BMO Financial Group

China's Role in the Global Food Economy

A Look Forward

BMO Financial Group
银行金融集团

BMO Financial Group in China - Timeline

BMO China Timeline

1818
BMO undertakes first FX transaction in support of trade with China

1961
BMO is one of the first western banks to establish direct business ties with the Bank of China

1996
BMO is the first Canadian bank licensed for a full-service branch in Beijing

2003
BMO becomes a 16.7% owner of Fullgoal Fund Management, China's 2^{nd}-largest mutual fund company (increased to 28% in 2004)

2004
BMO is the first Canadian bank to be licensed by the China Banking Regulatory Commission to sell derivatives in China

2005
BMO is the first Canadian bank licensed to provide RMB local currency services to foreign and local companies in China

2005
BMO selected to work alongside the BOC, the CITIC and the ICBC as a market maker for the new FX trading platform

2006
BMO opens Investment Banking representative office in Beijing

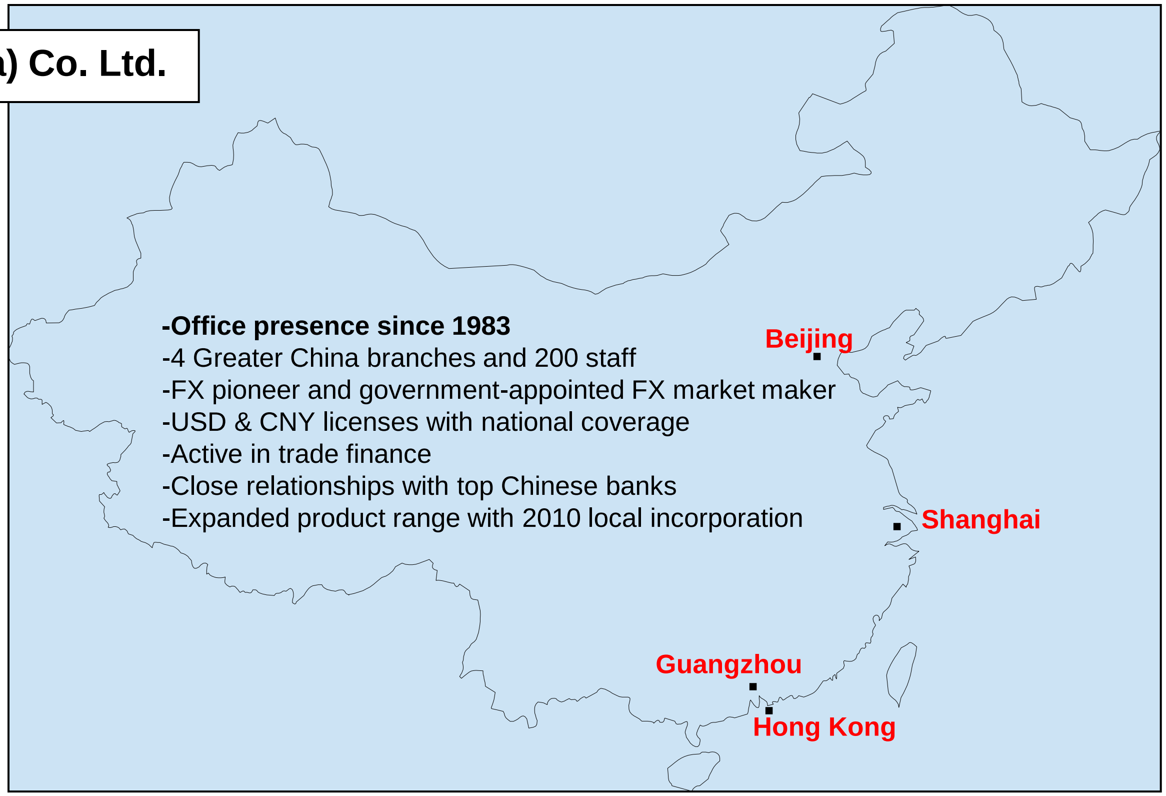
2008
Shanghai branch officially begins operations

2010
BMO is the first Canadian bank to incorporate in China

BMO Financial Group in China – Market Presence

中 国

Bank of Montreal (China) Co. Ltd.



