



# China's Food Safety in 2012

Assessing the Increased Risks

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August 2012



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# China's Food Safety in 2012

- **Food safety is a major consumer and social concern in China. Political manoeuvring makes it particularly important in 2012 and 2013, with greater downside risk to share prices for mismanagement.**
- **Companies can be significantly affected by reputational issues (consumer boycotts) or regulations (fines or factory closures).**
- **This report assesses 37 Chinese-listed companies in the food value chain, and provides background information about Chinese food safety regulators and regulations.**

## Executive Summary

Against a backdrop of heightened political focus and continuing scandals, this report provides an evaluation of the investment relevance of food safety to Chinese companies in the food value chain. The analysis combines two factors: an assessment of a company's risk exposure to food safety issues and an assessment of management preparedness and ability to mitigate these risks. These two factors are then combined to produce an assessment of overall investment risk. Further, this report aims to focus on the extent to which food safety incidents could be financially material to investors in these companies.

The framework is applied to 37 Chinese-listed companies, nine of which are involved in food production, 17 in food processing, five in food distribution and retailing, and six in restaurant and hotel management. For each company, publicly available information is used as a basis for estimating the level of exposure to food safety risks and relative preparedness to manage those risks. For the food companies in question, information was collected to identify their business segmentation, food safety management policies, systems, certifications or procedures, past food safety incidents or controversies, as well as details relating to suppliers, clients and other stakeholders.

Of the 37 companies, investment risks are assessed as low for 23 companies, medium for 12 and high for two companies. The two companies assessed as high investment risk are **China Yurun Food** (1068: HK) and **Synear Food Holdings Limited** (SYNF: SP), both of which are meat processors.

The low number of companies assessed as a high investment risk is in part due to the deep review processes that many of the companies have gone through following previous controversies. Nevertheless, this issue can have significant implications for all companies in the universe. Investor engagement on food safety risks can provide useful insights into management quality, which is relevant to all companies regardless of their degree of risk exposure.

# Introduction

## Food safety mismanagement diminishes value

China has been experiencing high-speed economic growth over the last two decades. Rapid industrialization and urbanization have led to an emerging middle class that is increasingly focused on quality of life and safety. This development, together with a long series of food safety scandals, has pushed food safety up the list of public and political concerns, making the issue increasingly relevant to companies and investors.

In February 2012, Li Keqiang,<sup>1</sup> the Executive Vice-Premier of the State Council of the People's Republic of China, called for strict and harsh punishment in response to food safety violations, and urged strengthened supervision to ensure food safety. He went on to say that authorities should take a proactive approach to deter violations, and that China would continue its heavy-handed measures against food scandals and seek to establish a long-term mechanism to monitor food safety in 2012.

These statements take on added significance in the context of Li's political ambitions. Li's current responsibilities include heading the food safety commission within China's cabinet. Many expect that Li Keqiang will succeed Wen Jiabao as the next Premier.<sup>2</sup> However, he faces real political risks stemming from food safety scandals. The public deeply mistrusts the government's ability to supervise the food market. In fact, public anger over these issues is reaching a boiling point, and any further food safety crisis could undermine public confidence in Li, jeopardizing his political prospects. Against this backdrop, companies involved in a food safety controversy can expect a heavy-handed response.

Even without this enhanced focus, food safety scandals in China can destroy corporate reputations, undermine brands, and raise costs. The cases of **Sanlu Group** (Non-listed), **Ajisen** (538: HK) and **Shuanghui** (000895: SZSE), detailed below, show how these risks directly affect investment returns, while a recent toxic gelatin capsule scandal implicating at least 10 companies highlights how the political context is raising the potential penalties that companies face.

Other companies recently involved in controversies in the local market include **Inner Mongolia Yili Industrial Group Co.** (600887: SSE), **Henan Huaying Agricultural Development Co. Ltd** (002321: SZSE), **By-health Co. Ltd** (300146: SZSE), **Beijing Sanyuan Foods Co. Ltd** (600429: SSE), and **Synear Food Holdings Limited** (SYNF: SP). Chinese media have also raised concerns about food safety at the Chinese operations of international brands such as **Coca-Cola** (NYSE: KO), **Carrefour SA** (CA: FP) and **McDonald's** (MCD: NYSE).

**Case 1: Sanlu Group (Non-listed)**

In the 2008 Chinese milk scandal large quantities of low-cost melamine were added to milk as filler. This resulted in a number of fatalities from kidney stones and other kidney damage, and approximately 300,000 children experienced severe health problems. Sanlu Group, one of the many companies involved in the scandal, was ordered to halt production and destroy all unsold and recalled products. The company subsequently received a bankruptcy order from a local court on December 24, 2008, and several of its top managers were sentenced to lengthy prison terms. Eventually the company was bought by Beijing Sanyuan Foods (600429: SSE), which has factory farms with an integrated industrial park in Beijing and, as such, greater control over its food safety.

