What the **Experts Say?**

Ten Highlights of China's Commercial Sector 2017

January 2017

FUNG BUSINESS INTELLIGENCE

Secretariat, Expert Committee of China General Chamber of Commerce

10 Highlights of China's Commercial Sector 2017

01 Consumer market continues steady growth; strengthening role of consumption to drive economic growth

02 Government issues multiple policies to support circulation industry development and facilitate supply-side reform

03 Online retail sales growth decelerates; e-commerce players aim for new growth paths

04 Smart business models emerge; social networks become new marketplace for commerce

05 "New Retail Regime" sees emergence of new retail formats and business models

New

06 Lifestyle service sector proliferates; growth engine for the commercial sector

07 Building a trustworthy business credit system

08 Strengthening agricultural produce circulation; contract farming gains attention

09 New forms of business collaboration; outbound M&A activities prevalent

10 Financing through public listing; smart logistics bring new opportunities to logistics sector

Contents

Foreword

2016 marks the 15th anniversary of China's accession to the World Trade Organization in late 2001. Over this one and a half decade period, both the Chinese economy as well as China's commercial sector have undergone significant changes. Businesses can access new export markets and foreign companies can sell their products and services more easily to China's increasingly affluent people. The unprecedented growth of e-commerce and mobile commerce (or m-commerce), as well as the rapid advancement in technologies have and will continue to change the way companies operate their businesses as we move into 2017.

Thanks to the proliferation of digital devices and platforms, Chinese customers are more empowered and connected today than ever before, and will be even more interconnected in the future. This will provide new development opportunities for commercial enterprises to interconnect with consumers. But questions remain: who are the target customers and what do they require? How to reach out to and engage with customers? How to make them spend, and also spend more?

For the 14th consecutive year, Fung Business Intelligence and the Expert Committee of the China General Chamber of Commerce jointly present their Ten Highlights report to provide enterprises with a comprehensive, insightful view of China's latest commercial developments. Over successive years, the report has been an important reference point for global retailers, commercial enterprises and individuals aiming to understand the latest commercial trends and issues in China.

In this report, we present the Ten Highlights of China's commercial sector – the key trends identified by 170 top-tier experts in China's commercial sector – together with additional Fung Business Intelligence analysis – to draw key insights into China's commercial developments over the coming year.

We would like to thank all panel members on the Expert Committee of the China General Chamber of Commerce for sharing their insights. We also thank our colleagues at Fung Business Intelligence for their contributions and assistance.

Chang Ka Mun
Managing Director
Fung Business Intelligence

Teresa Lam
Vice President
Fung Business Intelligence

Lucia Leung
Research Manager
Fung Business Intelligence

About the Organizations

The Expert Committee of the China General Chamber of Commerce

The Expert Committee of the China General Chamber of Commerce (ECCGCC), a sub-division of the CGCC, comprises over 170 prominent experts from various government departments, research institutes and universities, leading corporations, professional associations, consultancy firms and newspaper offices, which include the Ministry of Commerce, the Chinese Academy of Social Sciences, China Chain Store and Franchise Association, the Development Research Centre of the State Council, the Renmin University, the Capital University of Economics and Business, and the Beijing Technology and Business University, etc.

The ECCGCC serves as a platform for the experts to exchange ideas on the development of commercial enterprises and the distribution sector.

The China General Chamber of Commerce

Founded in 1994, the China General Chamber of Commerce (CGCC) is a quasi-government association endorsed by the State Council. The CGCC has around 70,000 members, encompassing enterprises from retail, distribution, services and tourism sectors, local commercial chambers, national professional associations, intermediary organizations and individuals.

Commissioned by the Chinese Government, the CGCC consists of 14 committees, working on areas such as retailing, wholesaling, public relations and industry analyses, etc.; it also supervises 40 national associations, and over 30 newspapers and magazines published both inside and outside China.

Fung Business Intelligence

Fung Business Intelligence collects, analyses and interprets market data on global sourcing, supply chains, distribution, retail and technology.

Headquartered in Hong Kong, it leverages unique relationships and information networks to track and report on these issues with a particular focus on business trends and developments in China and other Asian countries. Fung Business Intelligence makes its data, impartial analysis and specialist knowledge available to businesses, scholars and governments around the world through regular research reports and business publications.

As the knowledge bank and think tank for the Fung Group, a Hong Kong-based multinational corporation, Fung Business Intelligence also provides expertise, advice and consultancy services to the Group and its business partners on issues related to doing business in China, ranging from market entry and company structure, to tax, licensing and other regulatory matters.

