

REPORT

The World's Next E-Commerce Superpower

Navigating China's Unique Online-Shopping Ecosystem



THE BOSTON CONSULTING GROUP

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The World's Next E-Commerce Superpower

Navigating China's Unique Online-Shopping Ecosystem

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Introduction

China, already known to have the largest Internet population in the world, can now also claim the distinction of having the second-largest population of online shoppers—145 million people (versus 170 million in the United States). This is more than double the number in Japan and five times that of the United Kingdom. Moreover, online shopping will see exponential growth through 2015, with spending that could make China's e-commerce market worth more than RMB 2 trillion and possibly surpass the size of the U.S. market.

Research conducted by The Boston Consulting Group offers an in-depth look at the underlying dynamics behind this exciting time of growth. Drawing from surveys of more than 4,000 online shoppers across tier 1 through tier 5 cities, this report illuminates the conditions that make China's e-commerce environment unique compared with other markets and points out the crucial trends companies must be aware of to achieve success.

It is clear that Chinese consumers, especially the coveted urban dwellers and those in the middle and affluent classes (MACs), are quickly adopting “multichannel” shopping behaviors, creating both opportunities and challenges for brand companies, retailers, and e-commerce companies alike. Organizations that have been quick to capture the attention of these consumers are already reaping significant benefits. Vancl.com, for example, has become one of China's top-ten casual apparel brands (excluding sportswear) while selling exclusively online, with

expected 2011 sales of RMB 8 billion (four times 2010 sales).

Many companies, however, have been slow to respond, leaving significant growth opportunities on the table and allowing other merchants—such as those that sell on Taobao.com, a Chinese shopping portal in the vein of Amazon.com—to shape consumer perceptions of brands. Companies that do not have an active e-commerce strategy are allowing a fast-growing channel to develop without exerting any control or influence over the process.

Companies wishing to benefit from the rise of online shopping in China need to understand the circumstances that make the e-commerce environment there unique, as well as the trends and consumer behaviors that will direct future progress. At the moment, a very small proportion of overall category shoppers do their shopping online, leaving much room for growth. Usage and spending levels will increase in every e-commerce category, but certain categories are poised for more dramatic change. Consumers will become increasingly demanding as their needs alter, especially the heavy spenders, who will represent an outsize share of growth. Websites able to meet the need for better quality and service will win in an increasingly competitive online environment. And those that focus on the high profit potential of multichannel shoppers will also be at an advantage. Companies wishing to capture opportunities online must customize their strategies to account for the unique behaviors, demands, and challenges of the online ecosystem in China.

An Internet Giant

China's status as home to the largest population of Internet users is widely known and touted (457 million in 2010, more than in the United States and Japan combined). As Internet usage ramps up, so too does adoption of online shopping, aided by a number of circumstances that set the stage for a coming e-commerce explosion. (For a breakdown of China's e-commerce numbers, see the sidebar below.)

E-Shopping on the Rise

Consumerism is already big in China—people simply love to shop. Beyond this, the Internet is affordable, and thus widely available, thanks to government efforts to

modernize the country's telecommunications infrastructure. Broadband Internet costs just \$10 per month (against an average urban household income of \$830), compared with \$30 per month in India and \$27 per month in Brazil, and it is accessible to approximately 90 percent of China's population.¹

The years 2007 through 2010 saw rapid growth in the number of consumers going online. In each of those years, China gained between 73 million and 88 million new Internet users—a volume exceeding the population of France. (See Exhibit 1.) As new e-commerce offerings coincided with this growth, consumers went from having

1. See *China's Digital Generations 2.0: Digital Media and Commerce Go Mainstream*, BCG report, 2010.

China's Growing Online Market

- ◇ In 2010, the e-commerce market in China was worth RMB 476 billion as transaction value (actual value of sales, including all fees), nearly double that of Japan or the United Kingdom and a drastic increase from RMB 128 billion in 2008.
- ◇ E-commerce penetration has grown rapidly from a low level. Less than 10 percent of China's urban population shopped online in 2006. That figure jumped to 23 percent by 2010, and will nearly double to 44 percent by 2015, quickly narrowing the gap with the United States and other developed markets.
- ◇ By 2010, China had 457 million Internet users, with penetration of 52 percent in urban areas and 18 percent in rural areas. The number of e-commerce shoppers will take off through 2015, growing from 145 million people to 329 million.
- ◇ An astounding 30 million consumers are expected to shop online for the first time every year until 2015. That's a population nearly the size of Canada's beginning to shop online every single year.
- ◇ BCG forecasts that e-commerce will go from representing 3.3 percent of total retail value today to 7.4 percent in 2015. In the United States, it took ten years to achieve that growth. Our projection means that China will surpass the United States to become the largest e-commerce market in the world, achieving a compound annual growth rate of 33 percent, to reach more than RMB 2 trillion.

Exhibit 1. China's Rapidly Expanding E-Commerce Market Follows an Era of Exponential Growth in New Internet Users



a little familiarity with online shopping to a relatively high level of comfort and adaptation. In addition, the e-commerce industry has benefited from China's low cost of shipping—\$1 on average to ship a 1-kilogram parcel, versus \$6 in the United States. (For more on the industry's delivery and logistics challenges, see the next chapter.) All of these characteristics will make the coming years, from 2011 to 2013, a period of rapid e-commerce penetration.

Managing Early Obstacles

A few years ago, one of the most commonly cited barriers to e-commerce adoption in China was the lack of a satisfactory method for payment, especially given that credit-card usage is not prevalent. The shopping portal Taobao has resolved this problem for most shoppers through its innovative Alipay escrow accounts, introduced in 2003. Alipay has won consumer confidence

through a protective structure whereby payments from consumers are held in escrow until the consumer receives his or her order. (Paypal, by contrast, transfers money to the merchant when the consumer places an order, and merchants do not send out orders until their money is received.) Alipay has become the most common payment method for e-commerce in China, with more than 60 percent of consumers using it on Taobao, and approximately 20 percent using it on business-to-consumer sites.

Business-to-consumer companies also offer the simplest solution, cash on delivery (COD), which has been widely accepted by shoppers. Among the biggest of these websites, COD is rated the most frequently used payment method for nearly half of online shoppers.

The other most-cited obstacle to e-commerce adoption has been a low level of trust in a consumer population wary of fake or inferior goods. Taobao has effectively

addressed this issue, as well. The site features an extensive seller-rating system that enables potential shoppers to read up on the reliability of vendors and then make what they feel are dependable judgments about them.

