



Mengniu

CASE STUDY 2

Mrs Zhang's farmyard,
cows, and watchdog.

INTRODUCTION

Founded in 1999, Mengniu Group (Mengniu) has grown rapidly to become the leading dairy product manufacturer in China. Its principal products are liquid milk (UHT milk,¹ milk beverages, and yogurt), ice cream, and other dairy products such as milk powder, milk tea powder, and tablets. Mengniu has overtaken its long-established state-owned rivals through dedication to quality and innovation in all aspects of its business, including marketing, governance, and aggressive adoption of international quality and best practice standards.

CDH China Fund, an IFC investee private equity fund, invested in Mengniu in 2002. Mengniu went public in 2004 and trades on the Hong Kong exchange.

This sustainable business case study focuses on Mengniu's commitment to:

- Its supply chain, consisting of independent small farmers
- Adoption and implementation of internationally accepted management, systems for quality assurance, environmental management, and worker health and safety
- Its employees and the creation of a safe and desirable workplace (recognized in 2005 as one of the 20 best places to work in China based on the "Happy Workplace" index)
- Continuing improvement and innovation through joint ventures and use of state-of-the-art equipment.

1. Ultra-high-temperature (UHT) pasteurized milk does not require refrigeration, thereby providing extended nonrefrigerated shelf life of up to nine months and simplifying shipping and storage for the producer and consumer.

BACKGROUND

Mengniu is a manufacturer of milk products based in Inner Mongolia, famous for its grasslands and one of the traditional dairy regions of China. Mengniu was privately founded in 1999 by a management team with long experience in one of Inner Mongolia's state-owned milk product companies, Mongolia Yili Industrial Group (Yili). Mr. Niu Gensheng, the founder and chairman of Mengniu, had lost his position as vice-president of sales at Yili after an internal power struggle in 1999. Mr. Niu had worked at Yili for 17 years and his father before him for 38 years. Mr. Niu, and the small but experienced management team he brought with him from Yili, started Mengniu with \$12,600 of their own capital.²

Mengniu competes fiercely with Yili and the other big Chinese dairy, Bright Dairy & Food. The three companies collectively controlled approximately 60 percent of the market as of August 2005.³

In only five years, Mengniu has grown explosively, overtaking Yili as the top seller of milk and simultaneously becoming one of China's best-known brands. According to AC Nielsen, Mengniu was China's top seller of milk in 2004 with 22 percent of the market and revenues of US\$871 million. This represented a revenue increase of 77 percent over the prior year, with an increase in profits of 94 percent or US\$38.5 million. In the first half of 2005, sales increased 37

percent to US\$578 million and earnings 34 percent to US\$30 million, putting Mengniu on track to exceed US\$1 billion in sales and US\$60 million in profit.⁴

Mengniu's success is also a function of its commitment to innovation and quality in the dairy industry which has led it to adopt international best practices and to actively seek technological and operational improvements through joint ventures and demonstration projects with international leaders in the dairy industry.

THE DAIRY BUSINESS IN CHINA

The milk product market in China has grown dramatically in the last decade as a result of increasing levels of disposable income and improved consumer awareness of the need to improve dietary nutrition. The growing market for milk products is due in part to a government program that promotes consumption of dairy products for their health and nutritional benefits. The annual growth rate in dairy product consumption has been estimated to have increased from 5.4 percent to 14.4 percent between 1998 and 2002 nationwide and by as much as 30 percent per year in urban areas.

The dairy business in China involves the following process:

- Dairy farmers bring their cows to milk collection centers for milking.

- After each milking, the fresh milk is immediately transported by sterilized tank trucks to the Mengniu plant for processing.
- Milk is processed 24 hours a day.
- Products are packaged and warehoused.
- The products are then distributed to the market.

The collection centers, which were established by the government, consist of a central milking barn surrounded by a series of small cow barn and feeding yard complexes with attached residential units for the farmer and family.

The milking barn at each collection center is owned and operated by a third party who milks the cows and supplies the milk to a dairy products company. The cow barn and residential units in the complex are owned by the individual farmers, who must purchase them. The farmers must also supply their own cows and forage. The typical collection center/farm complex has 40 farmers and their families, and the average farmer has from two to ten cows. All manure is collected and sold to the farmers for fertilizer, and given the dry climate and relatively flat landscape, there is little runoff.

In Mengniu's case, each farmer has a contract to supply milk to Mengniu through the third-party collection centers, which also are contracted to Mengniu. The farmers are paid in cash after each milking, based on the quantity of milk produced. Mengniu also provides quality control supervisors.

2. Personal communication with CDH China Fund; *Business Week*, "China's Free Range Cash Cow," October 24, 2005.

3. *Business Week*, "China's Free Range Cash Cow," October 24, 2005.

4. *The Standard*, China's Business Newspaper, Top Stories: "Mengniu reaps 34 percent gain in profits as sales climb," August 24, 2005.