-Office presence since 1983
-4 Greater China branches and 200 staff
-FX pioneer and government-appointed FX market maker
-USD & CNY licenses with national coverage
-Active in trade finance
-Close relationships with top Chinese banks
-Expanded product range with 2010 local incorporation

Bank of Montreal (China) Co. Ltd is a wholly-owned subsidiary of BMO Financial Group

Observations

- The food industry continues to be one of China's largest, fastest growing and most important sectors.
- It also comes with a number of business challenges including:
  - Being highly fragmented
  - Lacking a national distribution network
  - Food safety concerns
  - Working with the "complexities" of various governments (regional and national).
- Opportunities abound for both Chinese firms looking to expand and enter new markets as well as international firms looking to enter China or increase their current presence in the country.
- Chinese firms have a number of different objectives and goals as they look looking to drive strategic growth through acquisitions, partnerships and other arrangements. While deal numbers and size are still small in comparison to International led Chinese deals they are growing and expected to increase.
- International firms continue to look to China as a critical piece of their emerging markets strategy and have shown a willingness to consider all options whether that be acquisition, JV or other contractual partnerships. Deal numbers and size continue to grow and foreign firms are adapting to what works and what doesn't.
- The pace of activity is only expected to increase and for firms looking to successfully participate in China there are a number of key success factors
- Financial Institutions continue to play a key role in helping facilitate these deals.
- Accession to the WTO has benefited Chinese industries across the board, with the gradual removal of market barriers and trade restrictions creating increased competition among domestic and foreign operators.

