China e-commerce: Heading toward RMB 1.5 trillion

Can China earn its place as the world's largest e-commerce market?

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China holds the potential to become the biggest market for virtually everything, and e-commerce is no exception. E-commerce is surging, opening up opportunities for companies if they pay close attention to the quickly evolving marketplace. How big is the opportunity? In 2010, China's e-commerce sales totaled RMB 460 billion. That figure is expected to triple to RMB 1.5 trillion in the next three years. By then, China may overtake the US as the world's largest e-commerce market – with online sales growing to represent 7% of all retail sales. In 2011, it contributed 3% of the total, a figure that still lags the US and Europe.

Consumer-to-consumer (C2C) online marketplaces such as Taobao.com dominate, with an 80% market share compared with the 20% of business-to-consumer (B2C) sites. But explosive B2C growth is underway, fueling the expansion of China's entire e-commerce industry. Many big traditional retail names are gearing up to seize the opportunity, including Wal-Mart, which is opening up its China e-commerce headquarters in Shanghai.

To better understand what the quickly changing habits of China's online consumers and fast-evolving ecosystem will mean for both traditional retailers and online-only companies, Bain & Company developed an overall picture of the e-commerce market in China, including a survey of nearly 600 shoppers in 6 cities. What motivates them to shop online, and what are the nuances of their online shopping behavior? The survey revealed a noteworthy trend. While price is still the primary motivator for shopping online, shoppers are shifting online for other reasons, too. Convenience and variety have gained ground and are now major considerations for a surprising number of online shoppers: 19% of survey respondents said convenience is the primary reason for shopping online, while 15% pointed to variety as the major reason. One of the important implications for e-commerce websites is that online consumers have started to diverge, with a significant number of consumers evolving from "price sensitive" to "shopping experience sensitive."

Another trend is that China's e-commerce ecosystem – including sourcing, payment and delivery – has developed to a point where retailers can quickly build and scale their own sites, establishing their e-commerce capability. By leveraging their bricks-and-mortar stores and other offline resources, these retailers will create a significant threat to online-only players. Our study does not include mobile Internet use, the online-to-offline market or virtual goods.

