining out demand fuels strong growth

**Fresh food has accounted for a 56% share of throat among Chinese consumers**, and we have seen healthy demand from fruit, fish and seafood, nuts, and vegetables in the past two years, primarily driven by volume rather than ASP growth. Moreover, there is a shift from institutional consumption to foodservice and retail consumption. We believe that: 1) the penetration rate of fridges at 90% in urban areas and 60%+ in rural areas has helped boost demand for perishable products; 2) growing health consciousness is driving higher consumption of specific sub-categories such as fruit, vegetables, fish and nuts; and 3) Chinese consumers are gradually eating out more, on the back of income growth, convenience, and entertainment needs.

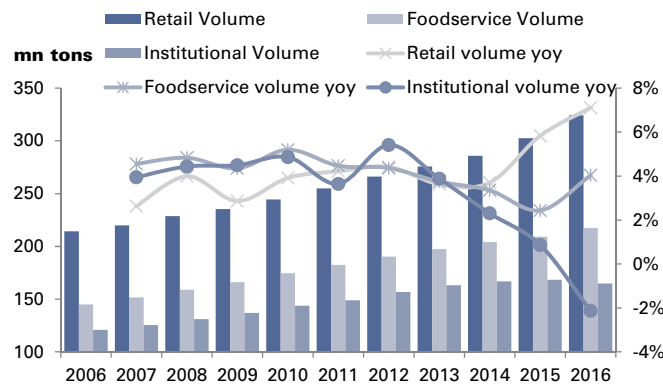
**Exhibit 107: Fresh food US\$697bn – fruits, fish and seafood, nuts, vegetables the bright spot**  
 Segment market size and 2014-2016 CAGR

**Segment (market size, 2-year CAGR)**



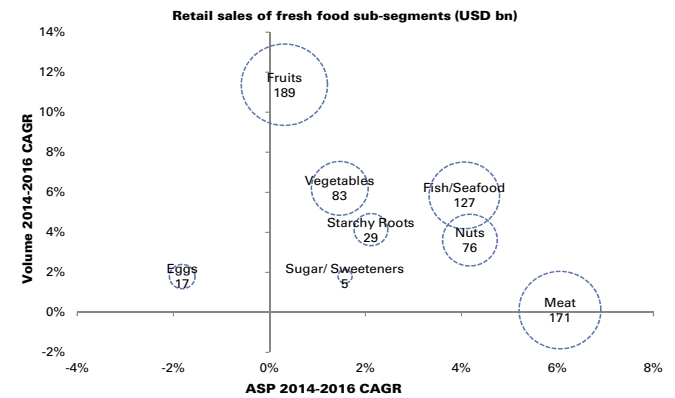
Source: Euromonitor.

**Exhibit 108: Retail and food services demand for fresh food have been picking up...**  
Volume of fresh food consumption in China



Source: Euromonitor.

**Exhibit 109: ...with retail sales growth being primarily driven by volume growth**  
Retail sales by fresh food sub-segments