Dynamics of the Food Sector in China

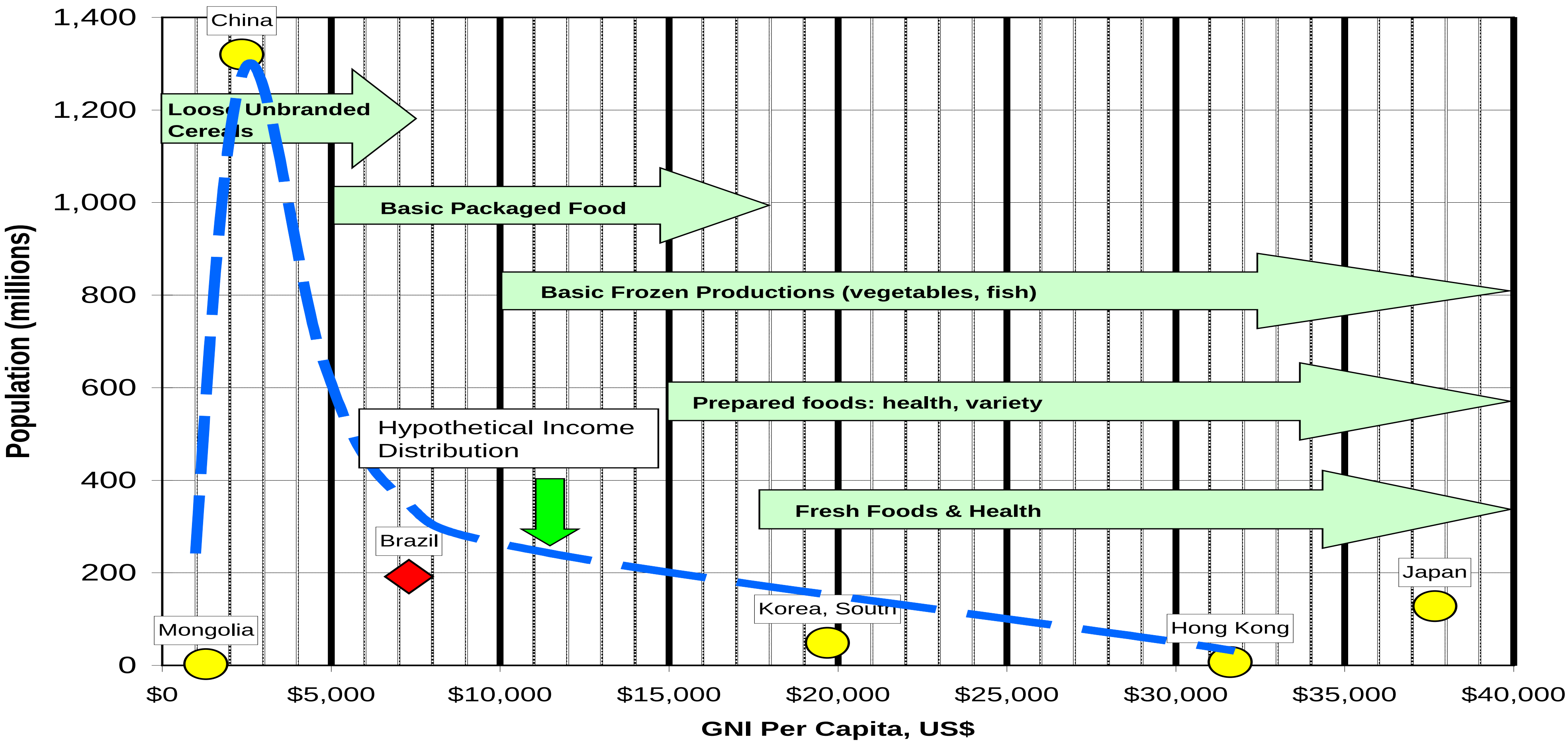
- By the end of 2011, 51% of China's population lived in urban centers (up from just 26% in 1990). It is expected that rate will jump to 70% by 2035. Changes in demographics and increased buying power will fuel interest in the food and agribusiness industries.
- China's food industry is among the country's fastest-growing sectors, with output rising by more than 20% annually.
- The industry continues to be highly fragmented, with localized brand preferences/tastes and lack of a true national distribution network.
- The country continues to be unable to meet its internal food production requirements which has been compounded by the economic expansion that has reduced the agricultural footprint. This has resulted in the continued increase in food imports while highlighting the need for assistance with productivity improvements in the agricultural sector.
- China enjoys the fastest-growing major economy in the world. This has lifted hundreds of millions of people out of poverty and has fuelled the rise in food consumption and the growth of the packaged food sector which offers convenience, quality and lifestyle. They are expected to be the world's largest packaged food market in the near future.

Dynamics of the Food Sector in China (cont'd)

- In addition to this rising middle class, concerns about food safety have created opportunities for international companies and brands. This concern strongly influences Chinese consumers' confidence in certain domestic products and categories. This concern is also shared by the government .
- Consumers welcome innovation and are willing to accept new ideas. They are beginning to pay increased attention to quality and to brands as well as becoming more concerned with product information (e.g. ingredients, nutritionals, product origin etc.). Significant regional differences exist within China covering everything from degree of urban development to average wage. The East and South are well-developed regions while the those regions in the West and center of the country have below average earnings/buying power.
- An abundance of partnerships between local players and multinationals have allowed for rapid development, with the former benefiting from the financial clout and operational expertise of the latter, and the latter benefiting from the former's local market knowledge and existing presence.

Impact of GNI Per Capita on Food Selection

- As China's GNI per capita increases we will expect to see continued increase in the penetration rate and sales of higher priced, value added food products. This is a significant trend for the future of food and agribusiness over the long term.



