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Wine Market Update

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Report Highlights:
While China's wine market is still in its infancy, opportunities remain if exporters take a long term approach and emphasize consumer education. China ranks as America's 20th market for wine exports. A rising middle class and an increasing openness to imported foods, combined with China's imminent entry into the WTO, could prove a winning combination for U.S. exporters in the long run.

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I. Summary

The Chinese wine market is still in its infancy, with the bulk of the domestic product being exactly that, cheap imported bulk wine blended with domestic grapes. The result is a fast improving, but often unpalatable, wine which dominates the bottom of the price and quality curve in the market. The top of the market (almost nothing exists in the middle range) is dominated exclusively by imported labels. Consumers also seem to fit into those two categories, although the market sorely lacks decent quality and affordable wines for inexperienced consumers to graduate to when they tire of "dry red" wine at the equivalent of $3 a bottle.

Following the boom in Chinese demand trumpeted in our last wine report in 1998, the market crashed due to a combination of new consumers turned off by low quality imported products that had flooded the market, and a growing inventory of bad wine imported by overzealous speculators. The poorly handled and poorly stored product, though largely unfit for sale, filled warehouses in South China to capacity, and proved an impediment to further imports. As that oversupply is now drawing down, China's imports are picking up once again, but at a much slower growth rate of 10-20%. Don't be fooled by the 250% jump in US wine exports to China in 1999. This is more a factor of wine entering the domestic market directly rather than via Hong Kong, which imported 40% less US wine than in 1998.

Many importers/distributors withered when demand dried up a couple years ago, whereas others relied too heavily on consignment sales and went bankrupt trying to collect from unscrupulous or insolvent retailers. The remaining importers/distributors either weathered the downturn by developing strong, long-term business with regular customers such as top-end hotels, or had the deep pockets of state-owned parent companies. Furthermore, the on-going anti-smuggling campaign has removed a major source of low quality imports, and has re-established the dominance of those whose focus is long term market development and consumer education. Several imported brands from a variety of countries were caught off guard when they learned--in the midst of a Chinese anti-smuggling campaign--that their distributors had been using grey channels, and have largely withdrawn from the market while shopping for a new market entry strategy and more reputable distributors.

It will take time to develop China's wine market, which until recently was dominated by the expatriates who brought their taste for wine with them. According to the Wine Institute of California and several of the more established importers/distributors, education is the key to developing the market. It will take many years for the market to mature, and, due to the fragmented nature of China's markets and its almost non-existent national distribution network, it will take a city by city effort. French wine sales were seriously damaged by 1999's cow blood scandal, largely due to a massive negative publicity campaign waged in the local press. This only emphasizes the importance of education as a tool to dispel myths about wine and capricious government policies which favor domestic producers.

II. Domestic Market

Although the wine market in China is emerging from almost zero consumption a decade ago, there is already a small but loyal following in major urban areas. A 1997 study conducted for the Wine Institute of California estimated that China is 61st in the world for per capita wine consumption, due mainly to its largely rural population of 1.3 billion. However, its urban consumer class is estimated to exceed the total population of the United States, meaning there is still a huge potential market for imported wine. Beijing and Shanghai are generally considered to have the largest markets for western foods, and most major hotels and restaurants feature wine, usually including some from California, quite prominently. Wine consumption, especially imported wine, drops below recordable levels outside of major cities.

Wine, especially red wine, is becoming fashionable at KTV lounges, night clubs, discos, and some upscale Chinese restaurants and is quite popular at banquets in place of the once ubiquitous “bai jiu,” an extremely potent grain-based alcohol. However, don’t be surprised if you see someone mixing their wine with a soft drink. This was popularized by none other than China’s President, Jiang Zemin! This is probably due to China’s long history of producing sweet and fortified "wines" with a high alcohol content, which featured flavors such as osmanthus or hawthorn, and consumers’ relative inexperience with grape-based dry wines.

Some wine is also available in retail outlets, but consumers tend to use wine for toasts in social settings rather than at home over a meal. Most consumers are attracted to wine by the positive press of its health benefits rather than for its taste. Undoubtedly, it will take time for a wine culture to develop in a country that is truly unexplored territory in terms of wine appreciation.