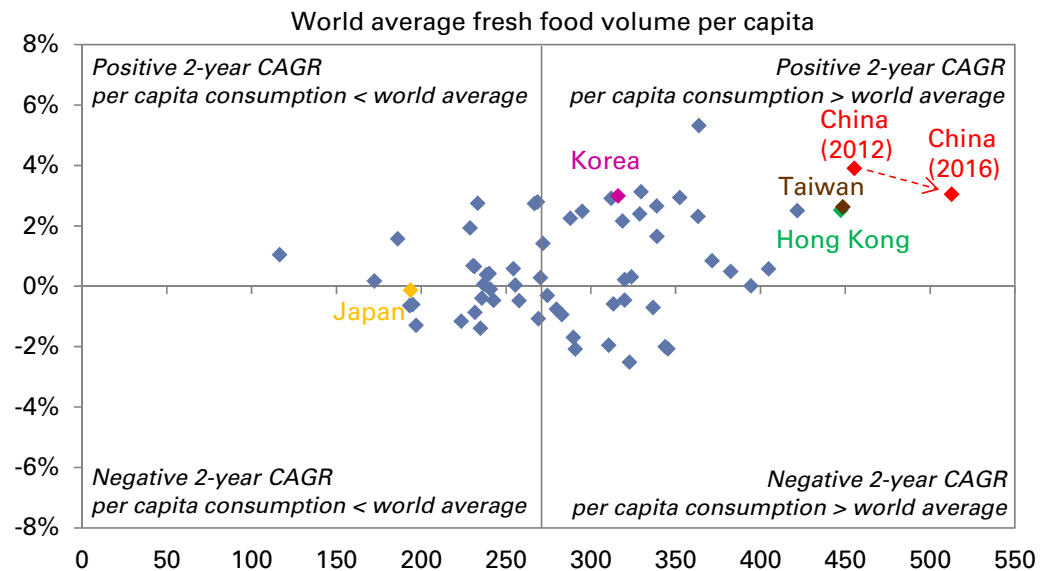


Source: Euromonitor.

Compared to most western countries, **Asian countries with has sufficient natural resources generally prefer fresh food over packaged food**, and the Chinese have consumed the highest total volume of fresh food consumption per capita (including retail, institutional and foodservice consumption) at 513kg per capita in 2016 and posted a 2014-2016 CAGR above the world average (3.1% vs 1.4%).

**Exhibit 110: China has the highest fresh food consumption per capita and remains low-single-digit growth**

Total volume per capita in 2016 and 2014-2016 CAGR except specified otherwise

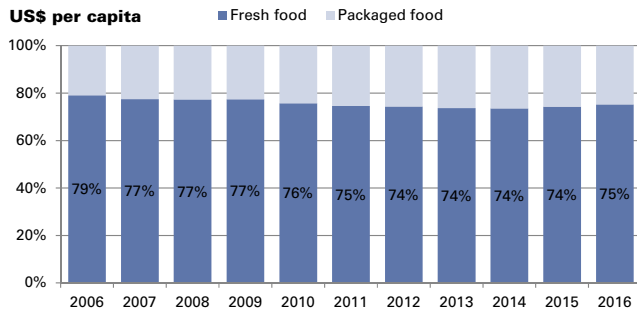


Source: Euromonitor.



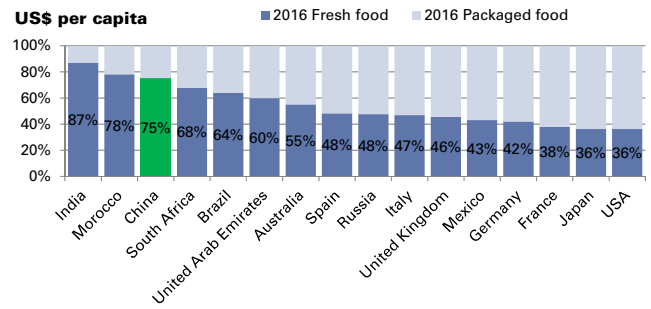
At the same time, over the past 10 years, fresh food retail sales per capita have dropped to 75% of total food spending per capita; compared with countries with available data, we see **more upside potential in the packaged food segment**.

**Exhibit 111: Chinese spending on fresh food declined gradually to 75% in 2006-2016...**  
2006 retail RSP per capita



Source: Euromonitor.

**Exhibit 112: ...and we see upside potential for the packaged food segment**  
2016 retail RSP per capita



Source: Euromonitor.

## Special disclosures

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# Mindcraft: Our Thematic Deep Dives

## Innovation & Disruption

Virtual Reality



Drones



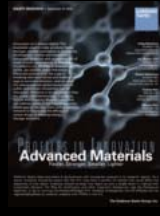
Factory of the Future



Precision Farming



Advanced Materials



Artificial Intelligence



Space



Store of the Future



OLED



## Rise of the Asian Consumer

Chinese Consumer



Chinese Millennials



China E+Commerce



Future of Finance



China FinTech



Blockchain



China AI



## Old China Commodities

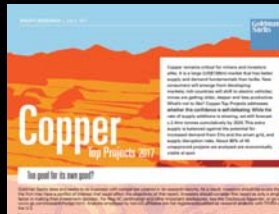
Top Oil & Gas Projects



Reforming China Energy



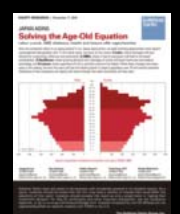
Copper: Too good for its own good?