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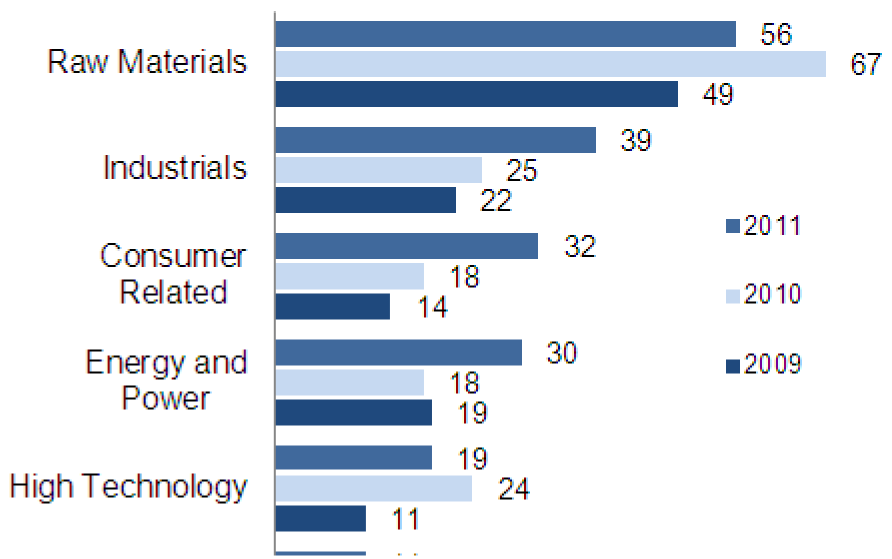
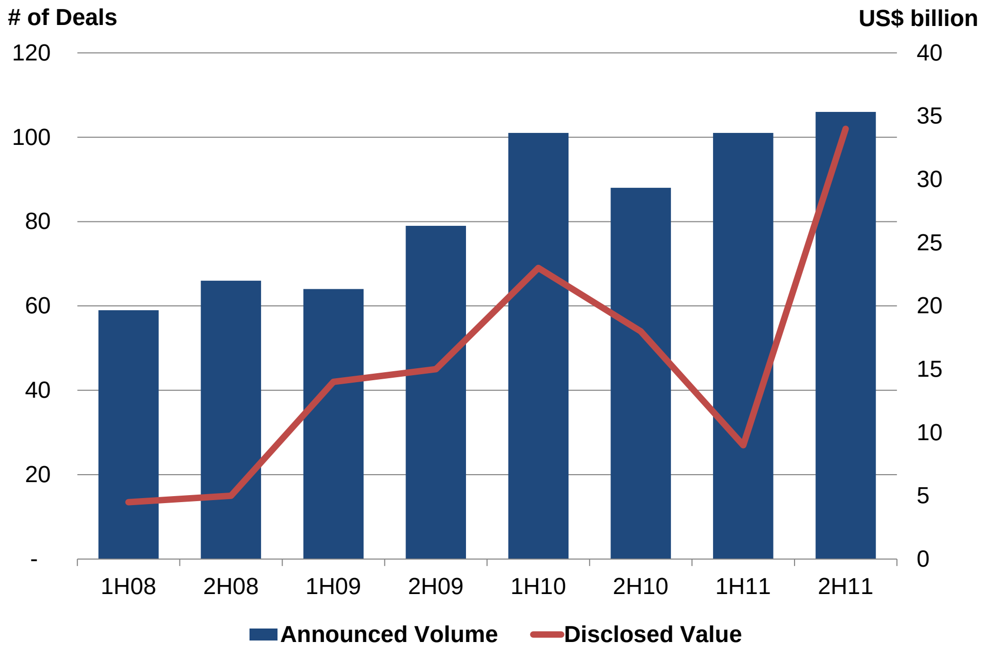
Chinese Firms Entering New Markets

- Increasingly Chinese firms are looking to expand into new markets (at home and abroad) for a variety of reasons:
  - Diversify capital investments
  - Gain access to new markets for their goods
  - Capitalize on the fragmented domestic market
  - Acquiring foreign brands and their attractive margins
  - Capitalize on inroads being made by foreign firms by producing cheaper versions of western foods
  - Desire to build a distribution footprint
  - Source “upstream” raw materials
  - Strengthen management talent
  - Gain access to technology, strong brands and marketing “muscle/know how”.
  - Build food safety knowledge and benefit from “halo” effect of global brands

