China's e-commerce prize

On a single day last November, more people logged on to China's most popular e-commerce site than the entire population of Brazil.

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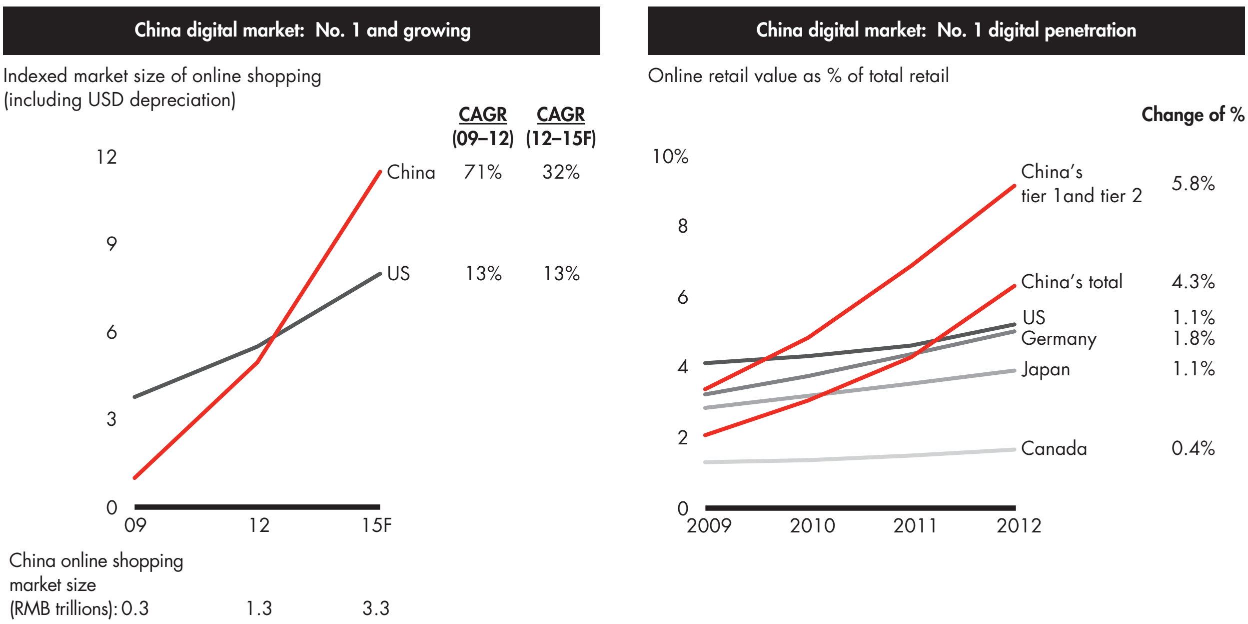
The year 2013 will be remembered as the one in which China surpassed the US as the world's largest digital retail market. Last year, Chinese e-commerce shoppers spent RMB 1.3 trillion online, a sum that has grown more than 70% annually since 2009 and is expected to continue on its amazing trajectory, reaching RMB 3.3 trillion by 2015 *(see Figure 1)*. Digital retailing has furiously transformed shopping and purchasing habits, opening up vast opportunities for retailers and brands that pay attention to the nuances of massively changing consumer behavior.

To better understand how Chinese consumers shop and purchase online—and what implications that has for retailers and brands—Bain & Company surveyed more than 1,300 online shoppers across all city tiers, incomes, ages and education levels. A follow-up to our initial 2012 China e-commerce report, it gave us the opportunity to dig deeper into the dramatic growth numbers to understand how the world of online retailing has changed their behavior *(see Figure 2)*. We found Chinese shoppers have been more willing than shoppers in other markets to use their smartphones to make purchases, are comfortable with third-party payments and online banking, and are happy to rely on third parties for deliveries—as opposed to picking up products in stores. Perhaps most important for the years to come is that we learned that digital retailing now is the major influence on their actual purchasing decisions.