Fung Business Intelligence was established in the year 2000.

The Fung Group

The Fung Group is a privately held multinational group of companies headquartered in Hong Kong whose core businesses are trading, logistics, distribution and retailing. The Fung Group employs 45,100 people across 40 economies worldwide, with total revenue of over USD24.8 billion as of December 2015. Fung Holdings (1937) Limited, a privately held business entity headquartered in Hong Kong, is the major shareholder of the Fung group of companies.

Expert Panel Members

Cao Jintang
Deputy Secretary General
Expert Committee of the China General Chamber of Commerce

Cao Lisheng
Deputy Secretary General
China General Chamber of Commerce

Chang Ka Mun
Managing Director
Fung Business Intelligence, Li & Fung Development (China) Limited;
Vice Chairman
China General Chamber of Commerce;
National Committee of the Chinese

Chen Liping
Dean of the Department of Marketing, Professor
College of Business Administration, Capital University of Economics and Business

Deng Li
Deputy Secretary General
China General Chamber of Commerce

Fu Longcheng
Vice Chairman
China General Chamber of Commerce

Geng Hongzhou
Deputy Director-General
Department of Market Supervision, Ministry of Commerce of the PRC

Hong Tao
Professor
School of Economics, Beijing Technology and Business University

Hu Bin
Deputy Editor-in-Chief
China Business Herald

Lai Yang
Director
Institute of Commerce and Economics, Beijing Vocational College of Finance and Commerce

Li Tao
Deputy Director
Expert Committee of the China General Chamber of Commerce
Group Chief Representative – Northern China
Fung Business Intelligence, Li & Fung Development (China) Limited

Pei Liang
Secretary General
China Chain Store & Franchise Association

Qiu Zhongyi
Deputy Director
Department of Market Supervision, Ministry of Commerce of the PRC

Ren Xingzhou
Research Fellow, former Director-General
Institute of Market Economy, Development Research Centre of the State Council

Song Song
Deputy Director
Department of Market Operations and Consumption Promotion, Ministry of Commerce of the PRC

Song Ze
Research Fellow; PhD Supervisor
Institute of Finance and Trade Economics, Chinese Academy of Social Sciences

Teresa Lam
Vice President
Fung Business Intelligence
Li & Fung Development (China) Limited

Wang Bin
Deputy Director-General
Department of Market Operations and Consumption Promotion, Ministry of Commerce of the PRC

Wang Dong
Director
Department of Policy Research, China General Chamber of Commerce

Wang Qiang
Deputy General Manager
Youxinpai (Beijing) Information Technology Limited

Wang Shuiping
Associate Research Fellow
Institute of Consumption and Distribution, Chinese Academy of International Trade and Economic Cooperation, Ministry of Commerce

Wang Xiaodong
Professor
Department of Trade Economics, Renmin University of China

Xia Lin
Deputy Secretary General
China Chain Store & Franchise Association

Xing Heping
Deputy Director
Expert Committee of China General Chamber of Commerce

Yan Juyang
Co-Founder
Business Observer, Green Pomelo Cultural Media Limited

Yan Yanchun
Founder & Director
eFuture Information Technology Inc.

Yao Liming
Director
Zhongshang Commercial Center for Economic Research

Yi Shaohua
Director; Associate Research Fellow
Department of Circulation, National Academy of Economic Strategy, Chinese Academy of Social Sciences

Yu Di
Deputy Secretary General
Expert Committee of the China General Chamber of Commerce
Chief Editor
China Journal of Commerce

Zeng Lingtong
Vice President
International Business Management Group

Zhang Hao
Assistant Research Fellow
Department of Circulation, National Academy of Economic Strategy, Chinese Academy of Social Sciences

Zhao Tao
Deputy Director
Department of Circulation Industry Development, Ministry of Commerce of the PRC

Zheng Wen
Deputy Director-General
Department of Circulation Industry Development, Ministry of Commerce of the PRC

Executive Summary

01 Consumer market continues steady growth; strengthening role of consumption to drive economic growth

In 2016, China's economy faced persistent downward pressure against the backdrop of a more complex internal and external economic environment. That said, the Chinese government's efforts to push forward supply-side reforms and transform the economy into a consumption-driven economy have seen some positive results so far. China's economy is set to maintain its growth momentum in 2017. GDP growth is expected to grow at 6.7% yoy and retail sales to grow at 10.2% yoy in FY17.