The Weight of Superheavy Spenders

New Internet users will certainly push e-commerce forward in the coming years, but so will the individual consumer's level of familiarity with online shopping. The more experience people have with Internet shopping, the more they spend online. Consumers can be divided into four segments according to how much they spend on the Internet, ranging from light to moderate to heavy to superheavy. Crucially, superheavy spenders make up just 7 percent of online shoppers but account for 40 percent of total online spending. Meanwhile, a long tail of light

Consumer familiarity with e-shopping will drive online spending in the coming years.

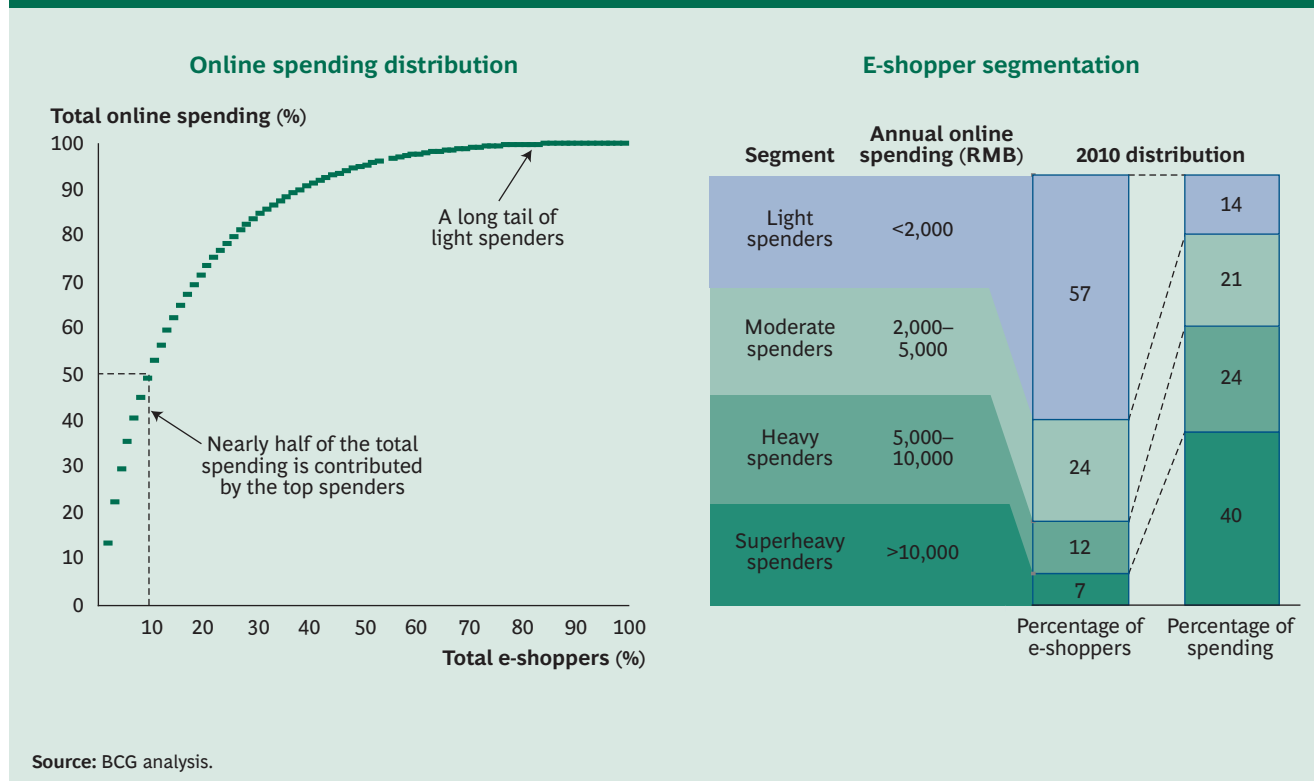
spenders—nearly 60 percent of total shoppers—accounts for less than 15 percent of spending. (See Exhibit 2.)

Experience remains a major driver of online spending, even when shoppers' income levels are factored in. Affluent shoppers with little e-shopping experience might, in fact, spend 60 percent less than emerging-middle-class shoppers who have accrued more experience shopping online. It typically takes affluent online consumers four or more years before they become superheavy spenders.²

By 2015, the majority of today's 145 million online shoppers will be "experienced," and more consumers overall will have entered

2. Affluent shoppers are those who earn more than RMB 10,000 in monthly household income; emerging-middle-class shoppers are those who earn RMB 4,000 to RMB 6,500 in monthly household income.

Exhibit 2. Seven Percent of E-Shoppers Are Responsible for 40 Percent of Total Online Spending



the ranks of the middle and affluent classes (MACs)—resulting in a sharp increase in the amount of money that each shopper spends online. Average annual online spending will have nearly doubled to RMB 6,220 per shopper, close to the \$1,000 (RMB 6,500) average in the United States today.

A Winning Proposition

There are a number of conditions particular to China’s consumer market that make e-commerce an attractive option for companies and that will help drive the coming years of growth.

The Limited Reach of Brick and Mortar. China’s massive geography hampers the effectiveness of physical retailing. The country’s coveted MACs are quickly expanding beyond the biggest cities, meaning that firms must constantly broaden their reach. There will be 365 cities with 100,000 or more MAC consumers by 2015. Today even the largest retailers in China, GOME

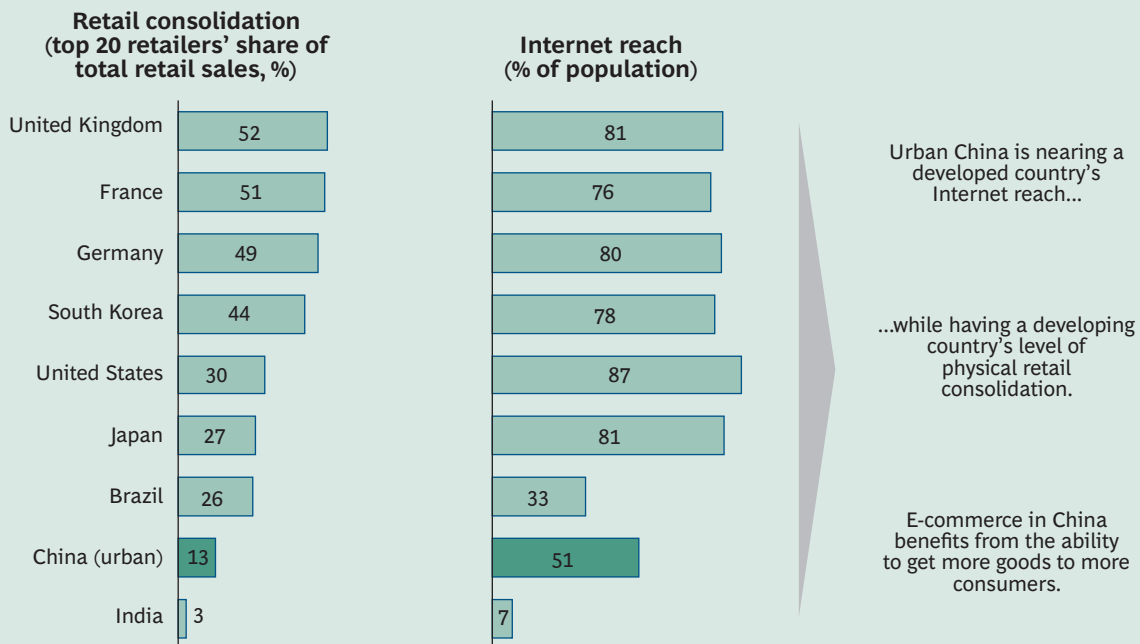
and Suning, have stores in only about 260 cities.³ And well-known multinational retailers cover even less ground. Walmart, for example, has stores in fewer than 120 cities.⁴ This limited reach results in the fragmentation of retailers. The country’s top 20 retailers account for only 13 percent of total urban retail sales.