In a surprising finding, more than half of those surveyed say that, regardless of where they end up making the purchase—online or in the physical store—they browse websites and make price comparisons before they buy. In fact, Chinese consumers spend much more time browsing online before making a purchase than their counterparts in other countries. More than 70% of survey respondents from all income levels say they often compare prices—online vs. offline and across e-stores. Such distinctive behavior is reflected in the quick popularity of Etao, a website that consolidates the prices from different e-stores, allowing consumers to

Figure 1: China is now the No. 1 digital retail market in value and penetration, with momentum that's expected to continue



Sources: iResearch; China statistics bureau; US Department of Commerce; Euromonitor; Bain analysis

Figure 2: Chinese digital shoppers display unique characteristics

"Repertoire" quickly ramps up online

- Chinese consumers like to buy multiple brands (see Bain's 2012 China Shopper Reports)
- They go down the experience curve and increase spending fast

"Bargain hunters"

- Chinese shoppers love sales
- Price is stated as the No. 1 reason for going online
- They like to—and actually do—compare price among multiple e-stores

"Smartphone animals"

- Chinese consumers are addicted to smartphones
- Smartphone penetration more than 50% in tier-1 and tier-2 cities
- More than 50% of digital shoppers browse via mobile

Fan of overseas purchase agency

- Chinese shoppers favor overseas purchases mainly due to health concerns and price difference

Source: Bain & Company; i-research; e-commerce related media researches

compare prices and then quickly navigate to the e-store offering the best price. The benchmarking site generates 2.3 million unique viewers each day, more than three times the volume of the website traffic for retailer Suning.

Nearly 70% of shoppers who bought online first went to a physical store to see the product and make their selection, before returning to their computer or smartphone to make the actual purchase. Because Chinese shoppers move easily between physical stores and online options, there's no overlooking the fact that online sites support brick-and-mortar store sales, and vice versa.

The wildfire-like adoption of digital retailing over the past two years is staggering. Consider the phenomenal growth in penetration for such categories as apparel, cosmetics, consumer electronics and books. In just two years, apparel penetration rose from a mere 1.6% to 13% in value, according to estimates by iResearch. Cosmetics rocketed from 2.5% to 11% and consumer electronics from 4% to 17%. Digital penetration in the books category grew from 4.5% in 2010 to 30% in 2012.

Until this year, the lion's share of growth came from increased sales from existing online shoppers. Over the next three years, the bulk of new sales—58%—will come from new consumers, according to our analysis. Digital retail penetration in China already has leapfrogged ahead of that of developed countries. When looked at as a percentage of the total retail value, online retailing in China totals 6% of all purchases, compared with 5% in Germany and about 3.9% in Japan. While online retailing has soared in China since 2009, it was relatively flat in developed markets.

How China's online shoppers are different

As they embrace digital retailing at an extraordinary pace, Chinese shoppers' unique characteristics are coming into sharper focus, helping brands and retailers hone their strategies. Our survey examined shopper behaviors and views in eight product categories that have an established digital presence. We learned what motivates them to shop online—and what keeps them away.

Our current survey and prior Bain research highlight the traits of Chinese consumers:

- They are what we describe as "repertoire" shoppers. Instead of showing exclusive loyalty to a single brand, in most categories they tend to choose from multiple brands for the same need or occasion. They not only tend to buy multiple brands, but they also buy from different e-commerce stores. (See the Bain report "What Chinese shoppers really do but will never tell you.")

- They are bargain hunters. In fact, half of those surveyed say price is the No. 1 reason for going online, where they compare prices among an array of e-commerce sites as well as physical stores. On average, they look at two to three websites prior to making each purchase. They also are motivated by promotions, whether or not the promotion actually is the lowest price. Their determination to find the best deal explains why Tmall's annual sales event, "11.11," on each November 11, has become the largest digital retailing day of the year (see the sidebar, "The Tmall phenomenon"). In 2012, the sales event lured 213 million shoppers to Tmall, according to company reports, enticed by up to 50% discounts.

- They have so embraced the technology that they are now addicted to using their smartphones as part of their shopping ritual. We found that a majority of those surveyed—more than 60%—rely on smartphones to browse or buy products. And the number is higher—about 75%—for upper-income consumers, those with monthly household incomes of more than RMB 50,000. The lightning-fast penetration of smartphones in China has accelerated adoption of digital retailing. (Smartphone penetration among mobile phone users in China is growing faster than in the US. In 2012, smartphones had penetrated 66% of China's mobile phone users, compared with 53% of those in the US.)

- They are purchasing massive amounts of products on overseas sites. Overseas digital purchases have skyrocketed in the past three years, with the amount doubling annually. In addition to searching for lower prices, consumers turn to overseas purchasing agents (stores on Taobao or Tmall that source merchandise from outside of China) when they have health concerns or want to ensure that a product is genuine. For example, Chinese consumers buy 10% of all infant formula and 7% of all cosmetics and skincare products through overseas purchasing agents. For baby formula, some overseas markets such as Hong Kong and Australia limit the number of cans purchased per-person, per-transaction—they don't want Chinese orders to cause them to run out of products too quickly.