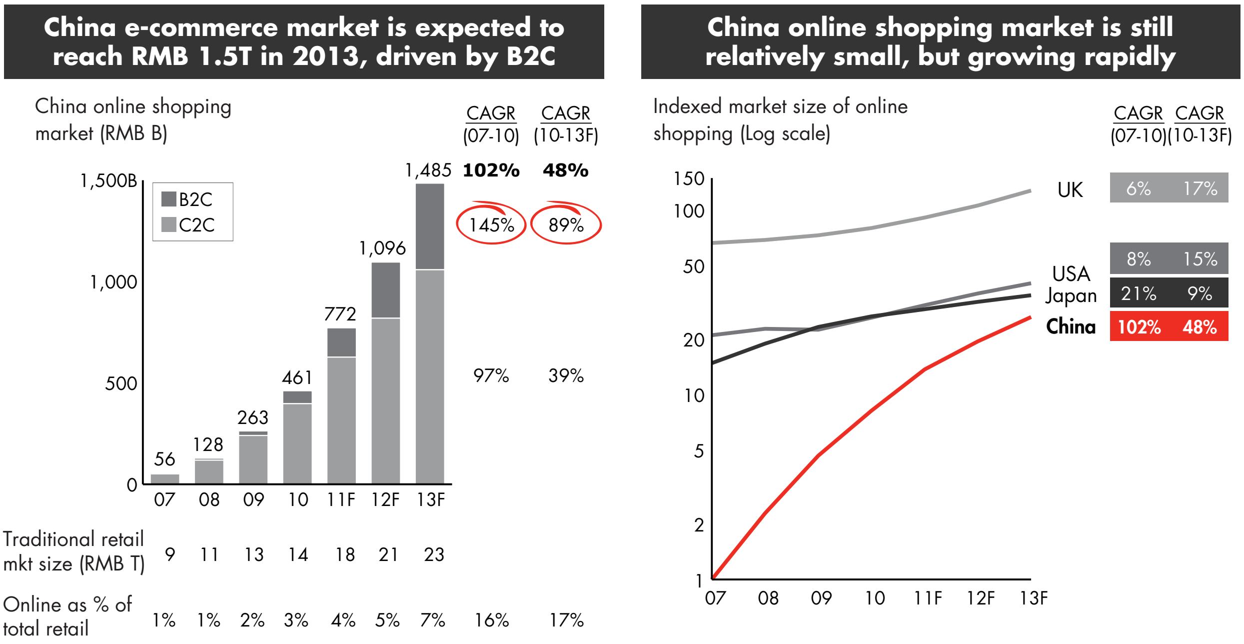
Speed rules: It is a digital pace

Indeed, China's e-commerce marketplace presents traditional and pure online players with different challenges and opportunities. Traditional players no longer can view launching an online channel as a novelty or marketing gimmick – it's imperative and urgent, with online platforms growing at triple the rate of traditional retailing. Going online is a critical defensive move to prevent the erosion of retailers' existing customer base as more and more shoppers head to the web.

A well-executed e-commerce platform gives omnichannel players a more cost-effective way to reach consumers in smaller cities. It also allows them to maximize offline and online channel synergies to attract additional business, helping them win and retain the most valued customers – and to do it profitably. Online sites serve as effective marketing tools, as shoppers increasingly rely on web searches and reviews. In addition, these sites provide an effective way for filling gaps in a company's physical store network, including untapped markets with little competition or product offerings that might not be available in physical stores.

To offer a seamless omnichannel experience, traditional retailers rely on their offline resources and strengths, creating an integrated marketing and sales organization. And they differentiate themselves from online-only players by providing an improved value proposition – for example, allowing customers to return web purchases to stores and showcasing their online products with store demos. To enhance their

Figure 1: China e-commerce is expected to grow fast, fueled by a surge in the B2C segment



China e-commerce market is expected to reach RMB 1.5T in 2013, driven by B2C

China online shopping market is still relatively small, but growing rapidly

Source: Bain analysis

competitive edge, they also acquire online pure plays to fill gaps in their capabilities or user base.

For both traditional and online players alike, four factors are expected to give e-commerce a further boost: more secure payment methods, more reliable delivery services, government regulations that standardize e-commerce and increasing numbers of customers who now are becoming comfortable shopping online. The size of China's overall e-commerce market will expand dramatically through 2013, growing at a compounded annual rate of 48% (see Figure 1). This growth will be fueled by an expected increase of more than 60% in the e-commerce customer base and a projected 40% or more surge in customer spending.

As that growth takes place, China's e-commerce market will stand out from other countries. Among the factors that make this market unique:

- Sales vary widely by region, with Tier-1 cities registering the highest rate of transactions.
- Government regulations result in most foreign companies partnering with local players. For example, e-commerce-related licenses are rarely granted to multinationals, leading them to form joint ventures with local partners as minority shareholders.
- Online shopping activity varies across regions, with the top 10 markets mainly located in coastal provinces.

A fast-growing ecosystem for e-commerce

The rapid growth of e-commerce in China is supported by an increasingly sophisticated ecosystem that speeds consumer products makers' goods to online shoppers. The emergence of well-designed, user-friendly online trading, payment and delivery services for both B2C and C2C companies has played a vital role in building a critical mass of Chinese users – and they will continue to evolve (see Figure 2).