The milk truck transfer operators own their own trucks but are also contracted to Mengniu. The trucks are sterilized after each load at the Mengniu plant's sterilization center.

Mengniu has some 3,000 collection centers under contract in China, with some 1,800 in Inner Mongolia.

ROLE OF THE CDH CHINA FUND

CDH China Fund took a very active role with Mengniu in the following areas:

- 1) Restructuring of the company's ownership and shareholding, which incentivized management to build long-term shareholder value as opposed to short-term personal wealth.
- 2) Improved internal corporate governance, which provided the foundation for the company to manage rapid growth (at times greater than 100 percent year to year) and create a sustainable platform to effectively compete in a highly competitive market.
- 3) Development of a stock option plan, which further supported and emphasized long-term, sustainable profitability.
- 4) Execution of an IPO: CDH was a key advisor to management throughout the IPO process, which was a huge success. Mengniu's going public was a critical part of the company's long-term viability, given the need for capital to expand.

Equally important, going public raised the company's profile and reputation and increased access to market intelligence.

- 5) Board-level Activity: CDH's Managing Partner, Mr. Jiao Zhen, was appointed Chairman of the Board and continues to be an active member, providing invaluable advice to Mr. Niu and the management team on business strategy and corporate finance issues.

CDH did not, however, have a specific role in the sustainable business aspects discussed in this case study.

THE MENGNIU SUSTAINABILITY STORY

This case describes four aspects of Mengniu's business model that have enhanced the company's sustainability and profitability, or triple bottom line:

- Commitment to and technical and financial support for the small farmers in the supply chain, which has fostered entrepreneurial growth in this sector
- Commitment to its workers, resulting in the company's top-20 ranking among places to work in China
- Implementation of international quality standards and certifications
- Continual improvement and innovation.

Commitment to Supply Chain

One of Mengniu's key competitive strengths is its ability to obtain a steady supply of high-quality raw milk. Its supply chain consists of some 500,000 dairy cows owned by 300,000 small, independent farmers in Inner Mongolia and adjacent provinces, with an average of 1.67 cows per farmer.

Prior to the creation of Mengniu, the state-owned dairy company, Yili, effectively had a monopoly as the only buyer of raw milk in the region. Yili was able to set prices and keep them

The Zhangs—Part of the Mengniu Supply Chain

Zhang Xiu Fang and her husband were traditional dairy cow herders from the western reaches of Inner Mongolia. Seeking a better quality of life, they heard about Mengniu's rapid growth and decided to explore opportunities in the Mengniu supply chain. In 2003, they moved to a collection farm where the dairy farmers were contracted to Mengniu. The company helped them to get bank loans to purchase a house and farm unit. In the last two years, they have been able to increase their herd from 10 to 50 cows by leveraging their earnings with the bank to buy additional cows. They have also increased their per animal production via the technical support they have received from Mengniu.

The Zhangs have profited from the arrangement but have concerns, because milk prices are steady but forage prices have been rising. They also miss their children who remained in their home town, but they are now participants in China's economic growth and own a truck, have a television with a satellite feed, and have achieved a higher quality of life than would have been possible in their former village.

low, in part because the supply then exceeded the demand.⁵

Mengniu was able to capture supply by offering a “fair” price and establishing contracts with farmers guaranteeing to purchase their milk at fair market value. The more entrepreneurial farmers saw this as a market opportunity to increase production by investing in more cows. Mengniu also assisted the farmers in obtaining loans from local banks, which allowed them to purchase farmettes at collection centers, as well as more cows.

Mengniu established the following principles for dealing with the supply chain:

- The farmers must supply milk to the collection center.
- Mengniu will pay the established market value for the milk.
- Mengniu will not pay more than other companies, but neither will it purchase milk for less than the established market value or contrive to pay less.

Mengniu’s pro-farmer program has been extremely successful, as evidenced by its milk collection performance. At the end of its first year, Mengniu was collecting 19 tons a day, whereas in 2005 they were averaging 5,000 tons a day, an increase of 263 times over six years.

Through its supply chain program, Mengniu has in effect served as an incubator for small business development, helping its small suppliers to access finance and fee-based technical support, and training in animal husbandry to

optimize their production. This has in turn improved the well-being and economic situation for the small farmers in their supply chain and the local economy (see box on previous page). The modern animal husbandry techniques have been drawn from best international practice, thereby improving the environmental sustainability of the small dairy farmers in Mengniu’s supply chain.

Commitment to Workers

Mengniu’s extraordinary growth and expansion would not have been possible without a dedicated workforce. Since its founding, the company has taken measures to create an esprit de corps and worker dedication to the company’s mission.