- They usually start shopping online with inexpensive apparel like t-shirts and then move on to bigger-ticket categories. Once online, Chinese shoppers soon increase their spending—and most survey respondents are satisfied with their digital experience and are willing to recommend it to others.

In addition, just as Chinese shoppers display unique digital shopping behavior, the market's category dynamics are distinct, and opportunities vary among categories. For example, apparel, consumer electronics and cosmetics have the deepest digital penetration, but categories like groceries and automobiles, which have supply chain challenges, have been slow to take off and will continue to lag behind other categories.

Pure plays dominate

As it explodes, China's digital retail market also is making a dramatic shift from consumer-to-consumer (C2C) sites like Taobao—which introduced shoppers to online buying—to business-to-consumer (B2C) sites like Tmall, which surveyed shoppers tell us they trust more than consumer sites. Between 2009 and 2012, the compounded annual growth rate for B2C platforms was 160%, and it's expected to continue to grow 53% a year through 2015. By comparison, Taobao, which represents the vast majority of the C2C market, grew by a compounded annual rate of around 65% in the years 2009 to 2012.

The potential is huge for B2C sites to win away shoppers from C2C sites. Based on our survey, 96% of C2C revenues come from shoppers buying new—not

The Tmall phenomenon

As retailers and brands frame their strategies, they can't minimize the importance of Tmall, the dominant site where the majority of China's B2C purchases take place. Tmall generated revenues of RMB 180 billion in 2012, and the site has deftly shaped online retailing in China. Consider its iconic 11.11 digital retail event, in which shoppers are offered up to 50% discounts on most products. The single 24-hour period in November delivered fully 7% of Tmall's annual revenues in 2012, according to company reports. By the end of the day 213 million unique visitors had logged on, the company reported, accounting for 106 million transactions.

A presence on Tmall is critical for any merchant trying to establish a foothold with China's online shoppers. Given its scale and ability to deliver enormous traffic, Tmall serves as a good entry option for brick-and-mortar retailers or brands that want to get shoppers comfortable with the experience of buying online. Then retailers can focus on convincing shoppers to make purchases on their own sites. Trouble is, our survey found that consumers often confuse flagship stores on Tmall with retailers' own e-commerce sites. The challenge is to clearly differentiate the retailer's e-store from its Tmall offering.

Ultimately, Tmall helps everybody grow, and fast. Its 11-11 digital holiday creates a halo effect that makes those 24 hours an exciting time for all online retailers in China.

second-hand—products like those sold on B2C sites. Tmall, probably the only profitable B2C e-store, is poised to gain from this trend. Its sister company, C2C giant Taobao, feeds traffic to Tmall without a fee.

These online-only pure plays lead the market over omnichannel retailers, those with both a physical and online presence. The pure player world supports three major business models. On **Pure Platforms**, such as Tmall and Taobao, vendors operate their e-store and own the products. These sites have no in-house logistics, relying on third-party players to fulfill orders. However, they integrate delivery into their sites, making it easy for shoppers. Taobao established a common platform that allows its third-party logistics partners to track the route and delivery status of orders. An **Open Platform** is a variation of this model. In sites like Jingdong (formerly 360buy), vendors own the products but only partially operate the e-store, although the platform will operate an e-store for a vendor for a service charge. While the Open Platform model has in-house logistics capabilities, an e-store may opt to use a third party and pay a service fee. Meanwhile, **B2C pure players** like 51buy operate the e-store, fully owning the products and using in-house logistics, except in remote regions.

Four factors contribute to a pure play's success:

Build scale for the price sensitive. The most critical factor for success: building scale and offering products across several categories. For example, Jingdong built enough scale to offer lower prices for a variety of merchandise. It started with the most popular, price-sensitive categories like consumer electronics and home appliances, then quickly expanded into other categories. At the same time, it kept a laser focus on increasing traffic to the site. But scale alone won't suffice without a winning value proposition.

Streamline the assortment and price for a differentiated portfolio. Some pure plays win by building a well-priced product portfolio that differentiates them from the pack, focusing on areas such as luxury fashions or mothers and infants. Redbaby and Blue Nile adopted this approach, which led to their early success.