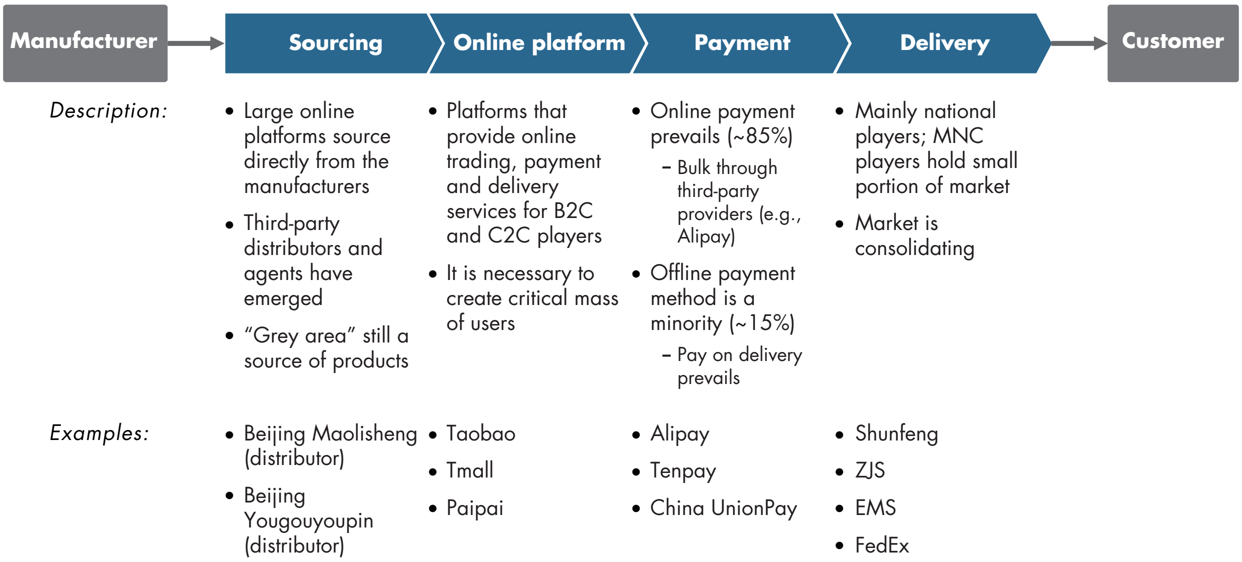
China's e-commerce platforms now easily facilitate both C2C and B2C transactions. For example, about 85% of all shoppers use online payment options as the process becomes easier, more secure and as a growing number of banks support it. Meanwhile, between 2007 and 2010, the delivery industry grew at a compounded annual rate of 74% – and growth is expected to continue at a similar rate through 2013. When it comes to sourcing, large online retailers currently have three options in China: buying directly from consumer products makers, using third-party distributors and agents to help them expand into new territories, or relying on opportunistic "unofficial distribution channel."

Attracting shoppers: Who's buying online – and why?

As companies pursue e-commerce consumers, they'll need to clearly understand who's online, what they're buying and why (or what's keeping them from buying) and how their shopping behavior is likely to change. Our survey of nearly 600 online shoppers throughout China provides insights into changing consumer behavior. We wanted to find out how companies can attract more online shoppers – and how to build a loyal customer base.

As we mentioned, one of the most surprising findings is that consumer segments are diverging. In the past, consumers cited cheaper prices as the major reason they went online. But a large number of consumers now are motivated by convenience and product variety. For retailers, this means that after initial

Figure 2: E-commerce ecosystem in China is becoming more sophisticated with full set of "enablers"



Manufacturer	Sourcing	Online platform	Payment	Delivery	Customer
Description:	• Large online platforms source directly from the manufacturers • Third-party distributors and agents have emerged • "Grey area" still a source of products	• Platforms that provide online trading, payment and delivery services for B2C and C2C players • It is necessary to create critical mass of users	• Online payment prevails (~85%) – Bulk through third-party providers (e.g., Alipay) • Offline payment method is a minority (~15%) – Pay on delivery prevails	• Mainly national players; MNC players hold small portion of market • Market is consolidating	
Examples:	• Beijing Maolisheng (distributor) • Beijing Yougouyoupin (distributor)	• Taobao • Tmall • Paipai	• Alipay • Tenpay • China UnionPay	• Shunfeng • ZJS • EMS • FedEx	