**Case 2: Ajisen (538: HK)**

The case of Hong Kong-listed Ajisen highlights the potential effects of reputation mismanagement even in the absence of a significant threat to human health. In 2011, it was revealed that Ajisen had overstated a marketing claim of the health benefits of its ramen soups. The company's shares were suspended, and it emerged that there had been a number of other small lapses of control (hygiene slips at a restaurant, use of a food production center for a short period after its license had expired, and use of an ingredient after it had been made illegal - though it was legalized again later in the year). Management had not considered these issues material, but Ajisen's shares were suspended for several weeks. The share price fell from HKD17.90 on July 20 (when the story broke) to HKD10.50 by August 5, reducing its market capitalization by about HKD6.5 billion (USD840 million).

**Case 3: Shuanghui (000895: SZSE)**

On March 15, 2011, the Chinese media reported that clenbuterol, a chemical used to minimize fat growth in animals but poisonous to humans, had been found in pork sold by Henan Shuanghui Investment & Development Co. The company's shares were suspended for a month, followed by three consecutive days of limit falls (10 per cent per day). Losses resulting from disposing of meat products tainted with clenbuterol reached RMB 31 million (USD4.75 million) by March 31. The company estimated that total losses in March caused by the scandal amounted to RMB 1.36 billion (USD208.17 million).

**Case 4: Toxic gelatin**

In April 2012, toxic gelatin was found in medicine capsules as well as some health food, yogurt and jellies. The Chinese government's reaction was prompt and decisive: it shut down 10 companies deemed responsible in the provinces of Hebei, Zhejiang, Jiangxi and Shandong, including Hebei Xue Yang Gelatin Factory (河北薛洋明胶原蛋白厂) and arrested 53 business owners, managers and workers. The government has clearly demonstrated its determination to crack down on any medicine or food safety offenses.

# Assessing Food Safety Risks at Chinese Companies

Food safety risk in this report is assessed through two components: risk exposure (Low, Medium or High) and management preparedness (Strong, Medium or Weak). Then the two components are evaluated jointly to produce a single framework, assessing investment risk as Low, Medium or High.

The evaluation of exposure and preparedness is based on the six indicators listed below. Relevant information is taken from annual reports, corporate responsibility reports, company websites and various media sources.<sup>3</sup>

## Exposure

1. The safety risk exposure based on the nature of the company's main products;
2. The reputational risk exposure of the company's main brand to a single food safety incident;
3. The concentration/centralization of the company's suppliers.<sup>4</sup>

## Preparedness

4. The comprehensiveness of the company's disclosed safety management policy, system, certifications or procedures (typically these may include HACCP, ISO 9001, ISO 22,000, or in some cases domestic certifications or company-specific systems);
5. The frequency and severity of the company's past food safety incidents or controversies;
6. Whether the company's food quality is audited by its main clients.

In some cases, ownership structure has also been considered to supplement understanding of exposure or preparedness. A company's pace of growth is another factor to consider, with companies growing quickly facing increased risk exposure to food safety incidents.

# Investor Engagement on Food Safety Risks

In addition to some of the issues highlighted above, investors are encouraged to engage with companies more deeply to assess how well they are managing food safety. Some questions for engagement include the following:

1. Has the company had any product recalls? What procedures are in place for handling recalls?
2. Are the company's product complaints tracked? How is this information used for product enhancement initiatives?

3. Does the company follow good manufacturing practices (GMP)? Are the GMP audited? How often is this done and is it traceable?
4. Does the company have an internal food safety management system in place? Does the system cover all internal processes, logistics and transportation?
5. Does the company have a supply chain policy? How does the company monitor its suppliers' food safety?
6. What additives does the company use during food production? Are quantities strictly monitored according to relevant national standards?
7. Has the company had any food safety incidents in the past? How has it changed its processes following the experience?

## Summary of Findings<sup>5</sup>

The following table summarizes this report's main findings, including the key food safety risks associated with each stage of the industry value chain and an assessment of investment risk faced by each company.

| Food Producers                                                                                                                                                                                                                                                                                                                          |  |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|
| <b>Key sector risks:</b> Excessive use of fertilizers, pesticides or hazardous chemicals during plantation; use of illegal additives and ripening agents in poultry or livestock farming; and outsourcing to small-scale farmers.                                                                                                       |  |
| <b>Key subsector risks:</b>                                                                                                                                                                                                                                                                                                             |  |
| a) <b>Fresh vegetables and fruits:</b> have comparatively low safety risk as problems are more easily detected by consumers, unless the produce is grown with excessive fertilizers, pesticides or hazardous chemicals.                                                                                                                 |  |
| b) <b>Dairy:</b> The 2008 Chinese milk scandal decimated Chinese dairy exports and renewed long-standing concerns about food security, corruption, and lack of political checks and balances. However, the scandal has also led Chinese dairy companies to review and enhance their food safety management.                             |  |
| c) <b>Poultry and livestock:</b> From a top-down perspective, the poultry and livestock sub-sector faces comparatively higher risks, because of the various diseases that animals can suffer as well as the various additives that are commonly used to quicken animal growth and the medication increasingly used to prevent diseases. |  |