Outbound Corporate Deals by Sector – 2009 to 2011[(1)]



Chinese Outbound Investment – 2008 to 2011[(1)]



(1) Source: ThomsonReuters and PwC analysis; PwC

Examples: Chinese Led Activity

- Total overseas investment surged to $21.4 Billion in the first quarter of 2012 (more than double the same period a year ago) led by purchase of resource related assets (94% of total vs. 24% a year ago).
- The vast majority of this activity was by state owned companies who accounted for 98% of all deal value in the 1st quarter vs. 53% a year ago.
- Major domestic food and beverage companies are looking at foreign mergers and acquisitions opportunities especially in the dairy, wine and confectionary industries. While the appetite is strong and growing the actual level of outbound investment is still small (roughly 1% of total China M&A activity is in the Food and Beverage sector).
- The acquisitions are often about sourcing "upstream resources" or increasing domestic market share.
- The global economic downturn has created "buying opportunities" for Chinese companies:

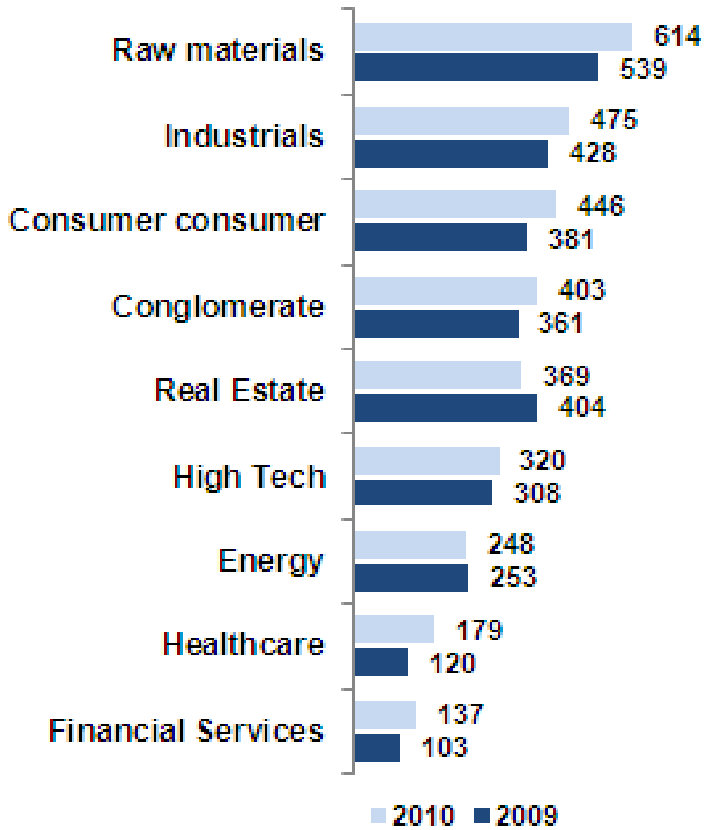
  - **Bright Food Group:**
    - They produce the popular White Rabbit candy brand, operate **Bright Dairy** and are considered to have a strong distribution network.
    - After a difficult start, which included four failed attempts at purchasing assets overseas, they've completed two overseas acquisitions since 2010:
      - Controlling stake in New Zealand's **Synlait Milk** in 2010
      - A 75% stake in **Manassen Foods** Australia Pty, an Australian branded foods business
    - In addition, they are currently in discussions with a French wine company about a potential acquisition.