China is unusual in that Internet access has far outpaced the reach of the top physical retailers, which could mean that its e-commerce development will not necessarily mirror the pattern in other countries. (See Exhibit 3.) It could progress much as the country’s mobile-phone industry has. China has more or less bypassed the landline phone system, leapfrogging from one phone per village to nearly one phone per person—and most of these are mobile phones. As of June 2010, China had 306 million fixed-line phone subscribers and 796 million mobile-phone customers.

3. As of the end of 2009.

4. As of the end of 2010.

Exhibit 3. Internet Access Has Far Outpaced the Reach of the Top Physical Retailers—a Dynamic Unique to China



Source: BCG analysis.

Note: 2010 Internet reach calculated using 333 million Internet users within an urban population of 654 million. Top 20 retailers account for 10 percent of all retail sales in China. We assume that 76 percent of retail sales in China come from urban areas (based on urban versus rural ratio of total disposable income in 2010), and all top retailers' sales come from urban areas.

Many consumers, especially in lower-tier cities and rural areas, began using mobile phones before landlines, thereby building up the habit of turning to their phones not just for communication but also for entertainment and other activities that previously would have required a dial-up connection on a personal computer. Consumerism in China could develop similarly, skipping the usual stages of retail development and arriving directly at a heavy reliance on e-commerce—a pattern completely different from the experience of other developed countries.

The High Cost of Brick and Mortar. Physical retailing is pricey for companies. Skyrocketing real-estate prices eat up a much larger proportion of operating costs for modern physical retailers in China than in more developed markets. Moreover, China's distribution structure is still inefficient and often involves multiple layers of middlemen and wholesalers, resulting in a loss of profit margins. Selling directly to consumers on the Internet circumvents both of these costly outlays.

A number of factors make e-commerce attractive on the consumer side, as well.

A Better Selection. E-commerce sites enable easier access to a wider range of goods. The majority of consumers in China are not looking for fake products online. Less than 5 percent of our respondents claimed to seek out fakes—though more than that may purchase them unknowingly. Up to a quarter of e-commerce demand in China is, in fact, for products that consumers cannot find in physical stores—a circumstance rather unique to China, where, as noted above, the country's immensity limits the coverage of many physical retailers.

This is particularly notable in the case of skin care and cosmetics products; 25 to 35 percent of the consumers we polled said that they shop online for items in this category that they cannot find in brick-and-mortar shops. In top-tier cities, more cosmopolitan (and often more well-traveled) consumers are seeking out brands that have not yet

entered China. In low-tier cities, e-shoppers are more often searching for brands with limited coverage that are not yet available in any physical stores in their city.

Better Bargains. Chinese consumers are price sensitive, and for a number of reasons, online channels are able to offer them the best deals. There is a large amount of excess inventory along the supply chain in China, due to the many layers of middlemen. In addition, lack of data transparency and the difficulty of accurately predicting demand mean that stores often have a lot of excess inventory at the end of the season. This is especially true in categories such as apparel, which has a short product life cycle and relies overwhelm-

ingly on a franchise model. It becomes convenient, then, to liquidate excess and dated inventory through online channels at a discounted price, which, of course, attracts consumers.

We estimate that apparel inventory accounts for approximately 50 percent of total market value. By contrast, in developed markets such as that of the United States, the United Kingdom, and South Korea, this figure is only 20 percent or less. That's why apparel has been the first e-commerce category to take off in China, and it is still the biggest.

Greater Consumer Trust. E-commerce sites offer a number of features that help increase the trust of consumers. The prevalence of low-quality and fake products in China has created a skeptical consumer mentality. Physical retailers are sometimes able to overcome this wariness through a trusted retail brand name or a personal relationship with the customer, but neither of these is common. The faceless nature of online shopping can make for even greater skepticism, but there are mechanisms unique to e-commerce that allow consumers to judge a potential purchase. These include extensive review and rating systems, word-of-mouth endorsements via online forums and message boards, and escrow service guarantees that go beyond what most physical retailers provide.

E-commerce sites
enable easier access to
a wider range of goods
at lower prices.

What Makes China Different

China's e-commerce environment is indeed ripe for rapid progress. Companies wishing to tap into the exponential growth, however, need to be aware of a number of characteristics that make China's online-shopping landscape different from elsewhere. The unique circumstances of the country's economic explosion have led to an equally unique e-commerce ecosystem. Highlighted below are four factors that are important for companies to understand when creating online strategies.

The Dominance of Taobao

Taobao.com accounted for an enormous 79 percent of transaction value in 2010. The company has virtually defined the e-commerce landscape in China. By contrast, most other markets are far more fragmented. In Japan, a leading company, Rakuten, has just a 30 percent share, while in the United States, Amazon takes a share of merely 14 percent. (For more details, see the sidebar "The Taobao Phenomenon.")

It is crucial for companies—even those that are solely engaged in physical retailing—to understand the degree to which Taobao may be shaping their online presence—even companies that are solely engaged in physical retailing. Many are unaware of the extent to which their products are already being sold by other merchants on Taobao. Companies without an explicit online strategy are allowing a fast-growth channel to develop without their control or influence. Companies that want to manage their products sold on Taobao can gauge from the site which of their items are most popular, and at what price points. They will need to carefully assess how to manage

product flow across channels, regions, or countries. They will also want to decide whether to set up their own independent online-selling site, create a Taobao-hosted site, or allow authorized retailers to act as channels. (For more on how to compete with Taobao, see the next chapter.)

Delivery and Logistics Challenges

Until now, e-commerce has benefited from low shipping costs but has been impeded by an inadequate delivery infrastructure. Online vendors are forced to rely heavily upon small, local, independent courier companies that mainly deliver newspapers to individual subscribers. In fact, the e-commerce industry appears to be driving the growth of the package delivery infrastructure. We estimate that 60 percent of package delivery revenue came from consumer e-commerce in 2010. Taobao alone probably accounted for half of all the packages delivered domestically.