  

| Low risk                                               |
|--------------------------------------------------------|
| China Green Holding Ltd. (904: HK)                     |
| China Mengniu Dairy Company Ltd (2319: HK)             |
| Inner Mongolia Yili Industrial Group Co. (600887: SSE) |
| Beijing Sanyuan Foods Co. Ltd (600429: SSE)            |

  

| Medium risk                                                   |
|---------------------------------------------------------------|
| Chaoda Modern Agriculture (Holdings) Ltd (968: HK)            |
| China Modern Dairy Holdings Ltd (1117: HK)                    |
| Fujian Sunner Development Co. Ltd (002299: SZSE)              |
| Shandong Minhe Animal Husbandry Co. Ltd (002234: SZSE)        |
| Henan Huaying Agricultural Development Co. Ltd (002321: SZSE) |

## Food Processors

**Key sector risks:** Reliance on fragmented supply chains; abuse of additives; cold chain logistics; and human contact in food processing.

### Key subsector risks:

- a) **Taiwanese food processors:** These companies tend to pay more attention to food safety issues. While they have also been involved in food safety incidents in the past, most exhibit comparatively stronger safety management than their mainland peers.
- b) **Brewers and wine-makers:** The key concern for brewers and wine-makers relates to excessive consumer use and related harm. Aside from this there have been no confirmed severe food safety incidents from listed companies in this sector in recent years, largely due to highly standardized production processes that use fewer additives.
- c) **Meat processors:** These companies face risk factors including fragmented supply chains and a high reliance on under-developed cold chain logistics.
- d) **Other food related products:** Companies that produce items such as seasonings, yeast, additives and health foods also face safety risks.

### Low risk

|                                                         |
|---------------------------------------------------------|
| Uni-President China Holdings Ltd (220: HK)              |
| Tingyi (Cayman Islands) Holding Corporation (322: HK)   |
| Want Want China Holdings Ltd (151: HK)                  |
| Tsingtao Brewery Company (600600: SSE)                  |
| China Resources Enterprise Ltd. (291: HK)               |
| Kweichow Moutai Co. (600519: SSE)                       |
| Luzhou Laojiao Co. (000568: SZSE)                       |
| Wuliangye Yibin Co (000858: SZSE)                       |
| China Huiyuan Juice Group Ltd (1886: HK)                |
| China Agri-Industries Holdings Ltd. (606: HK)           |
| China Foods Limited (506: HK)                           |
| Henan Lotus Flower Gourmet Powder Co. Ltd (600186: SSE) |
| Angel Yeast Co. Ltd (600298: SSE)                       |

### Medium risk

|                                                            |
|------------------------------------------------------------|
| Henan Shuanghui Investment & Development Co (000895: SZSE) |
| By-health Co. Ltd (300146: SZSE)                           |

### High risk

|                                         |
|-----------------------------------------|
| China Yurun Food (1068:HK)              |
| Synear Food Holdings Limited (SYNF: SP) |

## Distributors and Retailers

**Key sector risks:** Food supply chain management; food logistics and conservation.

### Low risk

Lianhua Supermarket Holdings Ltd. (980: HK)  
Beijing Hualian Hypermarket Co. Ltd (600361: SSE)

### Medium risk

Wumart Stores Inc. (1025: HK)  
Sanjiang Shopping Club Co. Ltd (601116: SSE)  
Yonghui Superstores Co. Ltd (601933: SSE)

## Restaurants and Hotels

**Key sector risks:** Franchising; reliance on fragmented supply chains; cold chain logistics; and human contact in food processing.

### Key subsector risks:

- a) **Restaurants:** There are only a few domestic-listed restaurants in China. Although some have obtained certifications, most of them have poor food safety records.
- b) **Hotels:** Most Chinese-listed hotels disclose little information about their food safety management. As catering is only part of their business, the impact on the hotels' overall brands from a single food safety incident is likely to be limited.

### Low risk

China Quanjude (Group) Co. Ltd (002186: SZSE)  
Jinling Hotel Corporation Ltd (601007: SSE)  
Shanghai Jin Jiang International Hotels Development Co. Ltd (600 754: SSE)  
Huatian Hotel Group Co. Ltd (000428: SZSE)

### Medium risk

Beijing Xiangeqing Co. Ltd (002306: SZSE)  
Ajisen China (538: HK)

# Company Analysis by Sector

## A. Assessment of listed food production companies

Food safety risk factors identified for raw food producers consist mainly of the excessive use of fertilizers, pesticides or hazardous chemicals during plantation, the use of illegal additives and ripening agents in poultry or livestock farming, and outsourcing to small-scale farmers.