02 Government issues multiple policies to support circulation industry development and facilitate supply-side reform

The government has promulgated several major policies to support the development of domestic trade and the circulation industry over recent years. Within the principle of supply-side reform (refering generally to the upgrade of quality outputs to accommodate an evolving demand pattern), the country's development themes of innovation, coordination, green development, openness and a shared economy will each play a crucial role in guiding the transformation and upgrading of the circulation industry.

03 Online retail sales growth decelerates; e-commerce players aim for new growth paths

After years of rapid growth, many online retail segments such as apparel and home electronics products have shown some signs of saturation. Players are now seeking to tap into new market segments and extend their offline reach. Additionally, they are finding new business practices in the hope of better meeting the needs of consumers. At the same time, the rural online retail market has become a particular growth engine with the near saturation of the urban online market. Some leading e-commerce players have increased efforts to expand their distribution networks in rural areas.

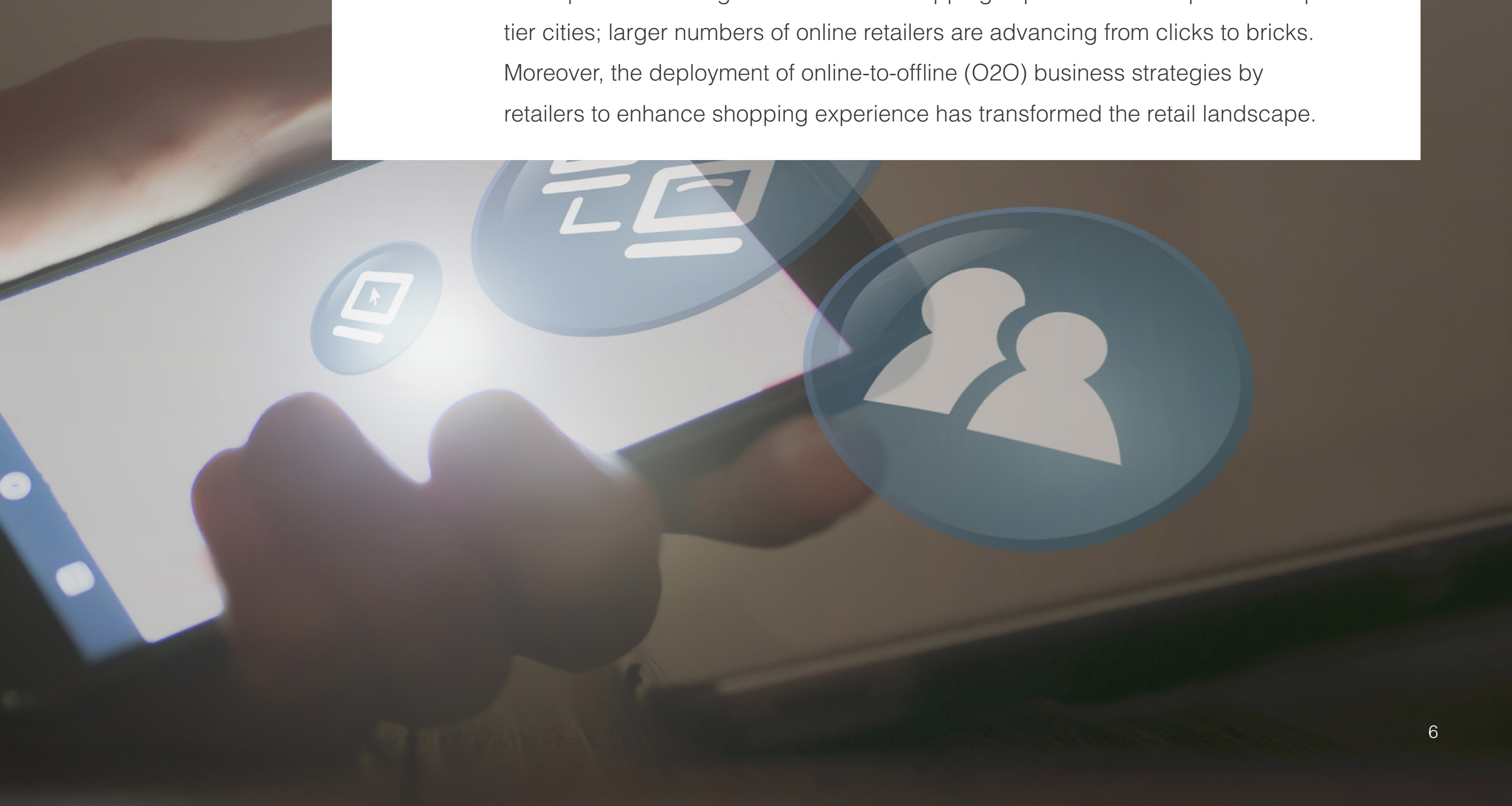
04 Smart business models emerge; social networks become new marketplace for commerce

In today's digitized world, the wide adoption of the mobile Internet and advanced technologies has facilitated the creation of new business models and innovative business practices. The adoption of virtual reality technology in business, the use of social media in the context of e-commerce and live streaming on social networks are examples. All these are set to revolutionize the ways enterprises operate their businesses.