Source: Bain analysis

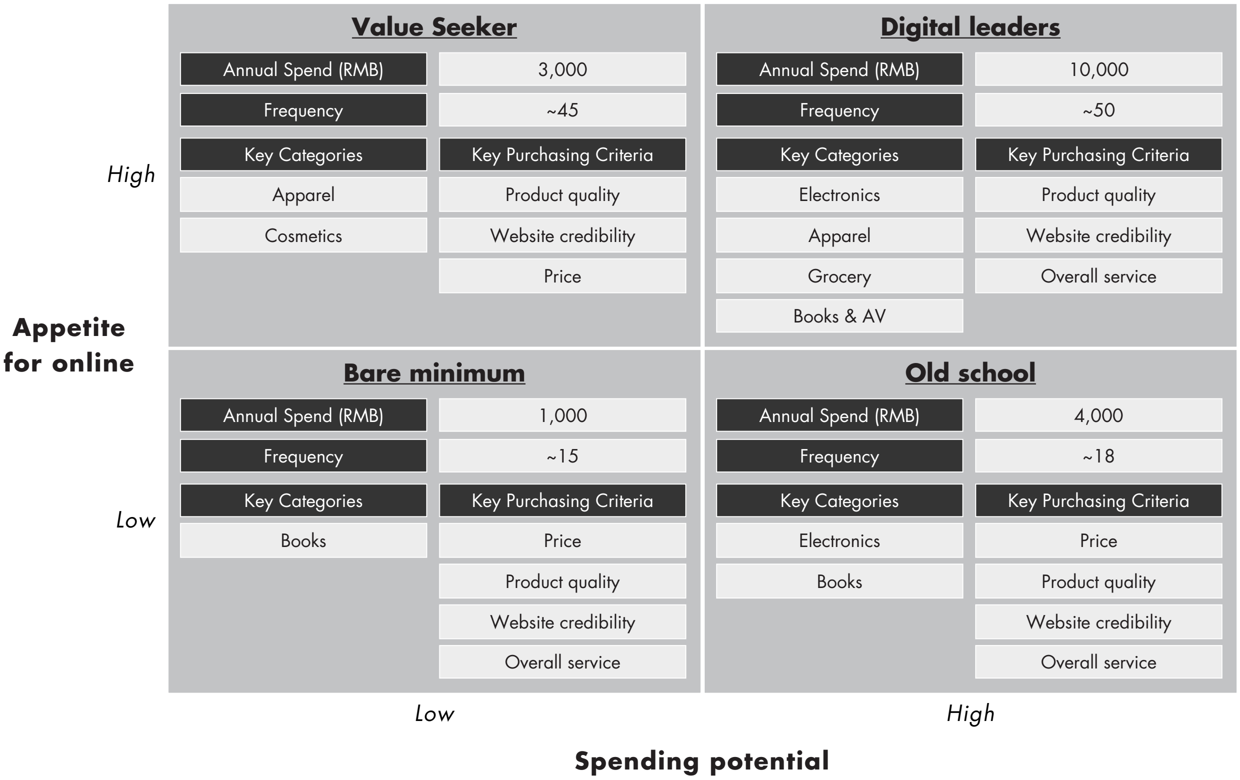
price wars, holding onto shoppers requires delivering superior customer service and focusing on cultivating customer loyalty.

Our survey verified the high growth potential in e-commerce. The bulk of non-e-commerce shoppers expect to make their first online purchase in 2012. About 40% of them will head to either Taobao or Tmall. The most popular categories for first-time e-commerce buyers are electronics, apparel and groceries. About 40% of online veteran shoppers in Tier-1 and Tier-2 cities plan to increase their spending over 2012.

The most frequently shopped categories are apparel and groceries, but respondents tell us electronics and home appliances deliver the best value. Consumers say that their purchasing decisions are influenced by the retailer's credibility, reliability and overall service, specifically whether it has an easy return and exchange policy, safe and convenient payment system and fast, dependable delivery. They prefer third-party payment methods to credit cards and cash. The major reasons that shoppers are dissatisfied with their online purchases include the fact that a product isn't what they expected, its quality is poor or that it took too long to arrive. Among survey respondents, most who are dissatisfied with their experience say they take action, including posting a negative online review or complaining to customer service.

Consumers we surveyed decide where to shop online largely based on word-of-mouth recommendations (more than 45%) and search engine results (more

Figure 3: Customers' characteristics and behavior are diverging, calling for better segmentation



Value Seeker

Annual Spend (RMB)	3,000
Frequency	~45
Key Categories	Key Purchasing Criteria
Apparel	Product quality
Cosmetics	Website credibility
	Price

Digital leaders

Annual Spend (RMB)	10,000
Frequency	~50
Key Categories	Key Purchasing Criteria
Electronics	Product quality
Apparel	Website credibility
Grocery	Overall service
Books & AV	

Bare minimum

Annual Spend (RMB)	1,000
Frequency	~15
Key Categories	Key Purchasing Criteria
Books	Price
	Product quality
	Website credibility
	Overall service

Old school

Annual Spend (RMB)	4,000
Frequency	~18
Key Categories	Key Purchasing Criteria
Electronics	Price
Books	Product quality
	Website credibility
	Overall service

Source: Bain & Company customer survey

than 20%). What stops them from making web purchases? Two primary concerns: payment security and product quality, with little variation in the results across all cities.