### Fresh vegetables and fruits

Fresh vegetables and fruits have comparatively low safety risk as problems are more easily detected by consumers, unless they are grown with excessive fertilizers, pesticides or hazardous chemicals. Compared with the numerous small-scale farmers in China, listed agricultural companies have much better food safety management systems to mitigate such risks.

| Company Name                                                      | Ticker  | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                                                               |
|-------------------------------------------------------------------|---------|-----------------|----------|--------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| China Green Holding Ltd.                                          | 904: HK | Low             | High     | Strong       | As a "green" brand it cannot afford controversy. However, with its strong safety management system and no history of incidents, the company's overall risks are low.                                        |
| Chaoda Modern Agriculture (Holdings) Ltd [suspended from trading] | 682: HK | Medium          | Medium   | Medium       | The company's share suspension is a greater reputational issue and is presumably taking management time away from operational issues. It is not clear in what form the company will return from suspension. |

### Dairy

The 2008 Chinese milk scandal decimated Chinese dairy exports and rekindled long-standing concerns about food security, corruption, and lack of political checks and balances, but it has also led Chinese dairy companies to review and enhance their food safety management.

| Company Name                    | Ticker   | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
|---------------------------------|----------|-----------------|----------|--------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| China Modern Dairy Holdings Ltd | 1117: HK | Medium          | Medium   | Medium       | While it predominantly uses factory farming, which is easier to control, any incident would create risk to the brand. Its supply chain also includes small farms. Incidents of environmental pollution indicate a lapse in management, albeit of a different process. The company was not involved in the 2008 scandal due to its factory farms, and has not benefitted from a major review of its operations since then. There are longer term food safety issues in the use of antibiotics in factory farms. |
| China Mengniu Dairy Company Ltd | 2319: HK | Low             | Medium   | Strong       | After the 2008 milk scandal, the company reviewed and consolidated its fragmented supplier base and put in place tight supervision with support from its new parent company. This reduces its risk exposure.                                                                                                                                                                                                                                                                                                   |

|                                                 |                |     |        |        |                                                                                                                                                                                                    |
|-------------------------------------------------|----------------|-----|--------|--------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Inner Mongolia Yili Industrial Group Co.</b> | 600887:<br>SSE | Low | Medium | Strong | After the 2008 milk scandal, the company reviewed and consolidated its fragmented supplier base and put in place tight supervision, reducing its risk exposure.                                    |
| <b>Beijing Sanyuan Foods Co. Ltd</b>            | 600429:<br>SSE | Low | Medium | Strong | As a state-owned enterprise, it has always been aware of the importance of food safety management, and was the only major milk processing company which was not involved in the 2008 milk scandal. |

### Poultry and livestock

From a top-down perspective, the poultry and livestock subsector faces comparatively higher risks, because of the various diseases that animals can suffer as well as the various additives that are commonly used to quicken animal growth and the medication increasingly used to prevent diseases. This group of companies generally discloses little safety information; however, there have been very few major food safety incidents.

| Company Name                                          | Ticker          | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                                                                                                                                                                                                      |
|-------------------------------------------------------|-----------------|-----------------|----------|--------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Fujian Sunner Development Co. Ltd</b>              | 002299:<br>SZSE | Medium          | Medium   | Medium       | There is no management system disclosed; however, it is likely that one exists, and the KFC audit chain provides reassurance. No incidents have been detected. As the business has two main channels (via KFC and its own brand) there is some protection if an incident were to occur as it would likely affect only one channel.                 |
| <b>Shandong Minhe Animal Husbandry Co. Ltd</b>        | 002234:<br>SZSE | Medium          | Medium   | Strong       | The company does not disclose a detailed food safety management system, but it has certifications and no incidents have been detected. Nevertheless, poultry production faces many risks and the company's single brand could suffer from a controversy.                                                                                           |
| <b>Henan Huaying Agricultural Development Co. Ltd</b> | 002321:<br>SZSE | Medium          | High     | Medium       | The company does not disclose detailed food safety management systems, but it has certifications. Nevertheless, poultry production faces many risks and the company's single brand could suffer from a controversy. Furthermore, the company's polluted farming environment indicates a loss of management control, albeit of a different process. |
| <b>Beijing Sanyuan Foods Co. Ltd</b>                  | 600429:<br>SSE  | Low             | Medium   | Strong       | As a state-owned enterprise, it has always been aware of the importance of food safety management, and was the only major milk processing company which was not involved in the 2008 milk scandal.                                                                                                                                                 |

## B. Assessment of listed food processing companies

Food safety risk factors identified for food processors include reliance on fragmented supply chains, abuse of additives, cold chain logistics and human contact in food processing.

