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Infant Formula Industry in China

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I. Overview of the Infant Formula Industry

Pediatric milk formula, a primary alternative to mother's breast milk, is a type of food manufactured to support the adequate growth of infants. The composition of pediatric milk formula is mostly based on mother's breast milk at approximately one to three months postpartum with additional nutritional supplements. The ingredients found in a majority of the pediatric milk formulas available on the market include: purified cow's milk, whey, and casein as a protein source; a blend of vegetable oils as a fat source; lactose as a carbohydrate source; and a mix of vitamins, minerals, and other ingredients.

Industry Overview

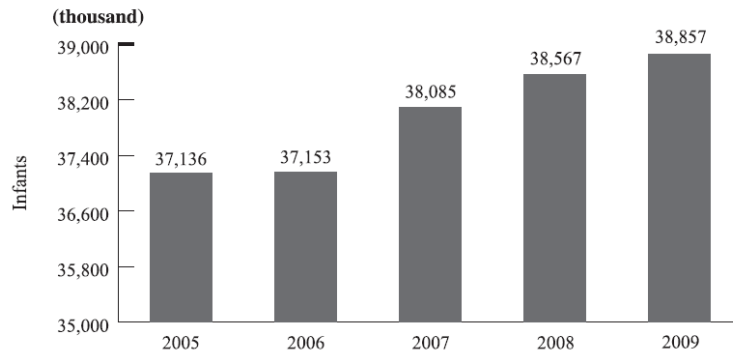
According to the World Health Organization, any pediatric milk formula that is prepared in accordance with the Codex Alimentarius is considered a nutritionally adequate and safe complementary food and a suitable substitute for mother's breast milk. The Codex Alimentarius is a collection of internationally recognized standards, codes of practice, guidelines and other recommendations relating to foods, food production and food safety developed and maintained by the Codex Alimentarius Commission, a body that was established in 1963 by the Food and Agriculture Organization of the United Nations and the World Health Organization. Pediatric milk formula is a primary type of milk product that the medical community considers nutritionally acceptable for infants under the age of one year.

Although cow's milk is the basis of almost all pediatric milk formulas on the market, unprocessed plain cow's milk is unsuitable for infants under the age of twelve months due to its high casein and low whey protein content, which may cause indigestion in infants or, in more severe cases, result in diarrhea or intestinal bleeding. As a result, all cow's milk used for formula production is normally processed into pediatric milk formula. This process includes altering the whey-to-casein protein balance to achieve a ratio similar to mother's breast milk to render the cow's milk protein more easily digestible, adding a number of essential nutrients such as calcium and vitamins, and replacing dairy fat with vegetable or marine originated fats.

China's birth rate has remained at a relatively stable growth level from 2005 to 2009. According to Euromonitor International, the 0 to 36 months old baby population increased from approximately 37.1 million babies to approximately 38.9 million babies within this period, representing a year-on-year growth of 1.3% from 2007 to 2008 and 0.8% from 2008 to 2009. It is expected that the number of infants in China will continue to grow at a relatively consistent level in the coming years. The following chart sets forth the number of 0 to 36 months baby population in China from 2005 to 2009:



Number of infants in China



Source: Euromonitor International

According to Euromonitor International, China’s pediatric milk formula market experienced rapid growth in the past several years, recording a CAGR of 25.1% during the period from 2005 to 2009 and a total retail sales value of US\$4,359 million in 2009. It is estimated that due to the booming economy and increasing baby population in China, China may overtake USA as the world’s largest pediatric milk formula market, in terms of total retail sales value, in 2010.

The following chart sets forth the total retail sales value of pediatric milk formula products from 2005 to 2009, and the estimated total retail sales value of pediatric milk formula products from 2010–2014:

(year, US\$ million)	2005	2006	2007	2008	2009	2010E	2011E	2012E	2013E	2014E	CAGR (05–09)	CAGR (10–14)
China	1,779.4	2,276.0	2,918.2	3,662.4	4,358.9	5,118.5	6,121.4	7,325.5	8,656.5	10,115.1	25.1%	18.6%
France	683.4	728.0	775.6	836.7	880.9	929.1	981.8	1,041.0	1,102.2	1,171.5	6.6%	6.0%
Germany	319.3	321.1	326.8	346.7	353.2	359.7	367.9	377.4	388.5	397.7	2.6%	2.5%
India	148.5	159.9	172.3	187.4	201.8	219.2	238.6	260.9	286.6	316.1	8.0%	9.6%
Japan	747.9	731.4	721.2	731.2	733.3	736.1	740.2	744.5	748.8	754.1	-0.5%	0.6%
South Korea	432.5	426.2	430.9	432.9	427.8	425.5	422.6	419.4	415.9	411.7	-0.3%	-0.8%
United Kingdom	370.0	385.2	403.4	455.4	476.2	492.4	507.4	520.9	532.6	541.9	6.5%	2.4%
USA	4,204.1	4,381.4	4,682.9	4,820.3	4,892.9	4,900.0	4,931.0	4,975.2	5,034.1	5,182.3	3.9%	1.4%