Given the immaturity of the infrastructure, package delivery concerns, not surprisingly, make up three of the top six reasons consumers may feel hesitant to purchase products online. And they are not just concerned about cost or the risk of damage during delivery. An incredible 45 percent say they worry that their purchases will be swapped out for fakes in transit. For all these reasons, consumers who do venture into online shopping tend to opt for e-commerce vendors that have distribution centers in their city.

Companies such as Taobao and computer, communications, and consumer electronics vendor 360buy.com are responding to these concerns in a number of ways. First,

they are making massive investments in distribution centers across the country. Taobao's parent company, Alibaba Group, has announced RMB 25 billion of investment over the next ten years, and the company's CEO, Ma Yun, has made public his ambitious goal of being able to de-

liver products to customers within eight hours of online purchase. 360Buy, for its part, has announced RMB 8 billion of investment over five years. Moreover, in cities where they have scale, many e-vendors are building their own last-mile delivery networks. In places where they

The Taobao Phenomenon

Taobao—part of the Alibaba group (which also owns the popular business-to-business site Alibaba.com)—is by far the most important company to watch in China's e-commerce landscape. More products were purchased on Taobao in 2010 than at China's top-five brick-and-mortar retailers combined, making it the biggest retailer in China. The site boasts more than 800 million online products, of which 48,000 are sold per minute.

Though Taobao has been called the eBay of China by Western media, it differs from eBay in that it does not primarily sell used items. The overwhelming majority of products sold on Taobao are new. Many sellers are either suppliers who have not found success with other retail channels or distributors selling excess inventory.

A Network Effect

Taobao benefits from high consumer "stickiness" due to its bargain pricing (online shoppers claim to be able to find items that cost 25 percent less on Taobao than through other channels), its convenience, and a number of other unique features. One is its enormous pool of merchants. Though the site was a relative latecomer to China's consumer-to-consumer market in 2003, it successfully captured more than 60 percent market share within two years thanks to its "free" strategy—it does not charge any registration or transaction fees. From there, it took off further as a result of a network effect: its large merchant pool made for high consumer traffic, which, in turn, attracted still more merchants, generating even more consumer traffic.

Shoppers are also reassured by Taobao's customer service. It has the largest call center in the world, as well as an innovative instant-messaging tool called Taobao wangwang that allows online merchants to communicate with consumers in real time. On average, every shop on Taobao has an amazing two to three customer-service representatives online at any given time, totaling millions.

Finally, Taobao's seller-credibility rating system—which allows buyers to rate and post feedback about vendors—creates a high level of trust regarding the products sold,

generates word of mouth for the site, and makes the shopping experience on Taobao appealingly social and interactive.

Business Model Evolution

In an effort to diversify from its original no-fee model, Alibaba launched Taobao Mall, or Tmall, in 2009 and is now strategically shifting resources to this new platform. The site mimics an offline mall, with different product categories offered on different virtual "floors," storewide sales, and a loyalty points program. Tmall is more discerning than the original Taobao and offers better customer service and reliability. Participating merchants must be authenticated by the site and pay both registration and transaction fees. Many branded suppliers have already set up official stores on Tmall, either directly or through distributors.

The model is proving successful. There are now about 150,000 merchants and 200,000 brands on Tmall, selling to 180 million customers. Tmall achieved a peak one-day gross of RMB 936 million in merchandise volume on November 11, 2010—half of Taobao's total transactions. Tmall benefits from synergy with the main marketplace site. Searches on Taobao automatically return Tmall shops, and the majority of Tmall users say they know about and trust the site because of Taobao. And while consumer perceptions of Tmall are still not as favorable as those of other business-to-consumer companies in terms of delivery and fulfillment services and reliability, they are quickly catching up and are a vast improvement over perceptions of Taobao in these areas.

In another step toward impressive diversification, Alibaba restructured Taobao in June 2011 into three separate companies: Taobao Marketplace, Tmall, and eTao (a service for searching across different Chinese shopping websites). The move should enable a more sophisticated consumer experience and give each of the three companies more nimbleness for future innovations. In light of Taobao's huge customer base and enormous volume of traffic, all of these moves represent the potential for robust monetization.

must rely on third-party delivery services—usually the aforementioned newspaper-delivery networks—they are taking steps to make these couriers seem more professional to consumers. Leading online apparel retailer Vancl, for example, requires anyone delivering its products to wear a standard Vancl vest.

Distinctive Online Behavior

The types of websites consumers choose for both their online and offline shopping (the latter for researching products or seeking out reviews) are quite different from those in other countries. Only 19 percent of consumers in China go to official brand or manufacturer websites, versus 41 to 60 percent in Japan, the United States, and the European Union. The Chinese websites of foreign brands are often direct translations of their home-country websites, with little customization or localization for the China market. In particular, they rarely create any sort of platform to engender a sense of community, which would attract consumers to visit frequently.

Chinese consumers are quite possibly the most social in the world during the shopping process. Certainly, they are the most prolific reviewers and readers of online reviews. Across 20 countries surveyed, Chinese shoppers were the most likely to respond that they had read or posted reviews online (more than 40 percent had done both). This is nearly double the rate in the United States. And, although social networking is still just emerging, Chinese consumers are the most likely to check for product recommendations on these sites.

A driver of these behaviors may be an underlying wariness about products sold online and a distrust of online

merchants. Reviews and recommendations from friends serve to alleviate some of this distrust. In fact, trust in online information sources such as blogs, review sites, and social networking sites is far higher than for offline sources like television ads or printed materials from manufacturers.

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A Unique Online-Shopping Ecosystem

The relationship between search and online retail sites is different in China. In most markets elsewhere around the world, searches begin with Google. In China, the top search engine is Baidu.com, but top e-tailer Taobao blocks the Baidu spider—meaning that consumers cannot find Taobao product listings through a Baidu search. Instead, they must start their search from within Taobao. In other words, given that Taobao accounted for nearly 80 percent of e-commerce volume as of 2010, Chinese shoppers are developing the habit of not relying on search engines to find products online.

Social networks offer another way to engage with consumers online, but they, too, play out differently in China. Most challenging is their fragmentation; there is no single top contender akin to Facebook in the United States, but rather multiple social networks that attract different demographics. For example, Kaixin001.com appeals to white-collar office workers, Renren.com to college students, Douban.com to the artistic and literary set, Qzone.qq.com to young and active adults, and many more are aimed at still other user segments. Another especially formidable site is the wildly popular Sina Weibo, a microblogging network used by celebrities and professionals from all walks of life.