05 "New Retail Regime" sees emergence of new retail formats and business models

New

China's retail market has seen a great deal of change as it entered a "New Retail Regime": An explosive growth of community-based small-format stores, dominated by convenience store chains, specialized stores, small-scale supermarkets and fresh produce grocery stores plus an increasing number of concept stores aiming to enhance the shopping experience have opened in top tier cities; larger numbers of online retailers are advancing from clicks to bricks. Moreover, the deployment of online-to-offline (O2O) business strategies by retailers to enhance shopping experience has transformed the retail landscape.



06

Lifestyle service sector proliferates; growth engine for the commercial sector

Thanks to the rapid development of e-commerce, booming O2O platforms and the rise of the sharing economy, the local lifestyle service sector in China have enjoyed impressive growth over the past year. Among the subsectors, the catering sector took the lead with mass dining being the key driver of growth. As well, the concept of O2O has evolved and extended to services beyond retailing. In particular, O2O food delivery, accommodation and housekeeping service industries have witnessed tremendous growth. These industries are expected to help push China's transition towards a more consumption-driven, service-based economy.

07

Building a trustworthy business credit system

China has witnessed extraordinary progress in economic development and commerce over several decades. Yet, exponential growth has also been accompanied by business malpractices. Food safety issues, corporate fraud, fake products, tax evasion, illegal crowdfunding, "brushing" orders on e-commerce platforms and raised prices before sale have drawn particular attention. Creating a sound, trustworthy business credit system will become a key government initiative in 2017.

08

Strengthening agricultural produce circulation; contract farming gains attention

China's "Internet Plus" strategy has substantially boosted the upgrading and transformation of agricultural circulation. The rise of rural e-commerce, in particular, offers a new distribution channel for farm produce. At the same time, agricultural production through contract farming, carried out according to prior agreement, has gained increasing acceptance as an innovative move and will continue to serve as a broad-based strategy for rural development.

09 New forms of business collaboration; outbound M&A activities prevalent

New forms of business collaboration and partnership emerged in China's commercial sector over 2016. To strengthen their industry positioning, increasing numbers of companies used mergers and acquisitions (M&A) to expand into related businesses. Many M&A activities appeared not only within the same industry but also between companies of different sectors, different channels and between traditional rivals. Additionally, China's "Go Global" strategy and "One Belt One Road" Initiative have prompted large domestic companies to seek overseas expansion through M&A. Both domestic and outbound M&A activities are set to remain prevalent in 2017.

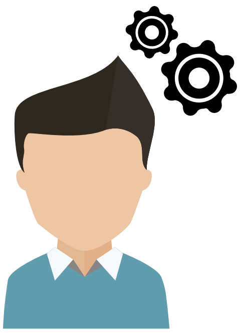
10 Financing through public listing; smart logistics bring new opportunities to logistics sector

China's logistics sector has entered a phase of transformation and upgrading in 2016. The integration of the express delivery market, in particular, has been expedited by M&A and restructuring, as increasing numbers of companies embrace capital markets. This trend will continue into 2017 and remain a strategic method for companies to expand their businesses. At the same time, the development of smart logistics and adoption of advanced technologies to improve operational efficiency and provide more high value-added services have become winning cards for the logistics sector.

Implications and Key Tips for Foreign Investors

2017 is set to be a transformative year for the commercial sector across the world. The global economy, international trade and financial markets face uncertain new prospects with the U.K.'s withdrawal from the European Union (or the "Brexit"), and a new U.S. President with different policies. This may, to an extent, affect investment incentives for foreign companies. But as reflected in this year's Ten Highlights, China's rapidly transforming commercial sector will provide ample opportunities for foreign investors. To tap this growth opportunity, foreign businesses have to stay on top of developments while also needing to find niche opportunities and stay nimble to take advantage of ever-changing consumer preferences. A more strategic approach to China entry and expansion strategies is advisable. Enterprises need to stay on top of developments and innovations.