A recent example of an incident occurred in April 2012, **Coca-Cola's** (NYSE: KO) subsidiary Shanxi Beverages Co. was ordered to temporarily halt production at a bottling plant in Shanxi province of China after media reports of chlorine in its products.

### Taiwanese food producers

Taiwanese companies pay more attention to food safety issues. While they have also been involved in food safety incidents in the past, most exhibit comparatively stronger safety management than their mainland peers. One major recent controversy was the 2011 "Taiwan plasticizer incident" when it was found that some companies had used a harmful plasticizer as a food additive. This had little impact on those companies with operations in mainland China.

| Company Name                                | Ticker  | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                                                                                 |
|---------------------------------------------|---------|-----------------|----------|--------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Uni-President China Holdings Ltd            | 220: HK | Low             | Low      | Strong       | The company has a strong management system and no incidents. Nevertheless, if an incident were to occur, it could damage its brands.                                                                                          |
| Tingyi (Cayman Islands) Holding Corporation | 322: HK | Low             | Low      | Strong       | The company has a strong management system and no recent incidents. Nevertheless, if an incident were to occur it could damage its brands.                                                                                    |
| Want Want China Holdings Ltd                | 151: HK | Low             | Low      | Strong       | The company has a strong management system and no recent incidents. Milk powder sourcing from New Zealand mitigates risks related to milk production. Nevertheless, if an incident were to occur, it could damage its brands. |

### Brewers and wine-makers

The key concern for brewers and wine-makers relates to excessive consumer use and related harm. Problem drinking can result in calls for higher taxation and is best managed through a comprehensive responsible drinking policy. Aside from this there have been no confirmed severe food safety incidents from listed companies in this sector in recent years, largely due to highly standardized production processes that use fewer additives. There are earlier reports of the use of anti-freeze in wine, and Chinese barley used in the late 1990s was allegedly heavily contaminated with pesticides and fertilizers. Barley is now mainly imported from Australia and Canada. There have also been a number of pollution incidents in the sector.

| Company Name             | Ticker      | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                       |
|--------------------------|-------------|-----------------|----------|--------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Tsingtao Brewery Company | 600600: SSE | Low             | Low      | Strong       | The company has a strong management system and no recent safety incidents. Its historically strong brand should give the company protection from a single incident. |

|                                            |              |     |     |        |                                                                                                                                                                                                                                                       |
|--------------------------------------------|--------------|-----|-----|--------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>China Resources Enterprise Ltd(CRE)</b> | 291: HK      | Low | Low | Strong | The company has certifications and a strong management system. Its diverse product line creates a higher chance of incidents overall, but the portfolio of brands reduces the company's exposure to a single incident.                                |
| <b>Kweichow Moutai Co.</b>                 | 600519: SSE  | Low | Low | Medium | There have been no confirmed severe food safety incidents by the listed Chinese white wine companies in the past few years, largely due to highly standardized production processes that use fewer additives. The company has strong brands in China. |
| <b>Luzhou Laojiao Co.</b>                  | 000568: SZSE | Low | Low | Medium | There have been no confirmed severe food safety incidents by the listed Chinese white wine companies in the past few years, largely due to highly standardized production processes that use fewer additives. The company has strong brands in China. |
| <b>Wuliangye Yibin Co.</b>                 | 000858: SZSE | Low | Low | Medium | There have been no confirmed severe food safety incidents by the listed Chinese white wine companies in the past few years, largely due to highly standardized production processes that use fewer additives. The company has strong brands in China. |
| <b>China Huiyuan Juice Group Ltd</b>       | 1886: HK     | Low | Low | Strong | The company has a strong management system and there have been no detected incidents. It has one major brand that would suffer if there were an incident.                                                                                             |

### COFCO's subsidiaries

As China's largest state-owned food processor, manufacturer and trader, China National Cereals, Oils and Foodstuffs Corporation (COFCO) pays careful attention to food safety issues, so its listed subsidiaries generally have strong safety management systems.

| Company Name                               | Ticker  | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                                            |
|--------------------------------------------|---------|-----------------|----------|--------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>China Agri-Industries Holdings Ltd.</b> | 606: HK | Low             | Low      | Strong       | Its main products carry relatively low risks; it has certifications and there have been no detected incidents.                                                                           |
| <b>China Foods Limited</b>                 | 506: HK | Low             | Low      | Medium       | It has consumer facing brands that would be harmed by severe incidents; however, it has certifications for all facilities. Though there have been incidents, these were a long time ago. |

### Meat processors

Meat processors face risk factors including fragmented supply chains and a high reliance on under developed cold chain logistics. A broken or interrupted cold chain will threaten the quality and shelf life of products.