Catching the E-Commerce Wave

To capture a share of the exponential growth ahead, it is crucial to understand a number of factors that will shape that growth. Some product categories will progress faster—and in different ways—than others as China’s e-commerce market makes its way toward becoming the largest in the world, worth RMB 2 trillion by 2015.

Fast Penetration into All Categories

E-commerce will develop rapidly across all categories through 2015. The number of e-shoppers will double, from 23 percent penetration of the total urban population in 2010 to 44 percent. And shoppers will buy online in more and more categories as they become more experienced and comfortable with making online purchases.

The growth potential, however, will vary by category. Some will more than double as they gain in popularity much faster than others. One example is digital cameras. In 2010, less than 15 percent of the e-shopper population bought cameras online, but that number will likely grow to 30 percent, given that a significant portion of the respondents to our survey said that a digital camera would be one of the next three items that they purchase on the Internet.

Still some categories will enjoy further growth as consumers move a larger proportion of their spending from brick-and-mortar shops to e-tail sites. For example, e-shoppers in the casual-wear category spend 30 percent online versus offline. Of that group, 60 percent plans to shift even more of their spending online. Along with casual wear, the categories growing the most in terms of online sales will be travel, consumer electronics, and

face care products, with a large and growing number of e-shoppers intending to switch more of their spending online.

Thus, e-commerce’s share of total retail spending will increase sharply, leaving the near future rife with opportunity. There has been a steep uptake curve over the past two years, and some categories have already surpassed their rate of growth in many developed markets. (See Exhibit 4.) In skin care and cosmetics, e-commerce sales in China have surpassed sales in the United States, the United Kingdom, and Japan to reach more than 10 percent of total retail sales, and that growth will continue to be in the double digits over the next five years.⁵ Consumer electronics are following a similar curve. Brand companies need to immediately think about where their products fall in this landscape of variable growth as they devise their Internet strategies in China.

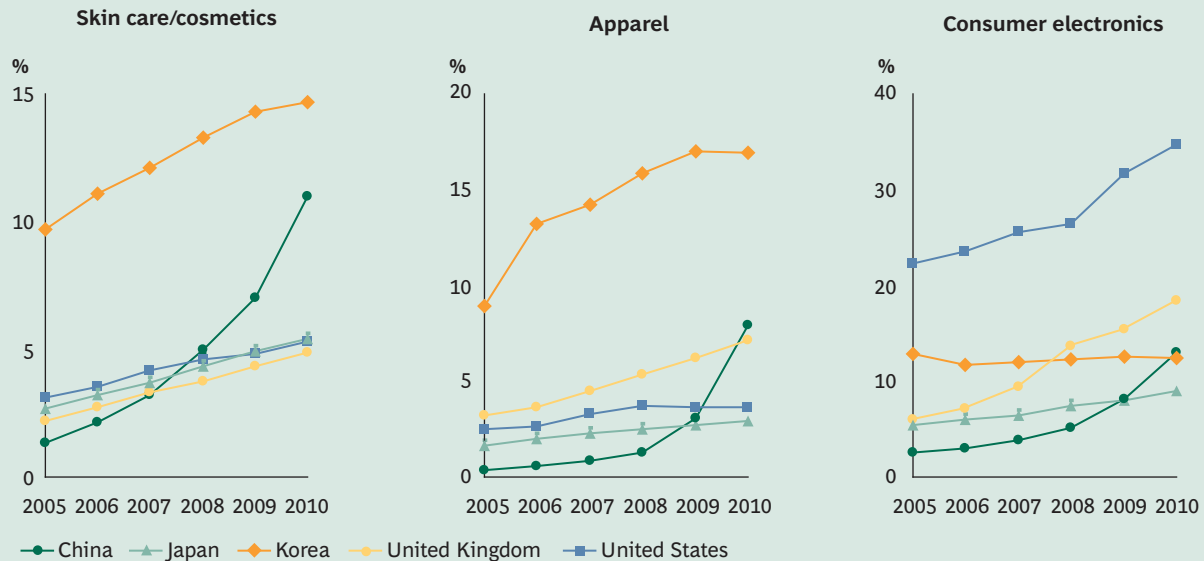
The Dynamics of Superheavy Spenders

As discussed in the first chapter, the increase in both the number of e-shoppers and their experience will shift the e-shopper base to a segment we call superheavy spenders. This demographic currently accounts for 40 percent of total online spending and engages in a larger number of transactions across a wider range of product categories. Superheavy spenders buy an average of 175 different items over the course of 50 transactions per year. Light spenders, by contrast, buy an average of 22 items and engage in 10 transactions per year, and their purchases are mainly just in the apparel category. Super-

5. Because of a lack of reliable offline sales data, estimates for online penetration by category are inexact.

Exhibit 4. China's E-Commerce Growth in the Past Two Years Is Significant Compared with Other Countries

Online sales as a percentage of total retail sales in selected categories



Sources: iResearch, Taobao datacube, Forrester, Goldman Sachs, Euromonitor, BCG analysis.
Note: \$1 = ¥82.4; \$1 = RMB 6.7.

heavy spenders not only spend more money than other consumers but buy more branded and high-end or premium products. For example, within the skin-care category, about 15 percent of light spenders say they buy private label or knockoff skin-care products online, whereas only 5 percent of superheavy spenders say they would do the same.

Consumers tend to shift toward superheavy spending as they grow more experienced with online shopping and accumulate more wealth. More than 70 percent of superheavy spenders are MAC consumers with more than four years of online shopping experience. Also, more than 80 percent of superheavy spenders are 25 or older.

The differing demographics of these superheavy spenders translate to differing attitudes, preferences, and emotional needs. Cost savings is one of the top reasons consumers say they shop online, but more superheavy spenders say they shop online for the latest fashions and entertainment. In fact, a higher level of consumer spending corresponds to a more emotional attitude toward

shopping. Superheavy spenders are more likely to go online with no specific purchase in mind. For them, e-shopping has become a pastime; they “like to browse online and look for great deals” on products they otherwise wouldn’t have planned to buy. By contrast, light spenders, and the majority of today’s e-shoppers, say they look online for deals on items that they have already decided to buy.

Fulfilling the emotional needs of superheavy spenders will be key to future success in China’s e-commerce landscape. Given their greater propensity to make an “impulse, unplanned purchase,” this means companies need to effectively bring deals to e-shoppers who may be idly browsing online. However, given the strong emotional bonds these consumers have with shopping, it will also be critical to engage them with value propositions beyond mere price savings—for example, by creating a fun shopping experience or by appealing to trend-conscious consumers’ sense of discovery by making them feel that they are learning something new in the shopping process. (For more on these shoppers, see the sidebar “Profile of a Superheavy Spender.”)