Source: Euromonitor International

The annual per capita consumption of pediatric milk formula in China has grown rapidly from US\$49 in 2005 to US\$112 in 2009, representing a CAGR of 23.0%. However, the per capita consumption of pediatric milk formula in China in 2009 was still behind the USA as well as South Korea and accounted for approximately 29.6% of that in the USA and 34.8% of that in South Korea. In 2009, the population of babies who are 0 to 36 months old in China was approximately 38.9 million, which was three times that of the USA and 29 times that of South Korea.

The following chart sets forth the global annual per capita consumption of powder pediatric milk formula from 2005 to 2009:



<i>(year, US\$)</i>	2005	2006	2007	2008	2009	CAGR (05-09)
China	49.0	62.6	78.3	97.1	112.0	23.0%
France	299.1	317.4	335.3	359.5	377.7	6.0%
Germany	149.3	152.5	158.4	171.9	177.5	4.4%
India	2.0	2.1	2.3	2.5	2.7	7.8%
Japan	236.9	239.3	240.8	247.6	251.8	1.5%
South Korea	303.7	311.0	322.0	325.2	321.4	1.4%
United Kingdom	177.9	180.7	185.9	208.0	217.9	5.2%
USA	343.6	353.8	373.1	377.6	378.0	2.4%

Source: Euromonitor International

Raw Milk Powder

Raw milk powder is one of the most essential ingredients in pediatric milk formula. Raw milk powder produced using plain cow’s milk is nutritious and has a similar texture, taste and nutritional content to mother’s breast milk. For example, mother’s breast milk contains, on average, approximately 1.1% of protein, 4.2% of fat and 7.0% of lactose and supplies 72 kcal of energy per 100 grams, while cow’s milk contains, on average, approximately 3.4% of protein, 3.6% of fat, 4.6% of lactose and 0.7% of minerals and supplies 66 kcal of energy per 100 grams. Because of the similarities between mother’s breast milk and plain cow’s milk in terms of nutritional content, raw milk powder that is produced using plain cow’s milk is irreplaceable as a key ingredient in substantially all pediatric milk formula products.

Liquid milk is transformed into raw milk powder mainly for preservation purposes. Raw milk powder generally has a much longer shelf life than liquid milk and does not require refrigeration due to its low moisture content. Transforming liquid milk into powder form also reduces its bulk for economy of transportation.



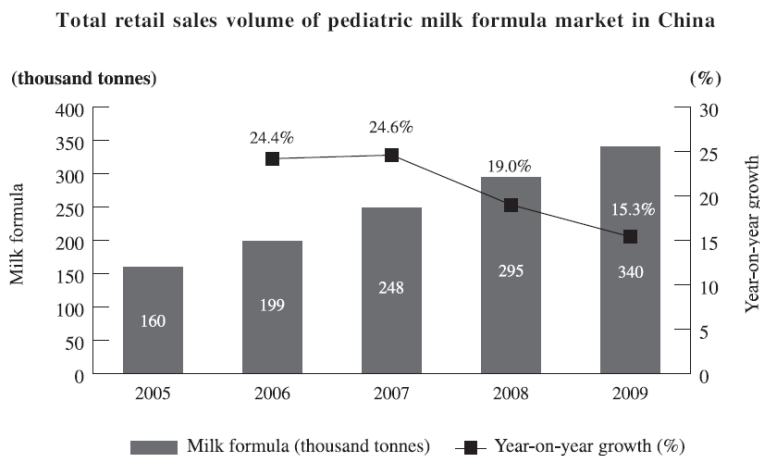
II. Infant Formula Industry in China

Overview

China is the world’s most populous country and one of the fastest growing pediatric milk formula markets in the world. The increasing trend towards double income families in China, coupled with the convenience and complete nutritional benefits offered by pediatric milk formula products, has resulted in increased acceptance by Chinese women of pediatric milk formula as a substitute for mother’s breast milk for their infants. According to Euromonitor International, pediatric milk formula powder products accounted for 69.9% of the entire milk powder market in China in 2009. Furthermore, the total retail sales volume of pediatric milk formula in China was estimated to be approximately 340,300 tonnes in 2009; hence, China accounted for the largest share in the global powder pediatric milk formula market, by total retail sales volume, in 2009, according to Euromonitor International. A large number of pediatric milk formula production enterprises, both foreign and domestic, have entered into China’s market in recent years to compete for a share in the nation’s pediatric milk formula market.