| Company Name                                | Ticker       | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                                                                                                                                           |
|---------------------------------------------|--------------|-----------------|----------|--------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Henan Shuanghui Investment & Development Co | 000895: SZSE | Medium          | High     | Medium       | Meat production entails higher risks than other forms of food production. The recent scandal in 2011 had significant implications, but the company may have benefitted from the opportunity to review and enhance its safety management. Nevertheless, its single brand is now fragile. |
| China Yurun Food Group Limited              | 1068: HK     | High            | High     | Weak         | Meat production entails higher risks than other forms of food production. The company's frequent incident history implies high potential risk to its major meat brands.                                                                                                                 |
| Synear Food Holdings Limited                | SYNF: SP     | High            | High     | Medium       | Meat production entails higher risks than other forms of food production, but the company has diverse products beyond meat. The company has comparatively strong safety management, but its major brand has been harmed by a series of incidents.                                       |

### Other food-related products

Other food-related products including seasonings, yeast, additives and health food also face safety risks.

| Company Name                              | Ticker       | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                       |
|-------------------------------------------|--------------|-----------------|----------|--------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Henan Lotus Flower Gourmet Powder Co. Ltd | 600186: SSE  | Low             | Low      | Medium       | MSG is controversial from a health perspective, though in general studies it has not been linked to health issues. The company has a range of certifications.       |
| Angel Yeast Co. Ltd                       | 600298: SSE  | Low             | Low      | Strong       | The company has comprehensive certifications and its portfolio of brands lowers its risk exposure.                                                                  |
| By-health Co. Ltd                         | 300146: SZSE | Medium          | Medium   | Medium       | The company's diverse supplier base raises the likelihood of an incident. Given its focus on health foods, the brand could be undermined by a food safety incident. |

## C. Assessment of listed food distributors and retailers

Food safety risk factors identified for distributors and retailers mainly include food supply chain management, food logistics and conservation. However, as most listed supermarkets usually sell many goods in addition to food, any single food safety incident may have limited impact to their overall brands.

In March 2012, **Carrefour SA** (CA: FP) apologized to Chinese consumers after one of its outlets in Henan province was found selling expired chicken and mislabelling regular chicken as a premium brand.

| Company Name                        | Ticker      | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                                                                   |
|-------------------------------------|-------------|-----------------|----------|--------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Lianhua Supermarket Holdings Ltd.   | 980: HK     | Low             | Low      | Medium       | There is no disclosure relating to management systems, but there have been no detected incidents. A single food safety incident would likely have a limited impact on its brands.                               |
| Beijing Hualian Hypermarket Co. Ltd | 600361: SSE | Low             | Low      | Medium       | Its own production bases, fresh food processing and distribution centre and centralized procurement network decrease the company's risk exposure, but an incident could affect its reputation as a food seller. |
| Wumart Stores Inc.                  | 1025: HK    | Medium          | Medium   | Medium       | It does not disclose detailed safety management information and a frequent incident history indicates poor preparedness. There are also risks to its brand.                                                     |
| Sanjiang Shopping Club Co. Ltd      | 601116: SSE | Medium          | Medium   | Medium       | Its limited safety management information disclosure entails potential risk to its brand as a famous online food seller.                                                                                        |
| Yonghui Superstores Co. Ltd         | 601933: SSE | Medium          | Medium   | Medium       | Its limited food safety and supplier management disclosure entails potential risk to its single brand as a food seller.                                                                                         |

## D. Assessment of listed restaurants and hotels

Food safety risk factors identified for restaurants and hotels include franchising, reliance on fragmented supply chains, cold chain logistics and human contact in food processing.

In March 2012, the license for one of **McDonald's Corp's** (MCD: NYSE) restaurants in Beijing was suspended after it was reported to be selling expired food. The company eventually issued an apology for violating operational standards on its website.

## Restaurants

There are only a few domestic-listed restaurants in China. Although some have obtained certifications, most of them have poor food safety records.

| Company Name                   | Ticker       | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                                                                                                                                             |
|--------------------------------|--------------|-----------------|----------|--------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| China Qianjude (Group) Co. Ltd | 002186: SZSE | Low             | Low      | Medium       | It has certifications and its own internal management system in place. Any single food safety incident is unlikely to significantly affect its historically famous brand, and there have been no detected incidents.                                                                      |
| Beijing Xiangeqing Co. Ltd     | 002306: SZSE | Medium          | Medium   | Medium       | Although no food safety incidents were found, the rapidly growing number of franchises adds to the difficulty of controlling food safety in all of its chain restaurants.                                                                                                                 |
| Ajisen China Holdings Ltd      | 538: HK      | Medium          | High     | Medium       | It has certifications and a management system in place, but it has had a number of incidents. Additional negative press could further damage the brand. However, management actions to mitigate risks following recent negative publicity may be sufficient to reduce risk going forward. |

## Hotels

Catering is only a part of hotels' business. Consequently, although most Chinese-listed hotels disclose little information about their food safety management, the impact on the hotels' overall brands from a single food safety accident is likely to be limited.