Empowered consumers are in charge



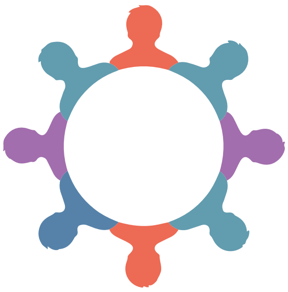
Today, customers, not companies, are driving business decisions. China's consumer market will continue to be driven by preferences of the rising middle class, particularly the growing, influential Chinese millennials (post-1980s, and post-1990s generations). Chinese millennials have different consumption habits, desires and viewpoints compared to their parents. They are connected, tech-savvy, mobile and socially fluid; they demand personalized products and services, and they find greater satisfaction in life experience, rather than static material possessions. They also have a strong desire for convenience and immediacy.

Winning players are those that can meet the needs of empowered Chinese customers – mobile, social, experiential, convenience-driven, personalized products and services. Enterprises have to connect seamlessly with customers across different channels while maintaining the overall customer experience.

Mobile, mobile, mobile

China is a mobile-first nation. There is no doubt that mobility is dominating the e-commerce market, with over half of all China's e-commerce sales are made with mobile devices. For small businesses and large enterprises alike, mobility is the latest frontier. Mobile-enabled e-commerce platforms and mobile apps with enhanced in-app functions are crucial. Today's connected customers not only use an app to look for product information or download discount coupons, but also use mobile devices to buy products in-store, make restaurant reservations, buy movie tickets, and make use of apps in-store. Enterprises should make sure their point of sale terminals and e-commerce platforms support mobile payment methods.

Go social



Social media is now an integral part of everyday life. Chinese consumers' deep involvement in social networks opens up huge opportunities for enterprises to leverage social media to engage with consumers, market brands and drive sales. The world of social media changes at an incredibly fast pace; advancement in technologies, together with enhanced mobile connectivity allows enterprises to come up with innovative marketing ideas and distribution solutions. For example, live streaming has emerged as an effective way for retailers to promote brands and sell products. It is also an excellent channel to increase band awareness, generate leads and create customer advocacy. Foreign enterprises need to be familiar with the functions and features of major Chinese social media sites and choose those that match their business and marketing needs.

Embrace O2O business models

For years, retailers have been evolving from single channel (offline only or online only) to multi-channel (separate online, offline and mobile channels) to omni-channel (integrated online, offline and mobile channels) operations, with the aim of delivering seamless and holistic customer experiences across all channels – in store, on the web, and on mobile devices – in real-time. A comprehensive O2O strategy, mobile-powered and social media-centric, is particularly important in China.

Forming partnerships with leading China Internet or e-commerce players is an accelerated way to embrace O2O practices. These players have established all-encompassing Internet and e-commerce ecosystems. More importantly, their services and products are already embedded in people's daily lives, from online shopping to payment to social networking to product delivery to O2O services, naming but a few. By leveraging third-party services, vast customer bases and real-time data, foreign enterprises can pursue O2O opportunities in the most timely manner.

Leveraging technology

The rise of e-commerce and digital disruption are having profound implications for the commercial sector. Competing on pricing or operational efficiencies alone will not be enough for a retail business to survive and stand out from competitors. Enterprises have to make the best use of digital technology to provide exceptional and dependable customer experiences, as well as higher engagement with their customers anywhere, anytime and by any possible means.

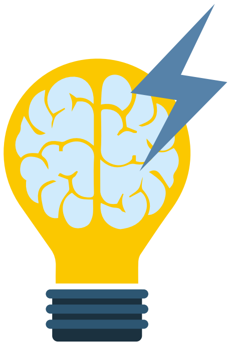
Embracing data and analytics

The use of big data is nothing new today. With the help of advanced technologies, accumulating large amounts of customer data is not a problem. Enterprises are collecting customer data via various means. Their key is to turn the right data into meaningful and actionable insights. So, enterprises need to find a way to analyze the ever growing disparate data and incorporate the analytics into their strategies. For instance, retailers could use data to perform in-depth analysis of the behavior of their customers and undertake proactive marketing, which could help them serve their best customers even better. Data also enable enterprises to deliver more targeted campaigns; this enables better customer segmentation.

Experience is King

Experiential retail is bigger and bolder. There will be more still in 2017, especially with the advancement of new technologies, such as virtual and augmented reality. In today's "New Retail Regime", characterized by the emergence of new retail formats and business models, convergences of online and offline business and new demand from empowered and connected customers, enterprises will have to offer seamless experiences at all touch points, based on a complete view of each customer. Enterprises will have to make use of the new technologies to fully engage customers and provide them with "wow" experiences.