Profile of a Superheavy Spender

Qinheng Zhao is a 27-year-old living in Chengdu, the capital of Sichuan Province. He is the project manager for a construction company and has been married for two years. He has four years of experience with online shopping, which is the typical amount of time it takes to become a superheavy spender.

Zhao shops online more than four times a week, across a wide range of categories. A look around his home reveals an astounding array of online purchases. In the living room, his sofa, tables, and chairs are all from Taobao. In the dressing room, 60 percent of both his and his wife's casual wear is from Taobao. Nearly 90 percent of his home appliances were bought online, and 60 percent of his personal-care products. Moreover, Zhao does 80 percent of his consumer-electronics spending online, 60 percent of his luxury-goods spending, and *all* of his travel spending.

Zhao is an extrovert, and his open attitude is reflected in his fearlessness about online shopping. "I am totally comfortable and trust my own judgment," he says. Price is no limit: he recently bought a RMB 13,000 stereo system and an Armani wallet online. Beyond these more typical categories, though, he also enjoys discovering new things online and will turn to e-commerce for products few others would buy online—bathroom tiles, for example. "I didn't know there were tiles sold on Taobao," he says. "But once I searched them out, I started buying most of our decoration materials online."

Zhao is undaunted by the occasional bad experience, saying, "I failed before when buying a Ferrari perfume, but it's not a big deal. I learned a lesson." The reward for Zhao is a sense of emotional fulfillment. He told us, "I get a strong sense of satisfaction when I save a lot of money buying online, and when others follow me to buy things."

Winning Customers Through Quality and Service

As consumers grow more experienced with online shopping, they will come to demand even better service and quality from e-commerce sites. They already express a great deal of dissatisfaction regarding delivery quality, cost, and lead-time. The future will see a shift in demand from low-priced but non-guaranteed items sold by sometimes dubious or unknown vendors to high-quality service and products from trustworthy sources.

Taobao's Loyal Core. Market leader Taobao both suffers and benefits from the fact that users often need a great deal of time to feel adept at using the site. This is an advantage in that many consumers began using the site three or four years ago, when there were few other options, and over the years they have become deeply loyal, "sticky" users. This core group of customers spends huge amounts of time on Taobao and will pore through hundreds of reviews in their hunt for the best deal and the most trustworthy merchants. They recognize that Taobao has problems with reliability, but they enjoy the search process and are confident they can find good deals.

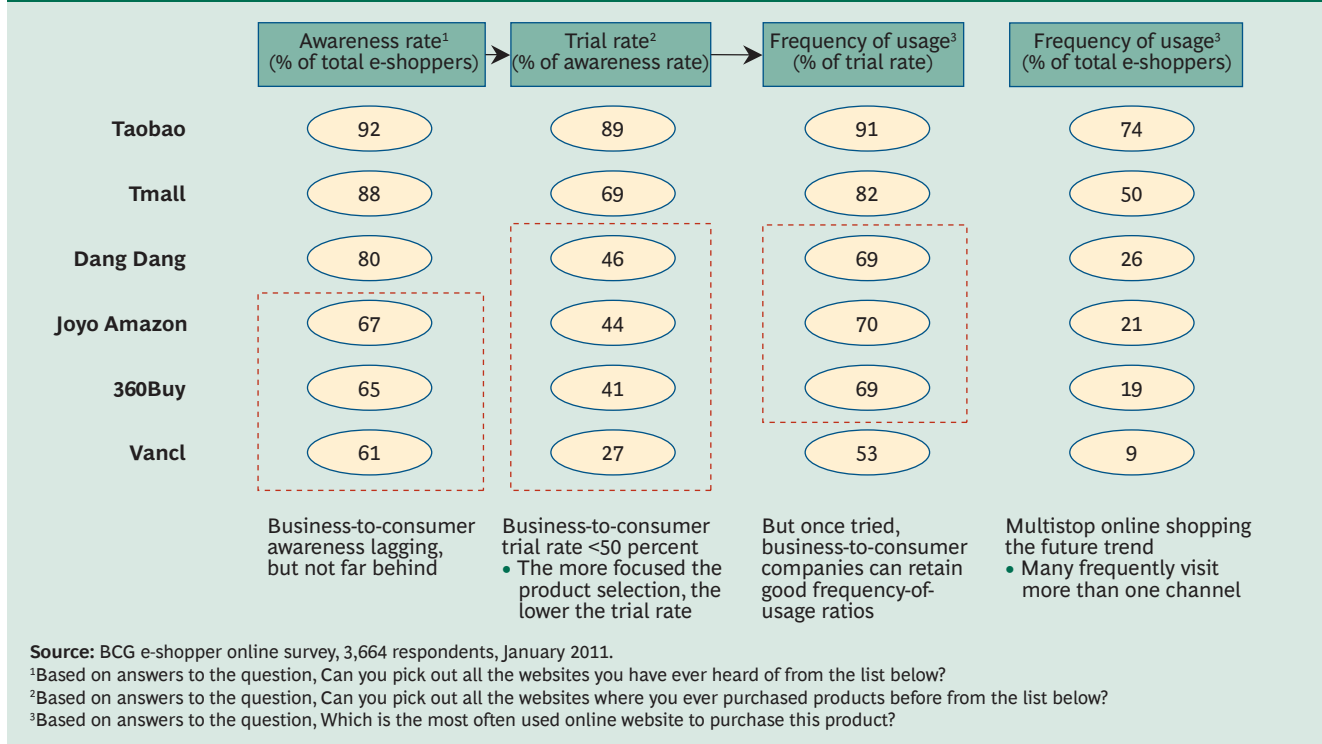
Competing with Taobao. This learning curve is a disadvantage for Taobao, however, when it comes to newer and increasingly busy shoppers who are frustrated by the

time-consuming and inefficient nature of the Taobao experience. In the past two to three years, several strong business-to-consumer sites have emerged that cater to specific consumer needs and don't require that customers become experts before they can feel confident about getting a good product.

As a result, these sites are winning market share from Taobao. (See Exhibit 5.) And though the user base of the top business-to-consumer sites is still much smaller than that of Taobao and Tmall—a recently launched offshoot of Taobao—some of them enjoy much more frequent visits from the users they do have. Online shoppers who have moved away from Taobao to these other sites overwhelmingly perceive them as offering much better quality assurance, professionalism, delivery speed, reliability, flexibility, and after-sales service.