Examples: Chinese Led Activity (cont'd)

- **COFCO Group:**
  - One of China's leading import and export companies which has an agri-processing arm (which produces edible oils, sugar and livestock), a branded food division (canned foods, condiments, confectionary and snack foods) and a beverage division (wine, tea and carbonated beverages).
  - **COFCO** acquired **Biscottes**, a Chilean winery, in 2010 and then Australian sugar producer **Tully Sugar** in 2011.
- **Hangzhou Wahaha Group Co:**
  - China's top beverage producer plans to invest in dairy farms in Western Australia in order to expand it's import channel for milk.
- **Kweichow Moutai:**
  - A leading local producer of ultra premium liquor, is looking into pursuing a strategic partnership with an international spirits producer in order to grow their international business.

International Firms in China

Domestic & Inbound Corporate Deals by Sector[1]



- Deal activity led by international firms continues to grow across all areas except the troubled Real Estate sector.
- There are an ever increasing number of deals as well as a growing willingness to consider multiple deal forms and structures (e.g. acquisitions, JVs and other contractual partnerships).
- Firms entering China are turning to these deals to help address:
  - Cultural issues
  - Speed to market
  - Distribution challenges
  - Cost reduction goals
  - Fragmented nature of consumer market
  - High level of consumer loyalty to local brands as well as localized consumer tastes.
  - Political/government/regulation concerns
  - Desire to gain rapid scale
- Many global brands have determined that strategic partnerships are a key facet of their China plan given the:
  - Lofty valuations of acquisition targets (P/E multiples of up to 50 or higher)
  - Targeted business's lack of interest in being acquired.
  - Attractiveness/value of the "networking" relationships partners may have with central or local governments
  - Ability to more easily adjust/pivot to market dynamics while being able to "hedge their bet" across multiple opportunities

(1) Source: PwC; ThomsonReuters and China Venture PwC.

International Firms in China (cont'd)

- These investments can take many forms:
  - Joint Venture
    - Usually >50% ownership, with management control
    - Far fewer new JVs today
      - 100% ownership permitted in most non-sensitive industries
      - Concerns about IP protection
      - Many JVs are often better described as joint "misadventures"
  - Representative Office
    - Incurs costs but may not book revenues or commit the parent company
    - Most suitable for sales and Quality Control
    - New tax treatment makes them less appealing
  - Foreign-Invested Commercial Enterprise (FICE)
    - Trading activities
  - Wholly-Owned Foreign Enterprise (WOFE)
    - Manufacturing

Examples: Activity Led by International Firms

- Examples of International led Food and Beverage activity include:

  - **SABMIller:**
    - Who plans a trial launch of it's international premium beer **Miller Genuine Draft (MGD)** in China through its local joint venture (49%) with **CR Snow Breweries**.
    - In the past **CR Snow's** growth strategy has been through "bolt on acquisitions" of regional breweries to increase market share with regional/local brands as well as strengthen the distribution reach of it's main brand.
    - While still not national, this expanded distribution footprint is critical in **Miller's** plan to try and establish a broad presence for **MGD** in the highly fragmented Chinese beer market where **CR Snow's** market leading share stands at just 21%.

  - **Moet Hennesy:**
    - China is currently the 5th largest wine market in the world and the number one market for French wine and spirits maker **Moet Hennesy**.
    - In an effort to capitalize on that success they identified an opportunity to produce a Chinese super-premium red wine targeting the palates of the country's wealthy wine drinkers.
    - Through a joint venture with Chinese liquor maker **VATS Group**, the plan is to utilize some of **VATS'** superior vines from existing vineyards as well as plant new ones together.
    - This is **Moet Hennessy's** third investment in China in the last five years following it's acquisition of Chinese white-spirits brand **Wenjun** in 2007 and an investment in 2011 to produce a premium sparkling wine in Ningxia.

Examples: Activity Led by International Firms (cont'd)

- **Nestlé's** takeover of confectionary maker **Hsu Fu Chi International** (60% stake) and a similar stake with **Yinlu Foods** (a producer of instant porridge and peanut milk). In addition, they plan to invest $395 million in Shuangcheng to open a dairy-farming institute to educate farmers on such things as the management of larger herds, food safety and productivity increases.