Keep innovating or get left behind



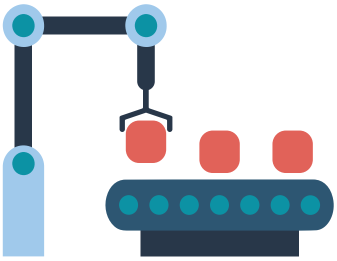
Innovation is a key theme in China's commercial sector; this is also a priority of China's 13th Five-year Plan. To keep pace with the rapidly evolving commercial landscape, foreign enterprises must constantly evaluate their business models and carry out format revamps and innovation to fit in with changing customer needs. They need to run their businesses in ways that are customer-centric rather than operation-centric. For instance, as Chinese consumers increasingly look for shopping convenience, large-scale retailers should consider setting up smaller-sized and more shopper-friendly stores. As consumers now view shopping as a leisure activity, brands and retailers need to offer "retail-tainment" experiences by adding fun and exciting to their physical stores to create memorable and unique shopping environments.

Look for blue oceans in new markets

China's large population, regional differences as well as rising consumer spending offer huge opportunities for foreign enterprises. New consumer demands have facilitated the growth of niche markets such as the rural, fresh produce and silver hair markets. These have grown rapidly and attracted increasing attention over recent years but have yet to be fully tapped by foreign companies. Cross-sector operations are gaining popularity in China. Enterprises should consider tapping into these growth markets to increase sales and expand their business scope.

Quality is always a competitive advantage

For most global brands and retailers, high-quality products and reputation offer them a huge competitive edge. Many Chinese consumers, especially from the younger generation, now value quality over price and are increasingly willing to pay premiums for better-quality products. Many favor foreign brands. Foreign companies should devote resources to constantly maintain product quality and ensure Chinese consumers know the origins of their products.



Put in place dynamic and digitized supply chains

In today's highly connected and digitized world where traditional brick-and-mortar companies are going online and pure-clicks are going offline, rigid supply chains no longer meet the changing demands of the marketplace. Digitalized supply chains that are nimble and flexible enough to adapt to the new demands are urgently needed – such as for O2O requirements for product assortments, inventory, warehousing requirements, product return processes, shrinking product cycles, personalized designs and new fulfillment options.

Convenience matters; strengthen last-mile delivery is key

Customers now want products as fast and as conveniently as possible, with some key Internet and e-commerce players such as Alibaba and JD.com promising delivery in under an hour in some cities. Some players continue to make huge investments in logistics infrastructure. Foreign enterprises should strengthen their "last mile" delivery capabilities and offer a wider variety of pick-up options and services such as pick-up lockers or partnerships with convenience or community stores to provide such pick-up services.

Keeping track on government policies

Over recent years, the Chinese government has issues a series of policies to support the development of domestic trade and the circulation industry. These policies all have the common goal of creating a better business environment for the industry. Foreign investors are advised to keep a close watch on the latest policy and regulatory developments so as to seize business opportunities and adjust their business strategies accordingly. This is particularly important in today's Internet-driven environment, requiring timely responses to changing needs of customers and business innovations.

01 Consumer market continues steady growth; strengthening role of consumption to drive economic growth

In 2016, China's economy faced persistent downward pressure against the backdrop of a more complex internal and external economic environment. That said, the Chinese government's efforts to push forward supply-side reforms (see Highlight #2 for details) and transform the economy into a consumption-driven economy have seen quite positive results so far. Our experts are optimistic that China can maintain its growth momentum in 2017.

> *The 19th National Congress of the Communist Party of China will be held in the second half of 2017. I believe the government will put greater emphasis on stabilizing economic growth. China's economy is expected to grow at 6.7% yoy in 2017."*
>
> *Cao Lisheng, Deputy Secretary General, China General Chamber of Commerce.*

Domestic trade: major developments in 2016

GDP growth was stable at 6.7% yoy in 1Q, 2Q and 3Q16

China's real GDP growth was 6.7% year-on-year (yoy) in 3Q16, equaling 1Q16 and 2Q16. In 1-3Q16, China's nominal GDP amounted to 53.0 trillion yuan, up 6.7% yoy in real terms. Our experts expect GDP growth in FY16 to be about 6.7% yoy. The Chinese economy has been growing steadily since the beginning of the year. The service sector has continued to grow at a faster pace than the secondary sector, with service sector value-added contributing 52.8% of China's nominal GDP in 1-3Q16, gaining 7.6% yoy in real terms in 1-3Q16. By contrast, secondary sector value-added increased 6.1% yoy in real terms over the same period. Meanwhile, the role of consumption in driving economic growth has been strengthening. Consumption made up 71.0% of GDP growth in 1-3Q16, 13.3 percentage points (ppt) higher than in the same period of 2015.