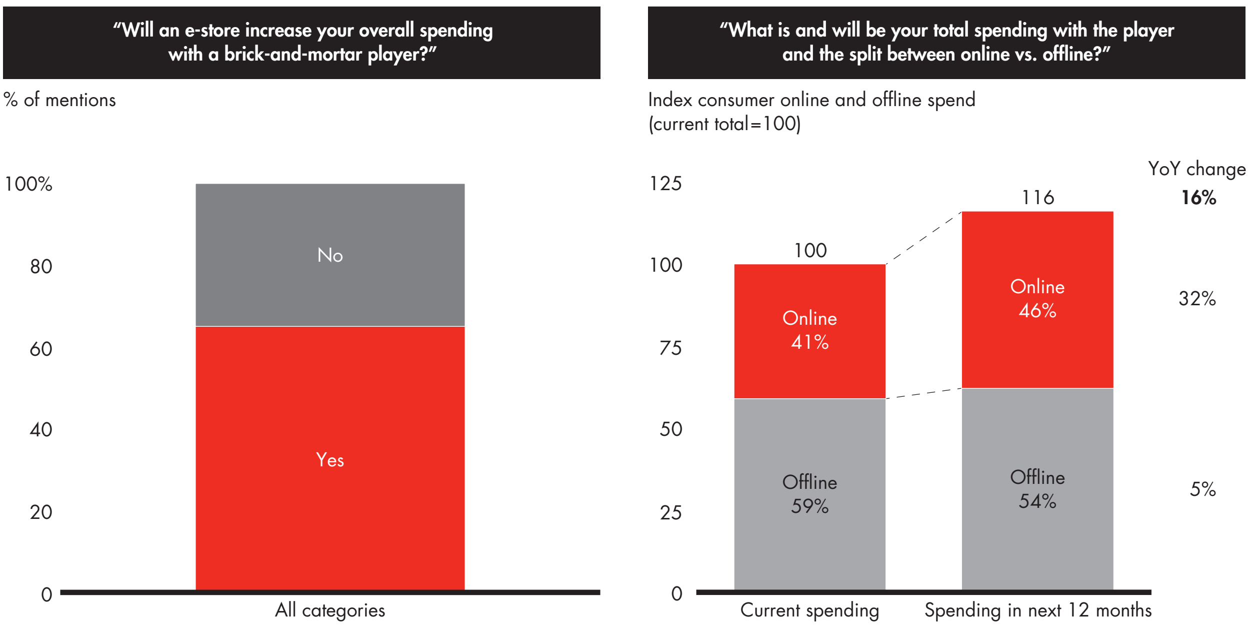
Hone a profitable business model. Leaders also create a profitable business model. So far, the only profitable models are pure and open platforms like Taobao and Tmall. Among the successful elements: charging commissions or rents to vendor tenants. Companies need to have the resources to invest in such areas as infrastructure and marketing and to cover losses for a long time as they build scale.

Create a strong supply chain. Both 51buy and Jingdong understood early on that differentiating themselves from competitors required a large initial investment to expand their supply chain coverage and enhance their management. If companies decide to go with their own in-house logistics, they can improve profitability if they expand geographically on a cluster-by-cluster basis. For its part, the e-commerce grocery business Yihaodian built a sophisticated, self-owned supply chain to handle the complex grocery category. It invested heavily to build an in-house delivery capability to serve the unique needs of grocer distribution, with logistics centers in key markets and an in-house delivery team to serve core cities.

The omnichannel promise

While pure plays dominate in the market, there is significant growth opportunity for omnichannel merchants. Among the most important developments we found in this year's survey: When offered the choice, Chinese shoppers prefer retailers' e-commerce stores over pure play sites like Jingdong. This is an encouraging finding for omnichannel players as they chart their futures. The survey also dispels a concern expressed by retailers that investing in their own website would cannibalize physical store sales. In fact, the opposite is true. The website *feeds* store sales, increasing a retailer's total combined sales *(see Figure 3)*.

Figure 3: For brick-and-mortar retailers, providing an omnichannel solution could lead to increased total consumer spending



Source: Bain 2013 digital shopper survey (n=1,324)

To learn more about their preferences, we asked shoppers why they would choose the e-store of a brick-and-mortar player over that of a pure play. Overwhelmingly, they mentioned the "touch and feel" of a brick-and-mortar store. In general, Chinese consumers lack confidence in merchants because they are worried that they will be sold fake or low-quality products, especially online. They are reassured by being able to examine products before committing to a purchase. A majority of those shoppers also cited offline after-sales service and a general comfort level with physical merchants as being advantages over pure plays. Further down the list of priorities: more new products and delivery of heavy products to the physical location.