In addition to financial performance incentives, the company has created an elaborate campus environment at its headquarters, including apartment complexes with gardens, fountains, shopping centers including grocery stores, and recreation centers complete with pools and other sports facilities. There is also a large U.S. suburban style neighborhood development for those with families, featuring individual houses with grass lawns and winding streets with newly planted trees. The company developed these facilities for those workers who can rent or purchase. For purchasers, the company arranges financing for employees to purchase the housing of their choice.

Mengniu was selected in 2005 as one of the 20 best companies to work for in China by the annual China “Happy Workplace” index competi-



Mrs. Zhang in front of her new truck and farmyard.

tion conducted by CCTV and based on research conducted by Beijing University’s Social Investigation Research Center.

Implementation of International Quality Standards and Certifications

As a part of Mengniu’s focus on quality and innovation in the dairy industry, the company has aggressively adopted and implemented international best practices and standards encompassing food safety and quality, worker health and safety standards, and environmental management. Mengniu is certified for and reportedly rigorously compliant with:

- ISO 14001, the international standard for environmental management.
- OHSAS⁶ 18001, the international occupational health and safety management system specification.

5. Dairy product consumption in China has increased dramatically in the last decade due to government programs that have advertised the health benefits of dairy products, and because of more effective marketing and distribution by companies such as Mengniu.

6. Occupational Health and Safety Assessment Series.



蒙牛乳业(集团)总部

HEADQUARTERS OF MENGNIU DAIRY INDUSTRY (GROUP)

One of Mengniu's seven state-of-the-art milk processing plants headquarters.

It is comprised of two parts, 18001 and 18002 and embraces BS8800 and a number of other publications.

- HAACP, or Hazard Analysis and Critical Control Point certification, the U.S. Food and Drug Administration's standard for food safety and quality control during production.

Mengniu is also certified under the Chinese Department of Agriculture's "Green Food Net" program. This rating system examines agricultural sector companies against certain set standards, including compliance with national environmental standards and technical product standards established by the Department of Agriculture.

Continual Improvement and Innovation

One of the major factors in Mengniu's success has been its dedication to improvement and innovation, both in the dairy industry and companywide. This is reflected in its aggressive adoption and certification program for quality standards described above, as well as its purchase of state-of-the-art equipment and business liaisons with leading international companies in the dairy industry.

STATE-OF-THE-ART EQUIPMENT

Mengniu's seven enormous production plants at company headquarters use the latest Tetra Pak machinery and equipment. The entire system, from filling and packaging to palletizing and warehousing, is computer controlled. In the modern warehouses at the rear of each modular production plant, robotic forklifts automatically carry and stack pallets of packaged products. Mengniu also has a sophisticated training program to

educate workers in the operation and maintenance of the equipment.

Tetra Pak has a strong commitment to the environment and sustainability as well, and its equipment is designed to minimize environmental impacts and energy and water consumption. Tetra Pak works closely with Mengniu to optimize performance and minimize impacts.

STRATEGIC LIAISONS WITH INTERNATIONAL COMPANIES

Mengniu has sought out a number of strategic relations with leading international firms to improve its own business as well as to raise the bar in the Chinese dairy industry as a whole. In 2005 alone, these included:

- An alliance with the Danish biotechnology firm Chr. Hansen, which provides ingredients to the food, dairy, human health and nutrition, and animal health industries. Chr. Hansen and Mengniu are teaming up to promote "probiotic" cultures for yogurt in China. Probiotic culture yogurt is extremely popular in Europe for its enhanced nutritional benefits.
- A joint venture with the Scandinavian food firm Arla Foods for the production of milk powder packs. China is the world's largest consumer of milk powder packs.
- A joint venture with the Australian company Autasia, a specialist in dairy cow breeding and husbandry and part of the Japfa Group and the Indonesian-based Salim Group, in the state-of-the-art Inner Mongolia Mengniu Autasia Model Dairy Farm. The 600-hectare farm has a planned capacity of 10,000 breeding cows and features a host of innovations to promote contented cows, including robotic milking

machines that allow the cows to milk themselves; hay from 12 species of grasses; piped-in music; foam sleeping mats; and self-grooming rotary brushes.

CONCLUSION

The sustainability aspects of Mengniu can be attributed at least in part to its many associations with international leaders in the dairy industry. But the paramount reason for the company's commitment to and successful implementation of these measures is the vision of its founder and the management team.

Second, while these initiatives identified have been presented as specific aspects or initiatives, they are actually fully integrated within Mengniu's business plan.

Last, in the conventional business sense, at least part of Mengniu's success would be attributed to brilliant marketing and strong policies and programs to build worker satisfaction and dedication. But from a sustainability perspective, these could be considered elements of a strong stakeholder engagement program. Mengniu has demonstrated a great knack for understanding the marketplace, and for using this understanding to develop products and advertising campaigns that have been extremely successful in a short time. Similarly, the extremely high worker satisfaction rating is evidence of a management team that is fully engaged with its workers, understands what they want, and is delivering.