Sales

China’s pediatric milk formula sector has been expanding rapidly due to its increased urbanization, its stable birth rate, the increase in disposable income and the increase in the number of working mothers. The total retail sales volume of pediatric milk formula in China has increased from approximately 160,000 tonnes in 2005 to 340,300 tonnes in 2009, representing a CAGR of 20.8%, while the total retail sales value in 2009 amounted to US\$4,359 million. The following graph sets forth the development trend of the retail sales volume of pediatric milk formula in China from 2005 to 2009:



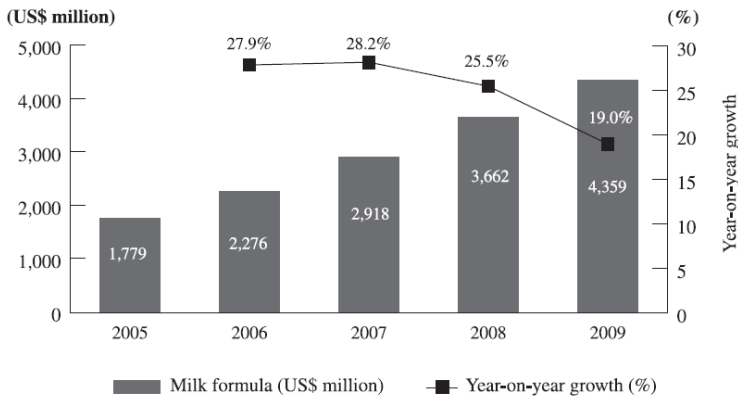
Source: Euromonitor International

Because the growth in China’s pediatric milk formula market is mainly attributable to the increase in sales of high-priced and premium-priced pediatric milk formula products, which are sold at significantly higher prices, the value of China’s pediatric milk formula market is expected to increase at a higher rate



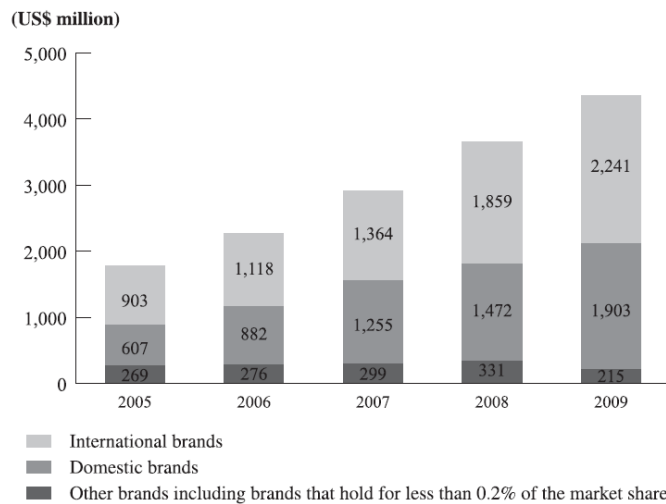
than the corresponding increase in retail sales volumes of pediatric milk formula. The following graph sets forth the development trend of the retail sales value of pediatric milk formula in China from 2005 to 2009:

Total retail sales value of pediatric milk formula market in China



Source: Euromonitor International

The graph below sets forth the breakdown of the total retail sales value of domestic and international brands, respectively, in the pediatric milk formula market in China from 2005 to 2009:

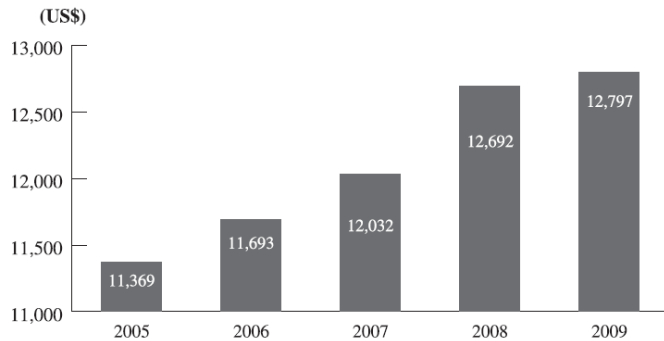


Source: Euromonitor International

As both the total retail sales volume and the total retail sales value of the pediatric milk formula market in China experienced a rising trend from 2005 to 2009, the average indicative price of pediatric milk formula sold per tonne in China annually has also experienced an increase from US\$11,369 in 2005 to US\$12,797 in 2009, representing a CAGR of 3.0%. The following graph sets forth the development trend of the average indicative price of pediatric formula sold per tonne in China annually from 2005 to 2009:



Indicative price of pediatric formula sold per tonne annually in China

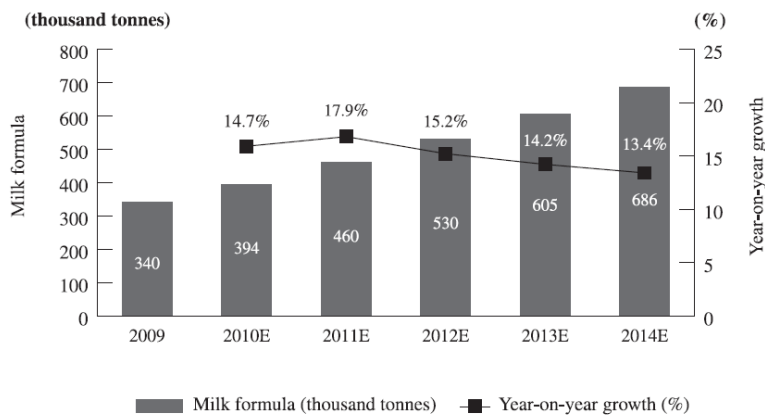


Source: Euromonitor International

Growth Trends

According to Euromonitor International, China’s pediatric milk formula market is expected to continue to grow due to the increasing demand for pediatric milk formula, higher average retail prices for pediatric milk formula products as well as macro-economic factors such as increasing urbanization, rising disposable income levels and the growing number of working mothers. The retail sales volume of pediatric milk formula is expected to grow by a CAGR of 14.9% from 2010 to 2014, with the retail sales volume size reaching 686,000 tonnes in 2014. The following chart sets forth the projected retail sales volume of pediatric milk formula products in China for the periods indicated:

Projected retail sales volume of pediatric milk formula products in China



Source: Euromonitor International

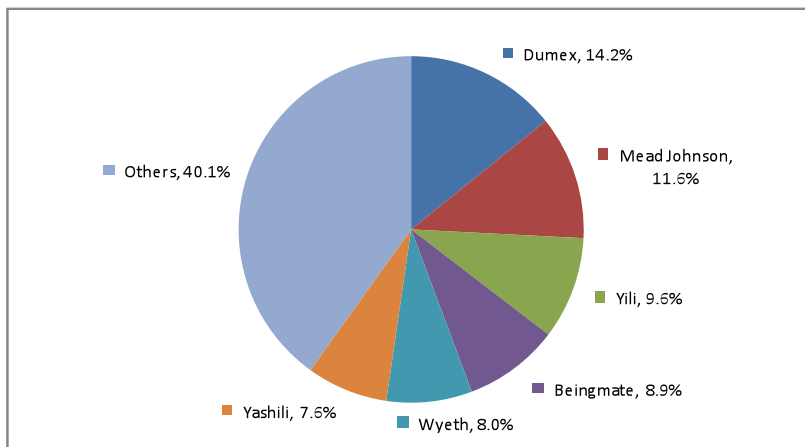


III. Competition in the Infant Formula Industry in China

Domestic and international producers of pediatric dairy products compete in the PRC pediatric milk formula industry. While the industry consists of a large number of players due to its attractive growth opportunities, according to data from AC Nielsen, the top six producers accounted for approximately 60% of the total market share of China’s pediatric milk formula market based on retail sales in 2009. Among the top six market leaders, three were international producers Dumex, Mead Johnson and Wyeth with market shares of approximately 14.2%, 11.6% and 8.0%, respectively, and three were domestic producers Yili, Beingmate, and Yishili captured market shares of approximately 9.6%, 8.9% and 7.6%, respectively.

The principal bases upon which pediatric milk formula producers compete in the PRC market are brand recognition, product quality, distribution networks, product pricing and offering range. Competition in the domestic market has experienced a trend favoring premium brands due to consumer’s increased appreciation for product quality and safety. This has led to increased significance in brand recognition and investment in quality control. Due to the significant expenditure required to build brand recognition and market scale and implement stringent quality control measures, leading players benefit from the high barriers to market entry opportunities for industry consolidation.