| Company Name                                                | Ticker       | Investment Risk | Exposure | Preparedness | Key Rationale                                                                                                                                                                                |
|-------------------------------------------------------------|--------------|-----------------|----------|--------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Jinling Hotel Corporation Ltd                               | 601007: SSE  | Low             | Low      | High         | It has a certification and a management system in place.                                                                                                                                     |
| Shanghai Jin Jiang International Hotels Development Co. Ltd | 600754: SSE  | Low             | Low      | Medium       | It is involved in running several restaurants and food companies, so a single incident at one outlet is unlikely to have a significant impact on the overall business.                       |
| Huatian Hotel Group Co. Ltd                                 | 000428: SZSE | Low             | Low      | Medium       | Its limited food safety management information entails some risk exposure, but the potential impact from a single food incident on the company is low due to its diverse business interests. |

# Annex One

## Food safety regulators and regulations in China

China's food safety regulation system is complex. The Food Safety Commission directly under the State Council coordinates and supervises the main authorities currently responsible for food safety in China, including the Ministry of Health (MOH), the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ), the State Administration for Industry and Commerce (SAIC), the State Food and Drug Administration (SFDA), the State Administration of Grain, the Ministry of Agriculture, the Ministry of Industry and Information Technology (MIIT) and the Ministry of Commerce (MOFCOM).

China has established its basic food, food additives and food-related safety standards system, which comprise a core of some 1,900 national food safety standards and over 3,100 industrial standards, as well as more than 1,200 local standards. There are numerous supplementary enterprise standards.

- On February 28, 2009, the Chinese parliament renewed the Food Safety Law of the People's Republic of China. The Food Safety Law strengthened the government's supervisory powers, unified food safety standards, changed the licensing system, and increased liabilities for non-compliance.
- On July 30, 2009, the SAIC published the Administrative Measures on Food Distribution Certifications, specifying the procedures and requirements for obtaining Food Distribution Certifications.
- On March 4, 2010, the MOH and the SFDA published the Administrative Measures on Catering Service Certification, specifying the procedures and requirements for the application, issuance and administration of Catering Service Certifications.
- On October 20, 2010, the MOH published the Administrative Rules on National Food Safety Standards, which contains detailed schedules and procedures for preparing, reviewing and publishing new national food safety standards.
- On January 20, 2012, the MOH published the 12th Five-Year Plan of National Food Safety Standards (Draft for Soliciting Opinions), which aimed to consolidate and unify most of the current, disparate standards by the end of 2015.

## Mandatory internal inspection and record system

The latest Food Safety Law (2009) requires the strengthening of the internal controls of food producers, distributors, importers and exporters over the procurement, distribution, storage and delivery of foods. According to the law, food producers in China must establish an internal inspection and record system for raw materials and their products (Article 37 and 38). Food distributors must also establish internal systems to record and inspect food products procured from suppliers (Article 39, 40 and 41). However, due to the tremendous number of food companies in China, it is difficult for government agencies to detect all violations if companies do not follow this mandate.

## Subheader

### Food recall system improved

Under the Food Safety Law, China is to establish a food recall system (Article 53). All food producers and distributors are encouraged to actively recall their defective food products; otherwise relevant government agencies (the AQSIQ, the SAIC and the SFDA) can order compulsory recalls. The law also increases the administrative penalties for non-compliance with government-ordered recalls. But the law does not clearly specify mandatory follow-up procedures after recalls, such as remedy, harmless processing or destruction. Therefore, there are certain cases where food companies have repackaged, re-labelled and resold, which were supposed to be destroyed.

### Good Manufacturing Practice (GMP)

In China, the food GMP system is not as comprehensive as the pharmaceutical GMP system and is still a work in progress. There are several national food GMPs adopted in China, such as *Good Manufacturing Practice for Puffed Food (GB17404-1998)*, *Good Manufacturing Practice for Health Food (GB17405-1998)*, *Good Manufacturing Practice for Beverage Company (GB12695-2003)*, *Good Manufacturing Practice for Dairy Products (GB 12693-2010)* and *Good Manufacturing Practice for Powdered Formula for Infants and Young Children (GB23790-2010)*. The *Good Manufacturing Practice for Health Food (GB17405-1998)* was modified in 2011; in particular, regulations on supply chain management and recall systems were added, and the requirements on the recording and traceability of production documents were enhanced. In China, there are also 25 national standards on Good Agricultural Practices (GB/T20014.1-25) covering farming, planting and breeding activities.

### Food safety focus of work in 2012

At the Food Safety Commission's fourth plenary meeting on February 8, 2012, the Executive Vice-Premier Mr. Li Keqiang pointed out that prominent problems threatening food safety had not been fundamentally rooted out, and China still faced a grave situation in ensuring its food safety. He called for strict and harsh punishments against food safety violations and as well as strengthened supervision.