Price is a major consideration to most Chinese, and imported wine is automatically out of reach to all but the wealthy enthusiast or to the businessperson who dines on an expense account. While China has a middle class approximately the size of the overall population in the United States, that population is spread out in pockets throughout the country, making it hard to market and distribute to this "niche." A domestic bottle of wine may retail for as little as US$3, whereas there is a minimum invoice price of US$2.70 for imported wine. After tariff and markup, the average price of imported wine climbs to $10-$20. After China’s entry into WTO, it is likely that the chasm between imported and domestic wine prices will shrink considerably, thus improving opportunities for imported brands.

III. Domestic Production

Several joint venture wineries, mostly Sino-French or Hong Kong invested, emerged about two decades ago during China’s initial opening to the west. They laid the ground work for the current official encouragement of fruit-based wine in order to divert staple grains away from the distillers. An underlying motive was to discourage alcohol abuse, in which the traditional domestic bai jiu played a large part. The press often prints articles extolling the health benefits of red wine in particular, although it is often urged that domestic wine is somehow actually made to a higher standard than imported wine. Compared to the glut of cheap imported wine that exists in the market, it is easy to make this claim. However, state-of-the-art bottling equipment and other imported technology aside, the domestic product rarely reaches international standards of quality. Poor handling in transit to domestic markets often spoils product before it reaches consumers, frustrating efforts to encourage wine consumption.

While China’s domestic wine producers have steadily improved over the last two decades, the overall market has only recently begun to produce palatable wines. However, Chinese wines, on average priced well below the imports, will always win on price. Yet, despite all of the nationalistic media campaigns exhorting Chinese to drink domestic wine, the little known fact is that most Chinese wineries blend as much as 30-40% imported juice into their domestic label wine. There is a shortfall in domestic wine grape production, although harvests are growing rapidly, necessitating the use of Spanish, Australian, Italian, Chilean, and just about any other bulk wine for local blending and bottling. American wine is rarely used as it is generally too expensive, although one or two domestic bottlers have teamed with importers/distributors to produce affordable locally-bottled American, Spanish, and other foreign-sourced wines that cater to the entry-level buyer. Other private label brands will likely pop up as bulk wine -- assessed the same tariff as bottled wine -- can nevertheless enter China with a lower invoice value, thus making it cheaper to import.

The domestic market is dominated by brands such as Dynasty, Great Wall, Dragon Seal and Imperial Court, all of which have joint ventures to blend and bottle their wine. The regions of Xinjiang, Tianjin, Shandong, Liaoning and Henan are suitable for wine making, but it will take time for domestic demand and wine culture to enhance the inherent capabilities of the wines grown there. Government largesse has given the domestic industry a real boost, and China's effective growing area is expanding rapidly. Product quality should continue to improve quickly as well, with the ultimate goal of competing with imports in a post-WTO world, as well as earning hard currency from potential exports.

IV. International Competitors

France was one of the first countries to enter the market over two decades ago, and through its overseas export marketing arm, SOPEXA, continues to exert the largest presence in terms of education, marketing, and also investment in China's wine-making facilities. Italy, which has made a similar investment into marketing its product in China, may combine efforts with France to create a trade promotion block. Australia, Chile and Spain are also major competitors in the market, though like the United States, they are less entrenched in the market than the French and have an uphill battle to educate consumers about the merits of their respective products.

American wine, and Californian wine in particular, benefits from the overall good reputation for high quality and healthy products shared by most U.S. foods in China. It ranks 6^{th} among imports after France, Italy, Spain, Australia and Chile, and had about a 4% share of the market in 1999. It remains to be seen what impact the French blood albumin scandal had on France's standing in the market, and for that matter, other exporters. Sources say that French sales have dropped off precipitously since the scandal, despite there being no merit to the claims that tainted wine reached this market. The overall wine market has also felt the impact of the scandal, but not to the extent that French wines have.