Our survey identified four distinct segments of shoppers with different characteristics and behaviors (see Figure 3). Winning companies will be those that understand these emerging segments and create strategies for serving their needs.

Digital Leaders (30% of those surveyed e-commerce users) have the highest income, make the most online purchases – more than 50 purchases annually – and are willing to spend more for quality, convenience and service. The typical profile is that of a 35-year-old married working mother whose household monthly income is about RMB 35,000 and who surfs the web about 10 hours a week. Digital Leaders spend an average of RMB 15,000 online a year and are attracted by both brand and good value, paying for purchases in multiple ways: Alipay, online banking and cash on delivery. This segment is gaining importance as it grows larger, populated by customers with the highest lifetime value.

The **Value Seeker**'s (20% of those surveyed e-commerce users) typical profile is a female about 23 years old, single, with a mid-to-low income, living with parents in a quickly expanding Tier-2 city like Shenyang. Members of this segment make frequent online purchases – about 30 times a year – and are influenced by word of mouth and price. Value Seekers spend an average of RMB 3,000 online annually, usually on apparel and cosmetics. Taobao is their most visited website because of its low prices and wide range of clothing choices. They prefer to pay with Alipay. They rely primarily on online searches to direct them to sites and make price comparisons.

The **Old School** (16% of those surveyed e-commerce users) finds online shopping complicated and isn't comfortable with C2C or B2C websites. Its members spend about RMB 2,000 a year on cell phones and books. The Old School's profile typically is a single male about 29 years old, earning RMB 10,000 a month and who prefers shopping with a girlfriend at traditional stores. To convince them to spend more online, retail sites need to be user-friendly, authentic and offer high-quality products with convenient return policies.

The **Bare Minimum** (34% of those surveyed e-commerce users) includes students and those with the lowest online spending – just RMB 300 annually on books, even though they surf online an average of 20 hours a week. They consider all shopping a waste of time. When their income increases, Bare Minimum spenders may evolve into more active online shoppers as their needs change.

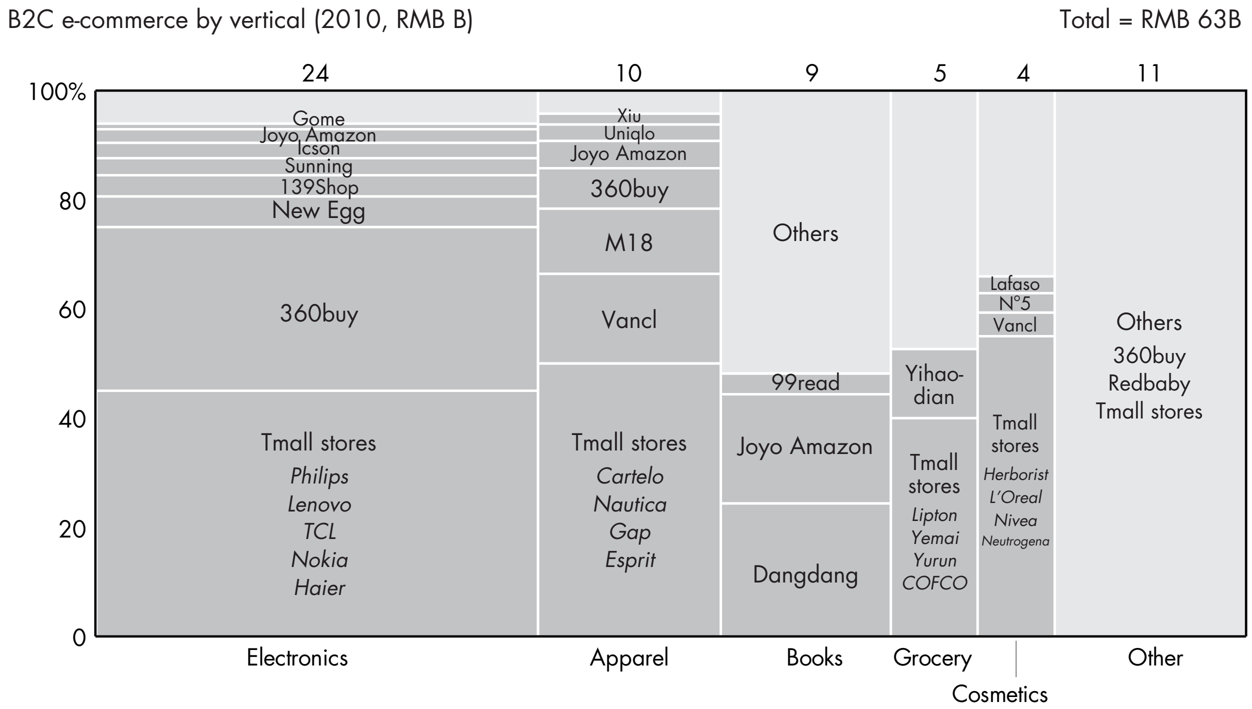
Who's getting ahead?