Retail sales growth and online retail sales growth moderated

China's nominal retail sales of consumer goods rose 10.3% yoy to 26,960 billion yuan in the period January to October 2016, growing 0.3 ppt lower than in the same period in 2015. By month, growth of consumer goods retail sales was stable at between 10.0% and 10.7%. Our experts expect retail sales growth in FY16 to be about 10.3% yoy. Online retail sales of physical goods were stable too, up only 24.9% yoy to 3,174.0 billion yuan in the period January to October 2016. Online retail sales of physical goods accounted for 11.8% of total retail sales of consumer goods, up 1.8 ppt from the same period in 2015. Still, the growth of online retail sales was faster than physical store sales growth by 16.7 ppt.

Growth of rural retail sales exceeded urban, but the difference narrowed

Rural retail sales have been growing faster than urban retail sales over recent years, but the difference narrowed in 2016. Rural retail sales rose 10.9% to reach 3,776.8 billion yuan in the period January to October 2016, 0.7 ppt lower than in the same period of 2015, while urban retail sales expanded 10.2% yoy to 23,183 billion yuan, 0.2 ppt down from the same period in 2015.

The faster growth in rural retail sales was partly attributed to higher rural household income growth. In 1-3Q16, per capita disposable income of rural households increased nominally by 8.4% yoy (or 6.5% yoy in real terms) to reach 8,998 yuan, while per capita disposable income of urban households rose 7.8% yoy in nominal terms (or 5.7% yoy in real terms) to reach 25,337 yuan.

Weaker retail sales of gold, silver and jewelry vs. stronger retail sales of building and decoration materials and furniture

Among all categories, only retail sales of automobile, petroleum and related products registered higher growth in the period January to October 2016 than in the same period of 2015. Retail sales of gold, silver and jewelry grew at their lowest pace in the period January to October 2016, registering -0.9% yoy growth, down 8.0 ppt from the same period in 2015. Sales of building and decoration materials and furniture, on the other hand, recorded the strongest growth among all categories. Sales of building and decoration materials went up 15.1% yoy in the period January to October 2016; and sales of furniture rose 13.5% yoy in the period January to October 2016.

Catering sales growth rose gradually; small catering enterprises saw higher growth

Growth of catering sales rose gradually in 2016. Nominal catering sales growth rose 10.9% yoy in the period January to October 2016, down by 0.9 ppt compared with the same period in 2015, and 0.6 ppt higher than total retail sales growth in the same period. O2O is still a trend to watch in the catering sector.

Meanwhile, small catering enterprises continued to perform well. Growth for catering enterprises below designated size and individual catering enterprises was up 12.7% yoy in the period January to October 2016, down 0.9 ppt from the same period in 2015, but higher than catering sales growth in general.

What the experts say ?

The 19th National Congress of the Communist Party of China (CPC) will be held in the second half of 2017, which will set out new directions for the future development of China. Our experts predict that the government will put greater emphasis on stabilizing economic growth in 2017, especially for investment and consumption. Our experts also highlight the following key points:

China's economy will face less pressure and see some improvements. The economy is expected to grow at 6.7% yoy in 2017. Domestic consumption will continue to grow steadily and make up a higher proportion of GDP growth. The circulation (or distribution) sector will play a more important role in facilitating economic growth. CPI is expected to rise moderately by 2.5% yoy, which will contribute to the stability of the consumer market. Total retail sales of consumer goods are expected to grow at 10.2% yoy in 2017.

Growth of household income will be stable. The government rolled out several initiatives in 2016 to raise incomes. For example, it increased the basic pension by 6.5% in 2016. Also, the government adjusted salaries of public institution employees. Additionally, in October 2016, the State Council announced the *Implementing Opinions of the State Council on Motivating Major Social Groups to Boost the Income of Rural and Urban Residents* following the proposal at the Fifth Plenary

Retail sales of large-scale retail enterprises slightly decreased

According to the China National Commercial Information Center, retail sales of 100 key, large-scale retail enterprises decreased 1.8% yoy in the period January to October 2016. Indeed, the performance of these large-scale retail enterprises was better towards the second half of 2016. Retail sales of 100 key large-scale retail enterprises increased 0.7% yoy in the period July to October 2016. On the other hand, small enterprises and individual enterprises have seen rapidly growing sales, contributing to the fast growth of mass-market consumption.

Session of the 18th CPC Central Committee to double urban and rural residents' per capita income between 2010 and 2020.