Several local importers/distributors and the Wine Institute of California are active in educating consumers about the health benefits of California wine, and regularly invite winemakers to cities like Beijing and Shanghai for winemaker dinners, trade show presentations and other educational and promotional events. Major brands such as Berringer, Robert Mondavi, Wente, Kendall-Jackson, Ironstone, Concannon, Stonehedge and Mirassou, among others, are well represented at the major hotels and some upscale restaurants. Mass market sellers like Gallo's Carlo Rossi label briefly held a top spot in several Chinese cities.

V. Importer / Distributors in the Domestic Market

Traditionally, wine entered the market via two channels, namely:

- China National Cereals, Oils & Foodstuffs Import and Export Corporation (CEROILS), the state monopoly wholesaler and distributor of alcoholic beverages. Traditionally the main channel for wine imports.
- Joint Venture and Foreign-owned hotels, as well as duty free stores under China Travel Services (CTS). Generally a limited channel as products are restricted from general distribution.

However, the current method for most successful importer/distributors is to obtain a sub-license from CEROILS and then to handle the marketing and distribution themselves. The main advantage is that there is more control over brand development, proper handling, and storage compared to a state-owned distribution company. At present, a few of the top wine importer/distributors engage in every aspect of sales and marketing in the domestic market, including climate-controlled warehousing, trade education, market promotion, sales, and delivery.

The more established importer/distributors in the market have become quite sophisticated in the last few years, and are generally focused on the ports of Tianjin and Shanghai. Some companies employ climate-controlled warehouses near the port of entry, and keep the wine in bond until needed in the local market. This reduces the up-front costs for the distributors as duty is not paid until the wine is released from the warehouse.

Currently, there are several importer/distributors of American wine in the market with English speaking staff and/or foreign management. Some examples are Asia Solutions Co., Califirst, City Trade Co., Montrose Food and Wine, Summergate, and Value Wine.

VI. Wine Tariffs and Labeling laws

As part of China's WTO accession agreement with the United States, it will reduce its tariff on wine from the present 65% to 20%, and it has been reported that the EU has already negotiated an even better 14% as part of their accession agreement. Upon accession, the present tariff will drop in equal steps until it reaches its final rate in 2004. In addition, the VAT may also be reduced by half, but this remains to be seen. Until China's accession to the WTO, which might occur as early as this year, China's tariff on wine will remain as follows:

(All rates are ad valorem assessed on a CIF basis.)

Import Customs Duties (ICD):	65%
Value Added Tax (VAT):	17%
Consumption Tax (CT):	10%

Total import tax will be ICD+CT+VAT, to be calculated in the following formula:

$$\text{Total Tax} = \frac{\text{ICD Rate} + \text{CT Rate} + \text{VAT Rate} + (\text{ICD Rate} \times \text{VAT Rate})}{1 - \text{CT Rate}}$$

$$= \frac{65\% + 10\% + 17\% + (65\% \times 17\%)}{1 - 10\%} = 114.5\%$$

China's Inspection and Quarantine (CIQ) Bureau recommends that American suppliers consult with Chinese importers about specific labeling requirements. As the Chinese authorities are now enforcing the Labeling Law with more regularity, we strongly suggest that American wine exporters should carefully follow the law's requirements to avoid possible monetary losses incurred from penalties or product being held in Customs. At present, the upshot of attempting to circumscribe the law is that, in addition to penalties, the manufacturer would in the end still have to comply with the law which will eventually be enforced in full measure. In addition, the authorities have recently given enforcement powers to CIQ, meaning that the labeling law now has real teeth and will be more evenly enforced at China's ports of entry.

The new Chinese food labeling law was designed and promulgated by the State Bureau of Technical Supervision to apply to pre-packaged food and beverage products to be marketed in China including alcoholic beverages, and closely follows standards recommended by the FAO and World Health Organization's CAC (CODEX STAN 1-1991). The law only applies to labels on "delivery units" that are pre-packaged for retail sales, but does not affect "shipping units" and bulk goods. After the promulgation of the old food labeling law which went into effect for Chinese-produced pre-packaged foods on February 1, 1995, the law was revised in a span of less than one year, and finally came up with an extension specifically granted to imported pre-packaged foods. The new law was put into effect on September 1, 1996, which also marked the start of banning the use of temporary adhesive labels (Chinese language stickers). Nevertheless, most foreign wines in China currently use their original label in the front with a Chinese language sticker attached to the back of the bottle.