## China Banks



## Japan Aging



## The Low Carbon Economy

Tech in the Driver's Seat



The Great Battery Race



China's Environment



China's Battery Challenge



Electric Vehicle Boom



## Music's Return to Growth

Opportunity



Risk



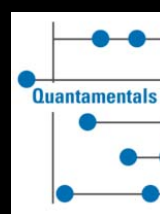
## Creating Tomorrow's Greater Bay



## Apple Suppliers' Dilemma



## Asian Quantamentals



## SUSTAIN

Quality problems, quality solutions



## Credit

Mapping Out China's Credit Market



# Disclosure Appendix

## Reg AC

We, Lincoln Kong, CFA, Yuqing Li, Christine Cho, Keiko Yamaguchi and Xufa Liao, CFA, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

Unless otherwise stated, the individuals listed on the cover page of this report are analysts in Goldman Sachs' Global Investment Research division.

## GS Factor Profile

The Goldman Sachs Factor Profile provides investment context for a stock by comparing key attributes to the market (i.e. our coverage universe) and its sector peers. The four key attributes depicted are: Growth, Financial Returns, Multiple (e.g. valuation) and Integrated (a composite of Growth, Financial Returns and Multiple). Growth, Financial Returns and Multiple are calculated by using normalized ranks for specific metrics for each stock. The normalized ranks for the metrics are then averaged and converted into percentiles for the relevant attribute. The precise calculation of each metric may vary depending on the fiscal year, industry and region, but the standard approach is as follows:

**Growth** is based on a stock's forward-looking sales growth, EBITDA growth and EPS growth (for financial stocks, only EPS and sales growth), with a higher percentile indicating a higher growth company. **Financial Returns** is based on a stock's forward-looking ROE, ROCE and CROCI (for financial stocks, only ROE), with a higher percentile indicating a company with higher financial returns. **Multiple** is based on a stock's forward-looking P/E, P/B, price/dividend (P/D), EV/EBITDA, EV/FCF and EV/Debt Adjusted Cash Flow (DACF) (for financial stocks, only P/E, P/B and P/D), with a higher percentile indicating a stock trading at a higher multiple. The **Integrated** percentile is calculated as the average of the Growth percentile, Financial Returns percentile and (100% - Multiple percentile).

Financial Returns and Multiple use the Goldman Sachs analyst forecasts at the fiscal year-end at least three quarters in the future. Growth uses inputs for the fiscal year at least seven quarters in the future compared with the year at least three quarters in the future (on a per-share basis for all metrics).

For a more detailed description of how we calculate the GS Factor Profile, please contact your GS representative.

## Quantum

Quantum is Goldman Sachs' proprietary database providing access to detailed financial statement histories, forecasts and ratios. It can be used for in-depth analysis of a single company, or to make comparisons between companies in different sectors and markets.

## GS SUSTAIN

GS SUSTAIN is a global investment strategy aimed at long-term, long-only performance with a low turnover of ideas. The GS SUSTAIN focus list includes leaders our analysis shows to be well positioned to deliver long term outperformance through sustained competitive advantage and superior returns on capital relative to their global industry peers. Leaders are identified based on quantifiable analysis of three aspects of corporate performance: cash return on cash invested, industry positioning and management quality (the effectiveness of companies' management of the environmental, social and governance issues facing their industry).

## Disclosures

### Coverage group(s) of stocks by primary analyst(s)

Lincoln Kong, CFA: A-share Food & Beverage, China Consumer Products. Christine Cho: Korea Consumer Staples. Keiko Yamaguchi: Japan Consumer Products. Xufa Liao, CFA: A-share Consumer Durables, A-share Food & Beverage, A-share Media, China Consumer Products.