Beyond consumer preferences, there are many ways omnichannel retailers may be better positioned than pure play competitors to ultimately win on the digital battlefield. For example, they can exploit existing investments to raise a retailer's brand awareness, build a supply chain network (including sourcing and delivery logistics), and create broad customer service coverage and capabilities.

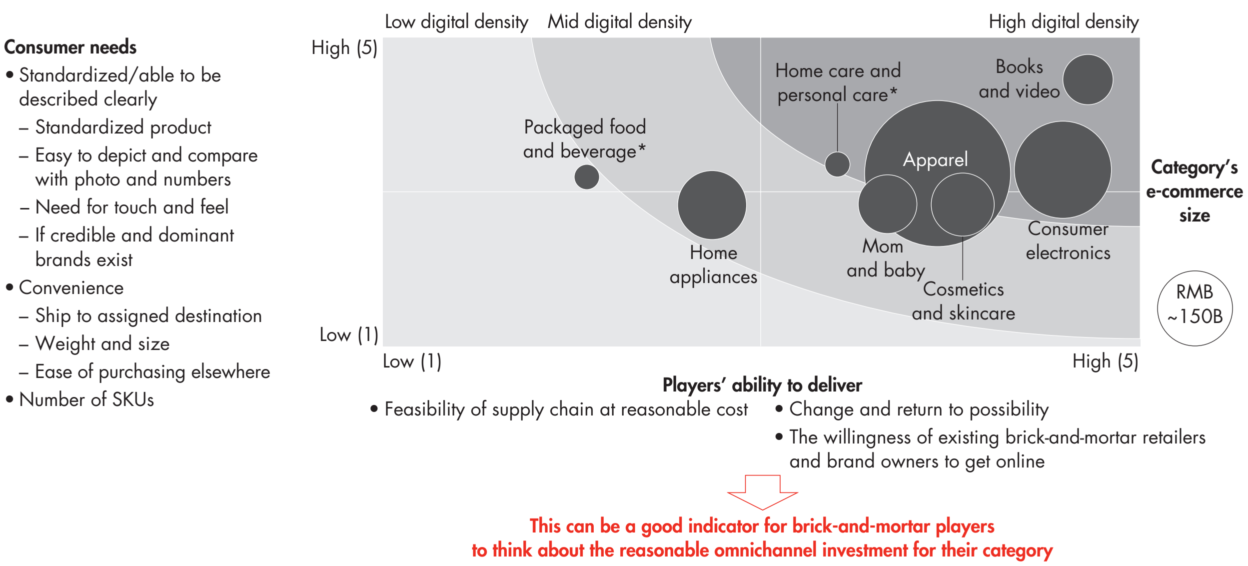
The winning approach

A winning omnichannel strategy requires understanding market shifts and consumer preferences. The strategy varies based on the different types of omnichannel players. They fall into three categories: traditional and modern trade retailers with physical stores such as Walmart and Suning, as well as department stores, and brands such as Mondelez (formerly Kraft Foods) and Abbott that work through distributors or retail channel partners.

Leading brick-and-mortar retailers aggressively pursue digital expansion, taking full advantage of their existing stores and supply chain infrastructure to gain an edge. They also develop new capabilities and an organization that is designed to support the omnichannel approach.

Another must: thoughtful consideration of the product categories a retailer chooses to sell online. The potential of each category differs based on a variety of characteristics, and retailers need to weigh a host of factors (*see Figure 4*). For example, are the products

Figure 4: The digital density of a category differs by its characteristics



*Size of "packaged food and beverage" and "home and personal care" are illustrative only
Note: Penetration of key categories in 2012: book ~30%, apparel ~13%, cosmetics and skin care ~22%, CE ~ 17%, grocery (made up of packaged food and beverage, home care and personal care) ~2%
Source: Bain & Company

standardized, easy to depict and easy to ship? Would a new product category add supply-chain complexity or make customer returns difficult?

Many retailers underestimate the cost of moving to an omnichannel model in China. It's often complex to launch an e-store while juggling daily retail operations. Omnichannel requires a large investment in "last mile" infrastructure capabilities, especially to overcome supply-chain and payment limitations in Tier-3 and Tier-4 cities. Finally, the talent shortage presents another hurdle to building a strong digital team.