While most companies still are in the early stages of building an e-commerce foundation, some are gaining strong traction. As we mentioned, the most popular e-commerce model in China is the C2C online marketplace, where sellers, usually individuals or small businesses, connect with buyers directly on online platforms. Despite increasing competition from B2C retailers, the overwhelming leader Taobao is also one of the fast-growing players: 38% of online shoppers make their first purchase on the site. To raise awareness even more and win over hesitant shoppers, Taobao has invested heavily in ads and promotions.

Taobao now is using its 370 million user base to feed traffic to Tmall, its entry in the B2C market, accelerating the three-year-old site's quick takeoff and making it China's largest B2C marketplace. As an online platform for brands and retailers, Tmall provides an alternative for shoppers concerned about the authenticity and safety of products sold on Taobao. In 2010 alone, it quadrupled sales, serving as a major profit generator for Taobao. However, Tmall's recent decision to dramatically hike fees has triggered strong pushback from the site's online vendors.

To further boost its competitive edge, Taobao plans to set up its own warehouse and logistics system, allowing it to offer the lowest price in many product

Figure 4: B2C e-commerce players are fairly specialized by vertical



Source: Bain analysis

categories. Plans also call for launching innovative services that deliver high customer satisfaction and build loyalty.

In the fledgling B2C market, 10 major players claim 80% of the market share. These are officially registered businesses that either work with third-party shopping sites or establish their own online sites. Three B2C categories offer the most promising growth: Electronics and home appliances are the largest of these while cosmetics is the fastest growing (see Figure 4).

In electronics and home appliances, competition has intensified. Online retail leader 360buy.com has built a customer base of 20 million with its low-price guarantee, extended warranty service and faster deliveries enabled by its largely self-owned and operated delivery system, winning the highest customer satisfaction ratings.

Traditional appliance retailer Suning is taking advantage of its established leadership position to expand into China's B2C market. The company's existing supply chain provides a critical cost advantage. To avoid undercutting in-store sales, Suning offers different products online.

Meanwhile, more brands are opening online stores on Tmall to take advantage of its large customer base and third-party services. For example, Uniqlo, the Japanese casual clothing maker, is building momentum through seamless partnerships, such as with Tmall, to tap their expertise in areas like website design, payments and deliveries while focusing on what Uniqlo does best: innovative marketing, pricing, merchandising and promotions.

Different categories command different approaches: cosmetics, apparel and grocery

A look at the emerging e-commerce landscape reveals how categories are growing differently. As we mentioned, electronics is the largest category whereas cosmetics is fast-growing, followed by apparel. Both cosmetics and apparel have much higher growth potential than other categories, with a compounded annual rate of 116% and 104% respectively, compared with electronics at 90%, slightly slower than the overall market.

In cosmetics, online retailers are gaining momentum, with some even launching their own product brands. For their part, traditional players gradually are making the shift and opening online stores. Lancôme uses its online shop for brand building by fostering a community of brand users and retaining shoppers by offering flexible payment options and free samples. Lafaso capitalizes on the "celebrity effect" – endorsements from fashion stars and beauty experts – to enhance its credibility as the go-to site for shopping, beauty and fashion information.

For its part, the apparel category remains fragmented, with several business models vying for market share. Vancl is the largest B2C direct apparel retailer in China, with its own designers, manufacturing alliances and largely self-owned logistics system. Its innovative customer experience allows customers to try on products when they arrive and then decide if they want to buy, exchange or return the items.