The labels for wines, champagne, sparkling wines and sake should include the following mandatory label contents in Chinese:

1. Name or Brand of the Wine
2. Ingredients
3. Net Content (ml)
4. Alcoholic Content (%) (V/V)
5. Production Date (yy/mm/dd)
6. Packer / Distributor (Name & Address)
7. Content of Must (%) (Sake is exempted from this requirement)
8. Country of Origin
9. Quality Guarantee and/or Storage Period (yy/mm/dd)
10. Content of Sugar (gram/l)

For more information, please refer to the ATO's **FAIRS** report, which has an updated section on the labeling law.

VII. Market Opportunities and Constraints

While the markets in Beijing and Shanghai are somewhat saturated, they are still the easiest cities for the first time exporter to approach with confidence. Several reputable importer/distributors are already established in these two cities, and California wine is well-represented in the major hotels, as well as in the majority of upscale restaurants. Several retail outlets which feature a wine shelf or wine department are also a good bet. Last, but not least, are the numerous night clubs and KTV lounges which often feature very exclusive wine lists.

Guangzhou, which until recently was the center for most grey channel activity, and for that matter the main channel for Hong Kong and Taiwan entrepreneurs to bring wine into China, was too difficult an environment for legitimate business, as the competition would always undercut on price by avoiding the customs duty. Much of the product that entered the market this way was really overstock or expired product sold at distressed prices. This arrangement suited some, but it resulted in poor handling and storage, little or no trade education on the product, and literally left a sour taste in the mouths of many consumers. Currently, some distributors have plans to re-evaluate Guangzhou, but its proximity to Hong Kong and its reputation may keep most distributors away.

Smaller cities which are within a few hours drive of Beijing and Shanghai also offer long term prospects, but trade and consumer education will in many cases require starting from scratch. Cities such as Hangzhou, Suzhou, Nanjing, Tianjin, and Dalian, all of which are situated in the more developed eastern region of China, have adequate access to distribution links, relatively decent commercial infrastructure, and a rising consumer class. However, it can be much more difficult to develop legitimate business contacts and operate in the more cumbersome bureaucracy of China's interior. Once your product has proven itself in a city like Shanghai or Beijing, then the experience learned in importing and distributing in China can be applied to more challenging cities.

VIII. Conclusion

Despite the numerous pitfalls of low consumer awareness, poor distribution infrastructure, highly regionalized markets, and other barriers to entry such as high tariffs, China promises to be a very rewarding market for those who take a long term approach. China's growing consumer class and strong brand loyalty may turn some liabilities into assets for those companies which are willing to invest in education and training. Brands which have already developed a following will have an advantage after China's accession to the WTO when the market is likely to be swamped once again with a variety of newcomers. However, foreign sellers need to keep an eye on capricious government policies which tend to favor domestic brands, as well as an ongoing effort to develop the export potential and, therefore, the overall quality of Chinese wine.

Although markets such as Taiwan, Singapore, and Hong Kong each buy more American wine than China, which is ranked as America's 20th wine export market, few markets can boast the long term potential that a largely undeveloped market like China represents. Continued economic growth in China, a burgeoning middle class, reductions in import tariffs and other barriers to entry should all go a long way to increasing opportunities for American wine, but increased competition from France, Italy, Spain, Australia, Chile, and other countries could likely expand the pie without greatly affecting market share. Education, aggressive marketing, and a long term approach to the market will be key to success for American wines in China.

IX. Contacts

For additional information about exporting to China, please refer to the ATO Shanghai web page (www.atoshanghai.org) and download a copy of the **Exporter Guide** and **Business Travel in China**. For up-to-date information about labeling laws and importation regulations, please see the **FAIRS** report. For additional information about the Chinese market for California wines, contact the Wine Institute of California's representative in Shanghai:

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