- **Pepsi's** equity stake in **Tingyi-Asahi Beverage Holdings** (5% with an option to increase to 20% in 2015).

- Government failure to grant deal approval is rare (perhaps confirming importance of foreign investment to county's growth plan):
  - While **Coca-Cola's** request to acquire beverage company **Huiyuan Juice Group** was not approved it has been the exception.
  - **Diageo's** recent successful acquisition of controlling interest (53%) in **Quanxing Group**, one of China's leading white spirits producers, was another strong indication of government thinking here.

- Not surprisingly, not all "deals" have been successful as evidenced by **Danone's** relationship with **Wahaha**, one of the leading Chinese Beverage manufacturers, which came to an end after a long running dispute.

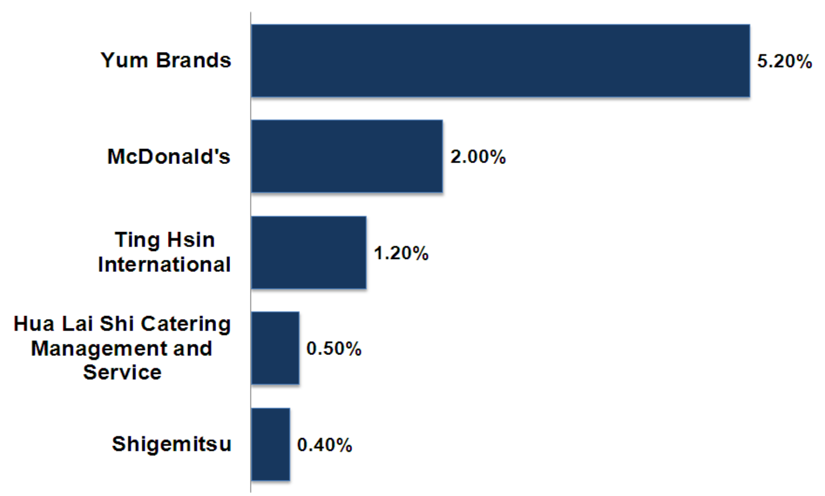
Going it Alone - Bringing Brands to China

- Despite the hurdles and longer time lines, many international brands have decided to “go it alone” when launching their brands in China.

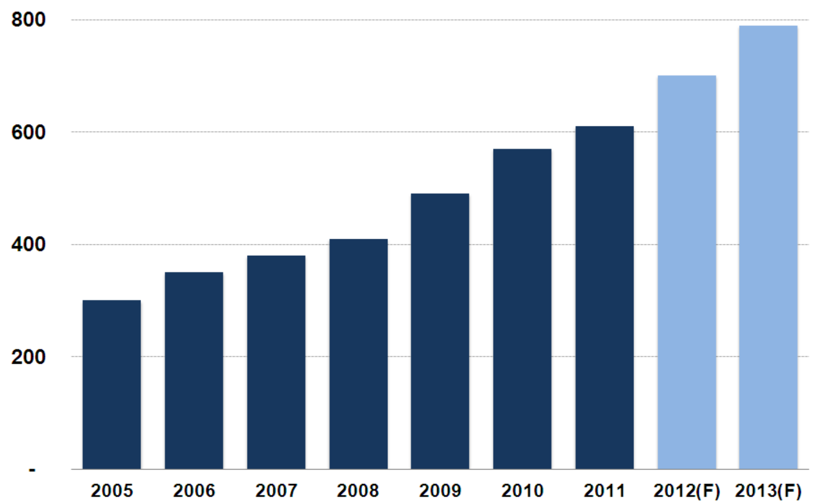
Example: Yum! Brands:

- Despite sagging domestic sales, Yum! Brands’ KFC business was able to beat profit forecasts in 2011, thanks in no small part to its global expansion. The popular fast food chain continues expansion despite a volatile global market, and now operates in over 110 countries and territories. A chief driver of this global growth has been expansion into China, where KFC has demonstrated an ability to manage risk and navigate its way through multiple challenges.
- Yum brands, which entered China 25 years ago with its first KFC, now has 4,500 locations and holds a market leading 5.2% share of the Chinese Food service market while McDonald's has 2%.
- A key to their success has been that in addition to offering global products they have adapted menus to local tastes (e.g. the bacon and mushroom rice and egg tart, a Chinese staple, that is offered at KFC).