Notably, these sites are penetrating quickly into the highest-value categories. For example, in casual wear, Taobao and Tmall are the default channels for 76 percent of e-shoppers. In the high-margin category of computers, though, only a little more than half of e-shoppers use Taobao and Tmall. Business-to-consumer companies have been growing at more than 200 percent in categories that demand high reliability and service-fulfillment capabilities, such as consumer electronics. It is clear that shoppers can be won over by sites that may have higher

Exhibit 5. Taobao Will Maintain Its Lead for a While, but Should Lose Some Share to Business-to-Consumer Companies



prices and less selection than Taobao, but whose quality assurance is perceived to be better.

Despite this, Taobao's leadership position will be difficult to shake anytime soon, given the large base of loyal customers who are already comfortable with the site and the company's efforts to continually diversify—including the debut of Tmall, which improves service quality by accepting only qualified, authenticated business merchants. Taobao's market share is bound to decline in the future from the 80 percent share it enjoys at the moment, but it will remain a significant force.

The Multichannel Advantage. The one sure bet for companies is to address a trend among consumers toward multistop online shopping. Consumers frequently visit more than one type of website for different product categories, and their desire for multiple options will only increase. In fact, consumers who shop in more than one channel can be three to five times more profitable than single-channel shoppers. Thus, it is increasingly crucial for companies to actively manage their online presence and engage consumers with a diversity of online options.

(For an example of an effective multifaceted online strategy, see the sidebar "Li Ning: A Case Study.")

The Offline Factor. Offering an online-only experience—even at multiple shops—is not sufficient. The offline, in-store experience remains a key factor that influences consumers' purchase decisions. Our survey shows that, on average, more than 50 percent of consumers pay a visit to offline retail stores before making an online purchase. Some browse online first and then visit the store to get a better sense of the look and feel of the product, while others develop their intention to buy at the retail store but make the final purchase decision online afterwards.

Furthermore, because of the rising demand for better e-commerce service and quality, companies with an offline presence have great potential to further differentiate themselves from online-only firms by providing after-sales services that leverage their offline assets and capabilities. This is particularly relevant to categories where exchanges (as in the case of apparel) or repairs (as in the case of consumer electronics) are often needed.

Li Ning

A Case Study

Successful local sportswear brand Li Ning maintains a good balance among multiple online channels. Each channel is positioned slightly differently, with different product offerings and pricing strategies targeted at different consumer segments.

- ◇ In 2007, the company authorized three core agents to set up 11 online stores on popular websites such as Taobao, Sina, and Eachnet. These special stores mainly sell out-of-season goods at a discounted prices—generally less than RMB 200. This enables Li Ning to serve the mass of more price-sensitive online buyers whom the company wouldn't otherwise approach, and it also establishes relationships with popular websites to promote the brand.
- ◇ There are about 400 individual consumer-to-consumer merchants selling Li Ning products online. Though they are unauthorized, Li Ning manages them through effective use of the supply chain, product services, and

training. By managing these mass merchants in this way, the company avoids any damage to the brand and product strategy. Merchants also sell out-of-season goods at a discount to thrifty consumers.

- ◇ Beginning in April 2008, Li Ning placed official flagship stores on a number of popular websites, including Taobao. This is an important way for any company to leverage existing outside resources to build e-commerce capability at a low entry cost, and it also provides for better management of the online brand image. The flagship stores are targeted at loyal Li Ning fans willing to pay high prices for newly arrived goods, which are sold in limited quantities.
- ◇ As of June 2008, Li Ning had built its own official online shopping mall. This, too, cultivates the company's e-commerce capability and is useful for managing brand image. And like the flagship stores, it is targeted at loyal Li Ning fans, as it sells new arrivals at full price.

Online-only firms should think about how to have an integrated offline strategy, especially given that most sales do require some offline element to close the deal. For offline companies, a multichannel strategy that leverages brand trust and offline assets will expose their products to a new group of online customers and potentially offer superior economics.⁶

Shopping by Mobile Phone

Roughly half of urban Chinese consumers have access to a mobile phone, and of those, about half use their phones to gain access to the Internet. These rates are on par with developed markets such as the United States, Europe, and Japan. However, China far exceeds those markets when it comes to people who indicate an interest in using their phone in the shopping process, whether to check prices or to find additional product information while shopping in physical stores. In fact, Chinese shoppers are already doing this, so as mobile-shopping platforms develop, it should be easy for customers to make the transition to actually shopping via mobile phone.

A look at mobile versus computer-accessed Internet penetration in China points to opportunities that differ

according to geography. In urban areas, where more than half of Chinese consumers get on the Internet via computer, mobile phones function as a supplemental rather than a primary means of going online. In these parts of the country, computer-accessed Internet, which enjoys such advantages as faster connections and easier-to-design interfaces, will be the primary driver of e-commerce. However, mobile shopping will grow quickly from its current small base, as e-commerce companies begin to introduce more mobile offerings. And once the country starts rolling out 4G networks with higher data speeds, and as more consumers correspondingly begin switching to smart phones, the growth of mobile-phone commerce will be stimulated still further.

Opportunities in rural China, however, are different. Here, mobile-phone penetration is high, but people are just beginning to have access to the Internet with computers—18 percent. Companies that count rural residents among their target customers should think about making mobile commerce their primary focus. This parallels the situation in India, where mobile penetration far outpaces Internet penetration.

6. See *Realizing the Multichannel Promise*, BCG Focus, July 2009.



Key Implications for Different Companies

Online sales may account for 20 to 30 percent of nonretail sales growth in China through 2015, growing from a market size of RMB 476 billion in 2010 to more than RMB 2 trillion. While many Chinese companies use or are planning to use the Internet as a selling tool, multinational companies have been slow to take advantage of this fast-growing channel. Those that do recognize the opportunity must understand that e-commerce in China will require a specific, customized strategy.

First, Chinese consumers—especially those who are urban and middle class—have shown that they prefer to be multichannel shoppers. In a few years, multichannel shoppers will make up nearly half of urban China’s consumers (accounting for around 80 percent of GDP). It is therefore not enough for companies to focus exclusively on consumers’ online or offline shopping habits.

Second, consumer needs vary. Heavy spenders have different concerns from their lower-spending counterparts, and consumers across city tiers and in urban versus rural areas are looking for different products. Companies have to be clear about who their target customers are, where they live, and what their specific needs are.

Finally, because e-commerce growth rates and penetration are higher in some product categories than in others, the online opportunity—and the potential role of the online channel—will vary across categories.

Different types of companies face distinct challenges and choices.

Strategies for Brand Companies

The need for action is especially critical for brand companies that participate in the fastest-growing online categories—travel, consumer electronics, casual wear, and skin care.

They must first decide what sort of online presence they want to have in China, and what role e-commerce should play in their strategy. To determine this, they must understand their target customers. What are their online and offline shopping behaviors and default shopping destinations? What are their needs, and which of those needs are not being met online? To identify their target customers and determine how best to reach them online, companies can consider a variety of approaches.

