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# The Dragon Code

## The driving forces behind China's sustainable e-commerce growth

April 2017



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The growth of e-commerce in China is one of the country's biggest success stories. Chinese e-commerce accounted for almost US\$630 billion in sales in 2015, 80% higher than in the US. Currently 13.5% of all spending, e-commerce in China surpasses all major economies (except the UK<sup>1</sup>). What is notable to investors today is that the software and services industry, wherein a large percentage of e-commerce transactions take place, has an MSCI China weighting of 30% and annualized returns of 40.6% over the past five years<sup>2</sup>.

As bottom-up investors in Chinese equity markets, we utilize a selective approach to identify companies with sustainable leadership and growth. Given the importance of China's e-commerce, we will explore the key unique driving forces behind the sustainability of this growth. These include the near-monopoly status of industry leaders, a strong and widespread rural population with a trajectory in online spending, and creative logistics solutions to tackle the vast geography and fluctuating demand.

### **How did e-commerce gain prominence in China**

China's combination of an underpenetrated retail market, large geography and widespread Internet availability, has enabled the rapid growth of e-commerce. China has very little physical retail infrastructure compared to other markets - its top 100 retailers make up less than 8% of total retail spend compared with the top US 100 comprising 57%<sup>3</sup>. This means decreased reach across the nation due to the country's vast area and number of small cities. Developing a physical presence is both difficult and costly and this has paved the way for an abundance of 'Mom & Pop' stores. Access to internet infrastructure however has made it easier and more economical to set up online stores.

### **Near-monopoly status of industry giants spurs growth**

Many Western e-commerce giants struggle to penetrate the Chinese market - not only due to the firewall and other restrictions, but also their business models cannot be easily embedded. Industry domination comes from a few domestic firms who have adapted to the market's unique demands.

Alibaba, one of the world's largest e-commerce players, owns Taobao - a shopping marketplace for individual consumers and retailers. Similar to eBay but without the bidding, where sellers are able to post goods for sale, there are no fees for listing items, and revenue is generated by the sale of ads. Unlike eBay China and Amazon, Taobao doesn't charge for transactions or retain a portion of sales as commission thereby attracting loyal customers in the process. Its large number of merchants offers a wide range of products to users making it a destination for shoppers.

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<sup>1</sup> McKinsey iConsumer China 2016 Survey, April 2016.

<sup>2</sup> Invesco, Factset. Performance of MSCI China's Internet Software & Service Index, annualized over 5 years ended Dec 2016.

<sup>3</sup> Ecommerce Worldwide, as at May 10, 2016



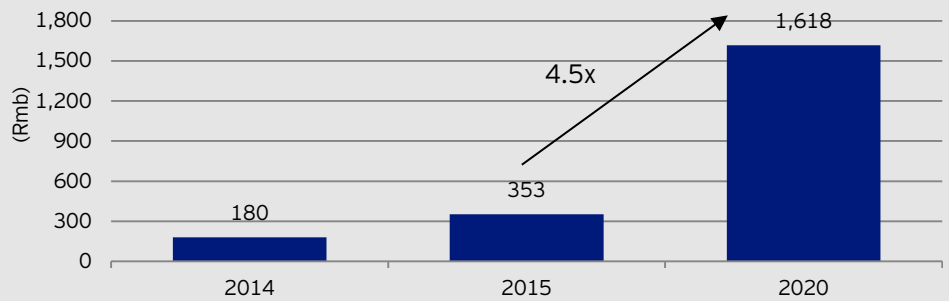
Taobao is a consumer to consumer (C2C) model and just one of Alibaba's core businesses. Tmall and Juhuasuan are two notable parts of the Alibaba family. Tmall is a business to consumer (B2C) sales platform for high-quality products and established brands while Juhuasuan is a group-buying platform for SMEs wanting to launch promotional sales. In our view, Alibaba's core businesses coupled with advanced logistics, cloud-computing, and product search services represents a complete and unique e-commerce ecosystem. Its seamless logistics operations, payment system, and near 24-hour online communication between buyers and sellers makes the firm a 'one-stop shop' for C2C, B2C, and group buys. Alibaba now holds approximately 80% of the e-commerce market share in China. Comparatively, Amazon has approximately 30% market share in the US due to online competition from independent merchants<sup>4</sup>.