For their part, brands face their own set of decisions. The omnichannel model allows them to keep pace with fast-evolving consumers and improves management of key functions such as branding, products and pricing. Selling directly online is an attractive but complex move. The key question is whether they can go it alone or need to team with others. Given the market's complexity, it's often quicker and easier to outsource to local professional e-store builders and operators. It allows brands to gain traction and generate enough traffic quickly to cover start-up costs and sustain business. But that sets up the challenge of finding the right partner.

Like their pure play counterparts, omnichannel players—retailers and brands alike—need to master the key success factors:

Invest early. Leaders stay ahead of the curve by having a clear vision and strategy that allows them to be the first to invest, either growing organically or making key acquisitions that jump-start growth. Most successful brick-and-mortar retailers scale up their digital businesses within two years, and they prepare their organizations for rapid change.

A prime example is Suning, China's largest omnichannel retailer. The company's online sales grew by a compounded annual 190% between 2010 and 2012. Suning built out a digital presence that made the most of—and enhanced—its physical operations. The strategy called for developing a user-friendly website with rich content and a heavy technology investment to ensure seamless online and in-store fulfillment. Over time, it expanded categories online, in its stores and on mobile applications. Suning worked to fully integrate its digital and store channels. By 2012, the retailer had solidified its leadership as the number-two B2C online player. Having an early start was critical.

Build a dedicated digital team. A successful team incorporates digital capabilities into different functions. At the outset, the team is often separate from the rest of the organization. After Suning set up its omnichannel vision it established a separate digital team—an independent operation with a highly entrepreneurial culture.

Invest in a world-class website. The site should be strong enough to win new consumers and earn their loyalty. Companies work with third-party website developers to speed the process. That's how Uniqlo, the apparel brand and retailer, streamlined its entry into China's digital retailing market in 2009. It outsourced development of websites for both its e-stores—the official Uniqlo site and another on Tmall. The sites use the same layout, categories, assortment, pricing and Web operators. Web giant Taobao provides the ordering and payment systems. For Uniqlo, outsourcing accelerated its online launch by tapping partners' knowledge, reducing IT costs and allowing the company to take advantage of its partners' established logistics and distribution.

Expertly manage assortments and price. Some apparel companies feature new and classic items and offer a variety of colors and sizes—with prices that are in line with those of its physical stores. But brands also use sites such as Jingdong to offer lower-price deals on a limited variety of shoes to bargain hunters. Retailers must master the art of using pricing and merchandising to differentiate themselves from pure plays. Our formula calls for a carefully balanced mix of products and pricing, covering 80% of all items sold online.

- 20% of the online SKUs are special products—these SKUs are the same price in stores but they're not available to pure plays.
- 30% of the online SKUs are the same price in stores but with different SKU coding—the different coding limits price comparisons.

- 30% of the online SKUs are the same—the in-store price and coding are identical, enabling comparisons with the competition.

Develop a seamless cross-channel experience. Winners create an enriched shopping experience by integrating their online, mobile and social-media presence and taking full advantage of their stores. Seamless cross-channel integration means shoppers can return online purchases to a nearby store. They also can check a store's inventory online or log onto a terminal in a store and make a purchase. Instead of losing out to a competitor when an item's not in stock, omnichannel retailers boost the odds of winning the sale.

For example, Suning offers the exact same product categories in physical and e-stores and is gradually converging pricing. Innovative technology weds online and in-store offerings—in-store sales reps can log on to suning.com via a digital terminal and view pricing, product and inventory information. For China's smartphone shoppers, an app enables flexible purchasing over a mobile device or with a mobile bar code. It also provides shoppers with information about in-store promotions, delivery status and after-sales service.

The bottom line is straightforward: As digital retailing sweeps China, brick-and-mortar retailers and brands are well positioned to exploit the tremendous opportunities of such explosive growth. But they need to act quickly and thoughtfully to wed offline and online strengths. Otherwise, they risk becoming irrelevant over time.

Success will be defined by those who capture a greater market share by pausing to understand new shifts in consumer behavior and using those insights to devise a thoughtful and integrated omnichannel strategy. Such a strategy not only protects a retailer's or brand's core business but also helps ensure that they remain ahead of the pack as China's retail marketplace evolves and booms. Only a select few have fully embraced an omnichannel approach, but the opportunities are as vast as China itself.

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