Gap launched its e-commerce entry in China in 2010. The multinational retailer is drawing on its global online experience to develop multiformat e-commerce offerings and maintains a stand-alone e-commerce division. Gap is making the most of the competitive advantages of the omnichannel business model: cost effectiveness and cross-channel synergies. To attract online shoppers, Gap uses its traditional stores to raise awareness by adding its website to promotional materials and reminding customers about the site as they check out. Once online, Gap works to keep shoppers coming back with an easy-to-use experience, online promotions and full refunds for the cost of shipping returned items.

Pure online players in apparel have largely differentiated themselves by offering discounts, but this strategy isn't sustainable unless they're able to achieve significant scale. At least for now, their impressive growth makes them formidable competitors for traditional companies.

M18.com focuses on affordable fashion for 18-to-35 year-old fashionistas and caters to the latest trends. The hip fashion retailer has built a loyal customer base, with competitive pricing and unique fashion designs.

Meanwhile, online grocers represent a new, quickly expanding category with increased competition. Yihaodian, among the fastest-growing entries, has invested aggressively in logistics to ensure low-price – even free – delivery. To acquire more customers, Yihaodian plans to rapidly expand its distribution network. Wal-Mart has invested in Yihaodian to speed the global retailer's learning curve as the multinational prepares to launch its own e-commerce platform in China.

Implications for online players

As China's e-commerce boom redefines the retail landscape, successful strategic paths differ for traditional retailers and online pure plays.

Traditional players: Omnichannel is a must

Adding an online sales channel is no longer an option – it's imperative. With online platforms expected to outgrow traditional channels by more than 400%, going online has become an inevitable defensive move, particularly with the existing customer base eroded by pure online players and peers continuing their own push online. A seamless and well-executed e-commerce platform will attract additional business. For example, the website serves as an effective marketing tool.

Traditional players can use e-commerce to win and retain their most critical customers – everyone from loyal heavy users to online opinion leaders. It allows them to access the white spaces where their physical stores are not yet available. They can make the most of their offline advantages to create an omnichannel experience that integrates their marketing and sales channels. The goal is to use offline resources and strengths to provide a better value proposition than their offline counterparts can offer, such as in-store returns of products purchased online or in-store demonstrations of products available online. For example, Wal-Mart's multichannel retail strategy links its online and physical stores: Customers can pick up products ordered online at a nearby store.

Companies that are late to the game can close the capability gap by pursuing mergers or acquisitions with online players. Third-party platforms can be used to test the e-commerce waters. But ultimately, a self-controlled online platform will best serve a multichannel strategy.

Growing an online presence while maintaining a bricks-and-mortar retail operation comes with its own challenges. Winners will strive for brand image consistency and price and assortment optimization. They'll focus on initial customer conversion and continuous customer experience improvement. They'll address organizational challenges by finding innovative ways to overcome online talent constraints and by finding partners within the evolving ecosystem.

Pure online players: Scale up fast, and build a repeatable and sustainable success formula

Consolidation in e-commerce will accelerate, and scale will be critical for sustainability and profitability. The pure online e-commerce business model still is unproven. Interviews with pure-play executives show that many companies aren't profitable yet as they burn through cash to win market share. We expect to see a consolidating pure-play market. Winners will focus on fine-tuning the customer value proposition to enhance customer retention. They'll improve customer acquisition efficiency through better segmentation and more effective recruitment and targeting. They'll enhance retention and boost customer lifetime value by increasing user stickiness through such measures as formal member rewards programs or customer up-sell initiatives.

Winners will optimize operations for profit. That means securing better sourcing terms and support from offline manufacturers and brand owners. It involves improving processes to reduce handling costs and refining the distribution infrastructure to ensure timely delivery at the lowest costs.

They'll focus on the future. Winners will seek strategic partnerships with traditional players. They'll leverage existing capabilities and platforms by pursuing adjacent growth. For example, they can expand to vertical segments, collaborate with brands by designing their websites and open offline stores to grow their customer base.

As China's community of online shoppers grows, so will the traditional and online players that make smart and strategic moves. That means developing insights into who's buying online – and tailoring your proposition to your best customers. It means making the most of the evolving ecosystem and considering category dynamics when developing strategy. And this is one situation in which speed counts. Winners will act on this opportunity with Internet speed.

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