**Rural population in China spends more online**

Online spending in China is growing in less-developed areas, with rural e-commerce comprising 9% of total online sales and forecast to increase over 4.5x by 2020<sup>5</sup>. Rural shoppers depend on e-commerce to access products and brands previously unavailable due to a lack of physical retail presence given the high costs of development across a vast geography. In addition, lower prices of everyday necessities such as clothing and the convenience of not having to travel long distances to the nearest mall are attracting increasing numbers of the rural population to online shopping.

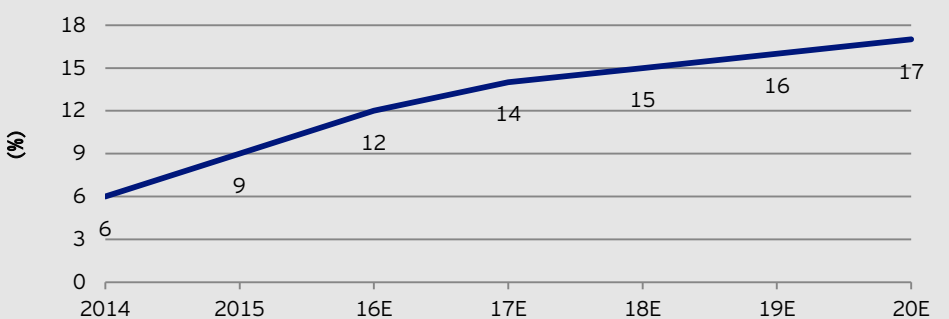
**Figure 1**

**Rural Online Sales**



**Figure 2**

**China rural gross merchandise value (GMV) % of total online sales**



Source: CLSA, as at Nov 2016

Rural populations spend almost as much online as populations in larger cities, despite having lower incomes on average. E-commerce activity in low-tier cities (3 and below) competes or surpasses that of high-tier cities (1 and 2), according to McKinsey's survey<sup>6</sup> (Table 1). Additionally, lower-tier cities have 74 million more online shoppers than those in higher tiers, as well as an estimated 160 million people yet to start shopping online. This represents great potential in terms of growth and investment.

<sup>4</sup> CNBC, May 5, 2016.

<sup>5</sup> CLSA, as at Nov 2016

<sup>6</sup> McKinsey iConsumer China 2016 Survey, April 2016. The survey sample consisted of 3,120 respondents, divided evenly between men and women and among five geographic categories (Tier 1 cities, Tier 2 cities, Tier 3 cities, Tier 4 cities, and rural areas). The respondents also represent a wide range of incomes and Internet-use levels.



**Table 1**  
**Low-tier cities spend more on e-commerce than high-tier cities**

	Tiers 1 and 2	Tiers 3 and 4
Share of national GMV <sup>1</sup>	49.9%	50.1%
E-commerce penetration <sup>2</sup>	89%	62%
Online shopper base	183 million	257 million
Online shopper growth	43%	61%

<sup>1</sup> Gross merchandise value.

<sup>2</sup> Of digital consumer age 13+

Source: McKinsey iConsumer China 2016 Survey, April 2016.

Major e-commerce platforms are investing heavily in customer acquisition and the creation of logistics networks in low-tier cities. Alibaba has established 16,000 village and 380 county-level service centers for deliveries and e-commerce activities since 2014<sup>7</sup>. The benefits of revisiting geographic strategies to take advantage of opportunities in rural areas for brands are clear. Top-tier cities are maturing in their e-commerce interaction and provide little room for growth<sup>8</sup>.