A-share Consumer Durables: Gree Electric Appliances Inc., Hangzhou Robam Appliances, Midea Group, Qingdao Haier Co., Suofeiya Home Collection Co..

A-share Food & Beverage: Anhui Gujing Distillery Co., Jiangsu Yanghe, Kweichow Moutai, Luzhou Laojiao, Qinghai Huzhu Barley Wine Co., Shanxi Xinghuacun Fen Wine, Tsingtao Brewery (A), Wuliangye Yibin.

A-share Media: Alpha Group, Beijing Enlight Media Co., Beijing Gehua CATV, Beijing Hualubaina Film & TV Co., BlueFocus Communication, China South Publishing & Media, Focus Media Information Tech, Guangdong Advertising, Huayi Brothers Media, IMAX China Holding, Jiangsu Phoenix, Oriental Pearl, Ourpalm Co., Wanda Film, Zhejiang Huace Film & TV.

China Consumer Products: Bright Dairy, China Modern Dairy Holdings, China Resources Beer, Dali Foods Group, Health & Happiness Intl Holdings, Mengniu Dairy, Tingyi (Cayman Islands) Holdings, Tsingtao Brewery (H), Uni-President China Holdings, Want Want China Holdings, WH Group, Yili Industrial, Zhou Hei Ya Intl.

Japan-Consumer Products: Ajinomoto, Ariake Japan Co., Asahi Group, Calbee Inc, Ezaki Glico Co., Japan Tobacco, Kao, Kewpie Corp., Kikkoman, Kirin Holdings, Lion, Meiji Holdings, NH Foods Ltd., Nissin Foods Holdings, Pigeon, Pola Orbis Holdings, Shiseido, Suntory Beverage & Food Ltd., Toyo Suisan Kaisha, Unicharm, Yamazaki Baking.

Korea Consumer Staples: Amorepacific, AmorePacific Group, BGF Retail, CJ CheilJedang, E-Mart, GS Retail Co., KT&G, LG Household & Healthcare, Lotte Shopping, Orion Corp..

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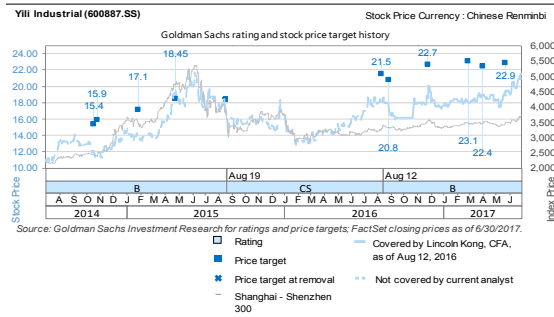
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Goldman Sachs Investment Research global Equity coverage universe

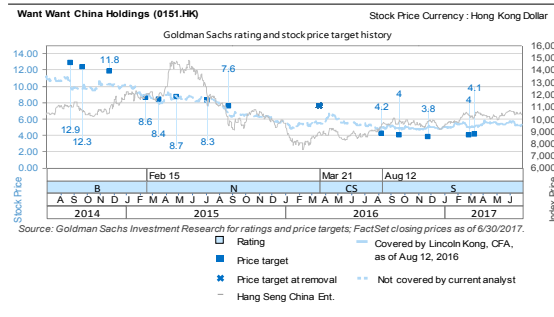
	Rating Distribution			Investment Banking Relationships		
	Buy	Hold	Sell	Buy	Hold	Sell
Global	32%	54%	14%	65%	56%	49%

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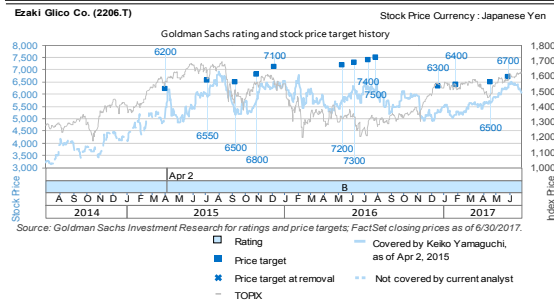
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