- ◆ Focus on engaging consumers purely on the basis of the brand.
- ◆ Target customers not yet served by the brand’s typical retail channels.
- ◆ Complement the current reach of retail. For example, push for more consistent replenishment purchases (of skin care products, for example) and expand the range of products typically found in the company’s stores, as well. Here branded companies must consider the implications that an e-commerce strategy has on the offline agenda. For example, if significant fulfillment is possible through e-commerce, then it might be wise to scale back some aspects of the offline presence—stocking enough products in physical stores to drive first-time purchases, for example, while dedicating the online channel to repeat purchases.

- ◇ Supplement the offline presence, which requires tight integration of the company's online and offline channels.

Brand companies must also choose among many options in crafting their online presence. Each choice comes with tradeoffs: a dedicated brand site allows full control over the consumer experience, but it can potentially be difficult or expensive to drive significant traffic. Tmall appears to be the best way to attract traffic, but it can be hard to generate a consumer experience that is distinct from that offered by competitors also selling on the site. And the viability of alternative business-to-consumer sites can vary significantly, as strong contenders have not yet emerged in all categories.

After deciding on format, brand companies need to consider their go-to-market setup, from the types of products to sell online to the logistics of accomplishing sales. Should they offer the same stock-keeping units (SKUs) online as offline, or should they limit the choices or even decide to make some items available only online? Should they use distributors to open stores, which makes for greater reach but less control? Or should they directly manage their own stores and logistics delivery? They must also design their margin structure, taking into consideration both offline and online trade economics.

Finally, brand companies must navigate a difficult incentives challenge. For example, the advantages inherent in not having to pay rent and other operational costs could make it possible to offer lower prices online. Such discounts, however, can create conflicts with the franchisees and distributors that handle the same products and sell them at full price. To manage this, a plan for cross-channel conflicts is necessary.

Strategies for Retailers

Retailers risk losing relevance online to exclusively web-based companies if they wait too long. In China, e-commerce is not yet common among traditional companies. Top retailers Gome and Suning have less than 1 percent of total sales coming through the Internet, whereas in the United States, Best Buy, for example, pulls in 7 percent of its sales from online.

Retailers can use e-commerce to increase their footprint in China.

Like brand companies, retailers should first decide on the role of e-commerce within their overall strategy. E-commerce in China is important to retailers, because it can be a lever for increasing their footprint—a costly task in China—and because it allows them the opportunity to build a true multichannel business model. Unlike the typical pattern in developed markets—where brick and mortar comes first—companies in China can develop offline and online at the same time.

Retailers should also think about how to leverage e-commerce and their offline assets. Rather than viewing online and offline as independent silos or standalone businesses, it is important to treat them as integral components of a single business model and to create long-lasting relationships with the most profitable multichannel customers. To that end, they should do the following.

- ◇ *Drive traffic from offline to online and vice versa.* Brick-and-mortar retailers must think about how to use their existing stores to best advantage. The ability to direct shoppers in physical stores to their online sites gives retailers an edge over e-tailers. Brand awareness and trust can also boost traffic beyond the confines of the store. In addition, retailers must think about how to influence shoppers online and direct them back to their stores. Consumers frequently decide on a brand and a particular product online but ultimately purchase the item offline—especially when high reliability is required of the product, as is the case with mobile phones, for example.
- ◇ *Target consumers with the right assortments and pricing.* As mentioned earlier, 20 to 25 percent of online purchases across selected categories are products that consumers cannot find offline. Companies that build trust and credibility regarding their assortment and pricing online may be able to offer a broader range of products online than in their brick-and-mortar stores.
- ◇ *Decide on a service and logistics model.* Filling online orders from physical stores can be cost effective, but it also restricts the online assortment to what is sold offline. Store-based logistics also typically limits distribution. Managing purchase orders and delivery for customers outside the existing physical network would

potentially require additional investments, since the company would have to either work through a third-party logistics provider or build its own delivery network.

- ◇ *Develop an online mindset.* It is crucial for retailers to learn to think like e-tailers. When they maintain a brick-and-mortar perspective and see their online presence as merely an add-on, they will likely underestimate the potential rewards.

Companies without an active online strategy in China will be missing out.

Strategies for E-tailers

E-tailers, whether established or new, face tremendous growth potential as the e-commerce market is going to at least quadruple through 2015. They currently enjoy a window of opportunity to establish brand recognition, loyalty, and share before retailers build their own multichannel capabilities.

They must, however, determine the categories they want to participate in and the customers they want to target. Then they must effectively differentiate themselves from Taobao through innovative business models and address the unmet needs of specific groups of targeted customers. To this end, they will have to do the following.

- ◇ *Include unique product offerings.* For example, tap into product categories where Taobao has not yet established leadership, such as high-end fashion.

- ◇ *Think about targeted service.* It is important for e-tailers to consider how to offer different services to the growing numbers of both heavy and light spenders, as well as to those consumers who each year are joining the ranks of online shoppers.

- ◇ *Offer value propositions to merchants and brands.* While brands are selecting the channels where they will build their online presence, e-tailers must offer compelling value propositions—for example, a more customized consumer interface to help brands differentiate themselves from competitors.

In addition, e-tailers face an unusual need to distinguish themselves in the realm of logistics capabilities—from back-end warehouse and facility setup, to information and process-management capabilities, to last-mile consumer-facing services.

The e-commerce market in China is evolving both quickly and in its own particular way. The next five years represent a crucial period in the development of a young and exciting industry. Any company that fails to develop an active, targeted online strategy will not only miss out on a key opportunity for growth but will also allow brand identity to develop without its input on platforms such as Taobao. The ever-shifting dynamics of this industry require constant monitoring of the competitive landscape and of new consumer needs. Companies able to move proactively within that environment will be the winners in the crucial years ahead.



For Further Reading

The Boston Consulting Group publishes other reports and articles on China that may be of interest to senior executives. Recent examples include the following:

Dressing Up: Capturing the Dynamic Growth of China's Fashion Market

A Focus by The Boston Consulting Group, July 2011

Taking Off: Travel and Tourism in China and Beyond

A report by The Boston Consulting Group, March 2011

Big Prizes in Small Places: China's Rapidly Multiplying Pockets of Growth

A report by The Boston Consulting Group, November 2010

China's Digital Generations 2.0: Digital Media and Commerce Go Mainstream

A report by The Boston Consulting Group, May 2010

The Keys to the Kingdom: Unlocking China's Consumer Power

A report by The Boston Consulting Group, March 2010

Realizing the Multichannel Promise

A Focus by The Boston Consulting Group, July 2009

The Multichannel Imperative

BCG Opportunities for Action in Consumer Markets, September 2008



Note to the Reader

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