**Creative logistics solutions take on vast geography and fluctuating demand**

China has 143 cities with populations of over 1 million (compared to 10 in the US)<sup>9</sup>, and a daily package volume of approx. 57 million<sup>10</sup>, making logistics large and complex. E-commerce firms previously used in-house warehousing and delivery to control quality and service within networks. However to tackle the growing complexity, a unique and decentralized 'platform approach' has arisen. This strategy is horizontally integrated and asset-light, utilizing the capacity and capabilities of logistics partners while empowering systems through more efficient data and information sharing. This makes effective collaboration between providers, distributors, and warehouses possible across an expansive land area.

Cainiao Network, the logistics affiliate of Alibaba, offers real-time information to logistics partners through its platform, linking providers, warehouses, and distribution centers. This allows for optimized routes, the elimination of delivery errors through data standards implementation, provides distribution center utilization rates and even order volume forecasts to distributors. The network has also announced the introduction of the 'Cainiao Alliance,' which will incentivize other vendors to join the platform for real-time logistics information.

Efficiency is key - Alibaba has a GMV of US\$485 billion<sup>11</sup> with Cainiao's headcount of over 1,200<sup>12</sup> to handle logistics. Amazon comparatively has a GMV of US\$205 billion<sup>13</sup> and in the US alone, is looking to employ 100,000 full-time employees between Jan 2017 to mid-2018 on logistics along with other roles<sup>14</sup>. Today, almost 70% of all parcels in China are now delivered via Cainiao, which processes 600 million shipping information units per day<sup>15</sup>.

<sup>7</sup> SCMP, as at June 5, 2016.

<sup>8</sup> SCMP, as at June 5, 2016.

<sup>9</sup> Cainiao Networks, as at December 2014, according to National Bureau of Statistics in China.

<sup>10</sup> Cainiao Networks; 'daily package volume' refers to express courier package volume per Morgan Stanley Research Report 'China Logistics' dated April 21, 2016.

<sup>11</sup> Alibaba's China retail marketplaces GMV in US\$ in fiscal year 2016, as reported in Alibaba's Fiscal Year 2016 Annual Report.

<sup>12</sup> Headcount of Cainiao as at March 2016.

<sup>13</sup> GMV in 2015, according to Morgan Stanley research.

<sup>14</sup> Headcount as at December 2015, according to Amazon's 2015 Annual Report.

<sup>15</sup> Internet retail.com, as at March 2016.



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As the logistics becomes more mature, we observe the emergence of a wider service offering to improve user experience. Alibaba has introduced a grocery app and 1-hour delivery service through Tmall. Its primary competitor JD (Yihaodian) has 'virtual stores' on physical walls where consumers can scan the items they want and have them delivered at home. Logistics company SF Express and brick-and-mortar supermarkets such as RT Mart, part of Sun Art Retail, are tapping into the online grocery segment, drawing on their fulfilment capacity and offline presence. Sun Art Retail's e-commerce platform, Feiniu.com, commenced its online-to-offline (O2O) program in March 2015 with over 11 million registered members after a year. In December 2016, 78% of sales were made through their mobile app<sup>16</sup>. In travel, Chinese agency Ctrip is able to deliver tickets daily to customers within 24 hours. Creative logistics approaches in China are fuelling businesses to meet ever-changing consumer demand.

### **Conclusion**

Given the near-monopoly status of e-commerce leaders, a strong rural population spending almost as much as those in high-tier cities, and logistics solutions tackling the country's vast geography, we believe e-commerce will continue to grow in China and offer new opportunities for consideration. That said, despite the sustainability of China's e-commerce growth looking ahead, not all companies in this industry will prosper. We believe bigger companies with scale, reach and efficiency are likely to see continued and sustainable growth, while smaller players may be hard to catch up.

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<sup>16</sup> Sun Art Retail Group Limited, as at March 21, 2017.