On February 26, 2012, the State Council of China followed up with *The 2012 Food Safety Focus of Work Arrangement* in which the central government vowed to continue its heavy-handed measures against criminal offenses in food scandals and would seek to establish a long-term mechanism to monitor and verify food safety in 2012. In the Arrangement, the central government highlighted seven food safety focus points for 2012:

1. Illegal use and abuse of food additives;
2. Several key food categories (dairy products, edible oil, meat, alcohol, food additives and health food);
3. Several key production areas (food markets, rural area, urban fringe, villages in urban, construction sites and schools);
4. Residues of pesticide and veterinary drugs;
5. Livestock and poultry slaughter;
6. Seasonings;
7. Tableware and food packaging materials.

# Annex Two

## Sample information for China Green Holding

|                                      |                                                                                                                                                                                                                                                                                                                           |
|--------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>China Green Holding Ltd.</b>      | 904: HK                                                                                                                                                                                                                                                                                                                   |
| <b>Investment risk</b>               | Low                                                                                                                                                                                                                                                                                                                       |
| <b>Key rationale</b>                 | As a “green” brand it cannot afford controversy. However, with its strong safety management system and no history of incidents, the company’s overall risks are low.                                                                                                                                                      |
| <b>Exposure</b>                      | High                                                                                                                                                                                                                                                                                                                      |
| <b>Main Products</b>                 | A vertically integrated food producer, its products include fresh vegetables, processed vegetables and branded food and beverage products.                                                                                                                                                                                |
| <b>Brand Exposure</b>                | Its brand “中绿China Green” has been recognized as a leading brand of green and organic food in China.                                                                                                                                                                                                                      |
| <b>Supplier Management</b>           | NA                                                                                                                                                                                                                                                                                                                        |
| <b>Preparedness</b>                  | Strong                                                                                                                                                                                                                                                                                                                    |
| <b>Quality and Safety Management</b> | The company has a vertically integrated production and processing platform, from sowing to harvesting, from sterilization to packaging and from uploading in the factory to delivering at the market. It obtained Safe Corp Certification, Green Food Certification, and certifications under ISO9001, ISO9002 and HACCP. |
| <b>Food safety incidents</b>         | None found                                                                                                                                                                                                                                                                                                                |
| <b>Clients’ Audit</b>                | NA                                                                                                                                                                                                                                                                                                                        |

Research for the other companies covered in this report can be obtained from Sustainalytics upon written request.

## Endnotes

<sup>1</sup> Li Keqiang is the seventh ranked member of the Politburo Standing Committee, which is the People’s Republic of China’s de facto highest decision-making body.

<sup>2</sup> The Premier is the highest administrative position in the Government of the People’s Republic of China. The Premier is responsible for organizing and administering the Chinese civil bureaucracy.

<sup>3</sup> Where companies do not fully disclose their initiatives, the information will not be captured, presenting a limitation of the evaluation process.

<sup>4</sup> Control over suppliers reduces risk. To the extent that such control is achieved through a concentration of suppliers, it may undermine the resilience of the distribution system. It may also be at odds with various other environmental and social objectives within food supply, such as supporting small-holders, ensuring a fair price for small producers etc. Nevertheless, such control is advantageous in the narrower context of food safety considerations.

<sup>5</sup> Companies that are involved in more than one section of the food chain are categorised according to their main food-related business

## About the Author



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Sun is responsible for corporate environmental, social and governance (ESG) research focused on companies in mainland China. Prior to joining Sustainalytics, Sun was a responsible investment analyst with Responsible Research, a company acquired by Sustainalytics in June 2012. His previous work experience includes three years in investment information research and public relations for China's Investment Promotion Agency within the Ministry of Commerce. Sun also participated in an internship program at the United Nation Economic and Social Commission for Asia and the Pacific (UNESCAP). His research focused on responsible investment related to ESG and corporate social responsibility issues as well as international finance, trade, foreign direct investments and regional integration and development in Asia and Pacific.

Sun holds a Master's degree in Public Policy specializing in Economic Policy and Analysis from Lee Kuan Yew School of Public Policy within the National University of Singapore. He also has two Bachelor's degrees in Management Information System and International Economic Law from the University of International Business and Economics, Beijing China.

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## About Sustainalytics

Sustainalytics is a leading global provider of environmental, social and governance (ESG) research and analysis for investors and financial institutions. We provide a global perspective, underpinned by 20 years of local experience and expertise in the responsible investment market. Sustainalytics strives to continuously provide high-quality solutions and commits to remain responsive to the current and future needs of our clients. Recently, Sustainalytics was voted Best Responsible Investment Analysis Firm in the IRRI 2012 Survey (conducted by Thompson Reuters Extel and SRI-Connect.com). Sustainalytics is headquartered in Amsterdam and has offices in Boston, Frankfurt, Madrid, Paris, Singapore, Timisoara and Toronto; and representatives in Bogotá, Brussels, Copenhagen and London.

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