Top Five QSRs in Chinese Market (Overall 2010 Market Share)(1)



Growing Food Service Industry (Sales in CN¥ billions)(2)(3)



(1)Source: Euromonitor; WSJ; (2)Source: Euromonitor; WSJ; (3) 1 billion Yuan = US$158.7MM

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Our Clients: What we're "seeing" here

- **Why are they investing in China?**
  - Cost reduction (although costs in general are rising)
  - Going forward, companies will rely on China for scale, infrastructure & quality rather than labor savings (China itself is now outsourcing to other lower cost labor markets like Vietnam).
  - Closer proximity to Asian buyers and the subsequent benefits of shorter transit times and well established intra-Asia logistics.
  - Exploitation of Chinese market potential.
    - Follow North American multinational clients to China
    - Sell to indigenous retail or commercial buyers
- **What challenges do they face when investing in China?**
  - A more discriminating government
    - China wants higher value-added industries and technology transfer
    - Money supply considerations

Our Clients: What we're "seeing" here (cont'd)

- **What challenges do they face when investing in China (cont'd)?**

  - Due diligence on acquisition of existing entities
    - Financial statements may not reflect reality
    - Ownership may not be clear
    - Tax compliance is often an issue

  - Approval process-3 to 6 months
    - Ministry of Commerce-registration followed by approval certificate
    - State Administration of Industry and Commerce-business license
    - Tax bureau
    - State Administration of Foreign Exchange
    - Customs

- **What risks do they face, post-investment?**

  - Currency controls
  - Policy changes (e.g. currency, tax incentives, etc.)
  - Access to financing
  - Invisible barriers

How Financial Institutions Can Facilitate

- Financial Institutions continue to play a key role in facilitating these “deals” through:
  - Providing sources of capital appropriate for a given situation.
  - Global Advisor M&A services (identification of potential targets through valuations and completion of deals).
  - Knowledge of Legal and Regulatory issues as well as ways to navigate through these issues.
  - Meeting all corporate banking needs – e.g. trade finance, FX, cash management, risk management, etc.
  - A wide breath of expertise and base of customers.
  - Identification of trends and best practices.

Success Factors – Today and Going Forward

- In looking at the common elements found in those “deals” that have been successful we find:
  - **Set Expectations**: Very clear objectives and reasonable expectations going into “deal” that are consistent among all partner(s).
  - **Build Trust:** The ability to quickly build trust across all stakeholders.
  - **Technology:** Focus on the protection of intellectual properties and think strategically on which technologies to share (all versus only “older” ones), in what form (finished products/solutions vs. designs/specs.) and what “form” (part of “deal” vs. a separate agreement).
  - **Relationships and Partnerships:** For international firms, the identification of partners with strong local, national “connections” and other tangible business contributions is critical.
  - **Think Local:** Understanding the need/benefit of catering to local tastes and customs.
  - **Access:** Realizing the value/importance Chinese firms and governments place on access to foreign markets, technology transfers, knowledge re: issues like food safety and increasing productivity (especially in agriculture) when deciding what “deals” to make/ approve.
  - **Timing:** Unlike in more developed countries, “Time is of the essence” as taking too long to make a decision can result in the option no longer being as attractive or relevant given how fast things change.
  - **Flexibility:** An understanding of the need to often layer/build multiple “deals” given lack of one stop national solutions due to fragmented nature of most markets and the lack of national distribution networks.