The following chart sets forth the market shares held by domestic and international pediatric milk formula producers in China based on retail sales in 2009:



Source: AC Nielsen



IV. List of Domestic Infant Formula Players

Brand Name	Chinese Name	Public/Private	Comments
Yili	内蒙古伊利实业集团股份有限公司	Public (600887.CH)	Listed in Shanghai stock exchange
Mengniu	中国蒙牛乳业有限公司	Public (2319.HK)	Listed in Hong Kong stock exchange
Guangming	光明乳业股份有限公司	Public (600597.CH)	Listed in Shanghai stock exchange
Sanyuan	北京三元食品股份有限公司	Public (600429.CH)	Listed in Shanghai stock exchange
Shengyuan	圣元营养食品有限公司	Public (SYUT.US)	Listed in Nasdaq since 2005.
Yashili	雅士利国际控股有限公司	Public (123.HK)	IPO in Hong Kong in Oct 2010
Feihe	黑龙江飞鹤乳业股份有限公司	Public (ADY.US)	Listed in US since 2003
Nanshan	湖南亚华乳业有限公司	Subsidiary of a Public Company	Fully owned subsidiary of Hunan Yahua (000918.CH)
Weiwan	杭州味全食品有限公司	Subsidiary of a Public Company	Subsidiary of KangShiFu (322.HK)
Qinyong	西安银桥乳业集团	Subsidiary of a Public Company	Subsidiary of China Dairy Group (CDG.SG)
Beingmate	贝因美集团	Private	Preparing for IPO
Wandashan	完达山股份有限公司	Private	Received captial injection from Beidahuang (600598.CH) and UniPresident (220.HK)
Gucheng	山西古城乳业集团有限公司	Private	Regional brand. Total assets about RMB400mm.
Jinxing	哈尔滨金星乳业有限责任公司	Private	Regional brand



V. Potential Opportunities and Challenges in the Infant Formula Industry

Potential Opportunities

- Demand for premium infant formula products is huge
 - As the income level of the population grows, parents are more willing to pay for better quality infant formula products. Brand names that have established their reputation with high quality and safety will gradually capture a majority of the market share in China.

Challenges

- Imported Pediatric Milk Formula Products
 - As the 2008 nationwide melamine incident affected the health of a substantial number of infants and children in China, many parents have lost confidence in infant formulas that are produced domestically. Since the melamine incident, leading brands in China have devoted substantial resources towards convincing the Chinese population of the safety of their dairy products. Consumer confidence levels in China were still in recovery as the retail value size growth rate has slowed down from 25.5% in 2008 to 19.0% in 2009. The PRC pediatric milk formula industry may face challenges as a result of the increase in consumer demand for imported pediatric milk formula products; as such products may provide a higher confidence in terms of safety and quality to the consumers in China.
- Consumer Confidence
 - Recently, there have been media reports linking hormone levels in the pediatric milk formula products of a domestic manufacturer with alleged premature development and sexual precocity of infants in the PRC. While China's Ministry of Health has already conducted a clinical investigation and found no evidence of abnormality in the hormone content of the said products, it is uncertain what impact, if any, these media reports will have on the PRC pediatric milk formula industry. If the negative publicity surrounding this incident causes a confidence crisis in the quality and safety of pediatric milk formula products among consumers in China, the PRC pediatric milk formula industry may face another challenge similar to the 2008 nationwide melamine incident, with adverse effects on the results of operations of the entire industry.
 - Furthermore, there have been recent media reports that melamine-contaminated products under the product recall in 2008 have been leaked and sold in the market. There have also been reports that victims from the 2008 nationwide melamine incident are unable to receive compensation for emergency and medical costs from the compensation fund; however, no further judicial decision was rendered on such claims quoted in relevant reports. Such negative news may continue to undermine and affect consumers' confidence and perception of the PRC pediatric milk formula industry. Currently, it is uncertain how long such repercussions of the 2008 nationwide melamine incident may last and what impact, if any, such negative publicity will have on the PRC pediatric milk formula industry going forward.



➤ Birth Rate in China

- China may experience a decreasing birth rate, even though China's birth rate has remained at a relatively stable growth level from 2005 to 2009. With China's stringent one-child policy and numerous deaths caused by natural disasters every year, the birth rate in China may decrease which, in turn, leads to a decrease in demand of pediatric milk formula products. This is a possible challenge to the PRC pediatric milk formula industry.



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