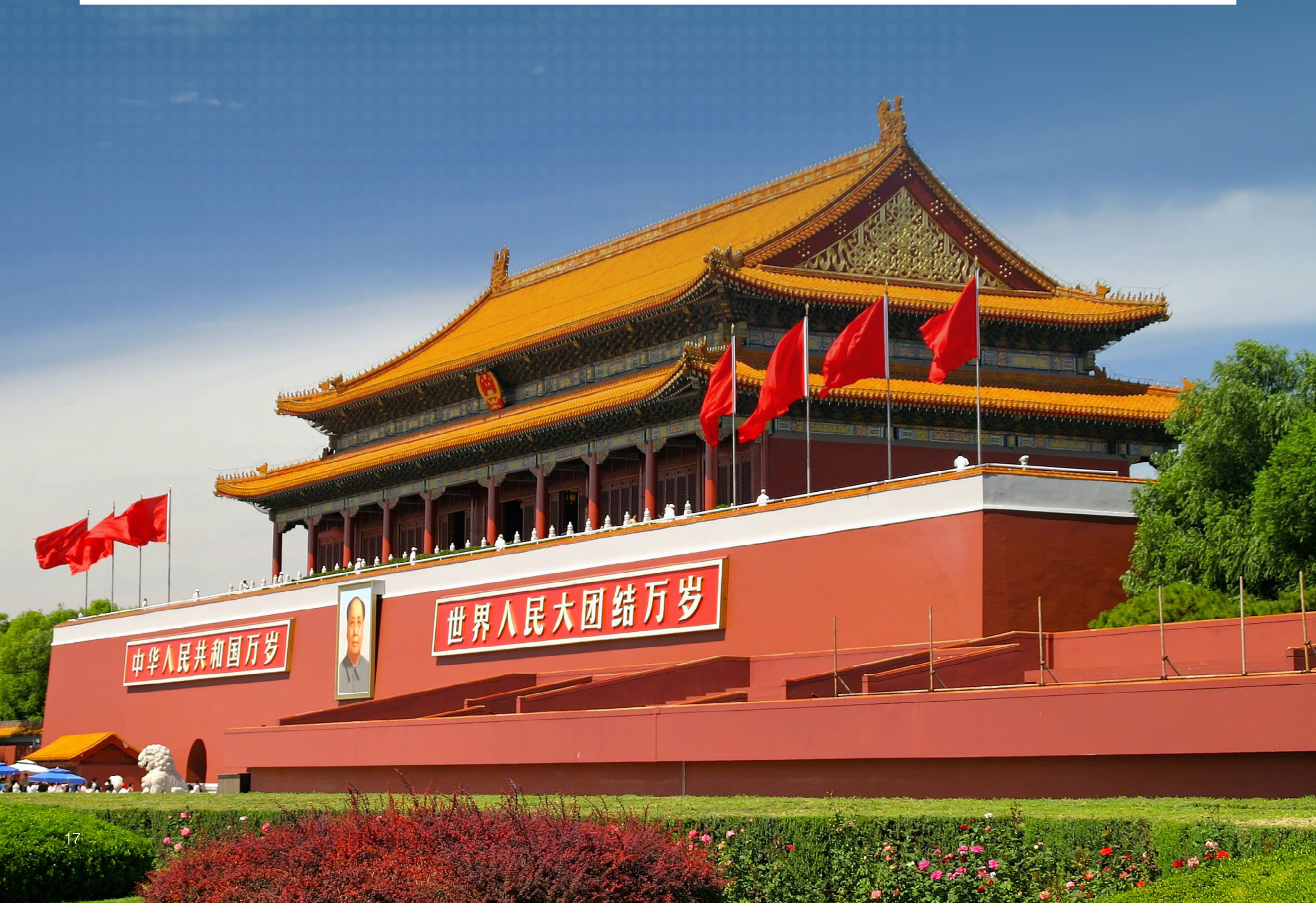
Reform of the retail and catering sectors will further deepen. More new retail formats and business innovations will emerge. Further segmentation of the retail sector is expected. Traditional large- and medium-sized retailers will focus increasingly on enhancing supply chain efficiency. Also, supply-side reforms will lead to greater choice and a better quality of products. Innovative marketing tools will emerge to draw customer traffic.

Investment will play a crucial role in stabilizing economic growth. Although China has been gradually shifting towards a consumption-driven economy, investment continues to play an important role in stabilizing economic growth. Growth of fixed asset investment rebounded in the second half of 2016, and is expected to stay at a similar or slightly higher level in 2017. The property market will probably grow at a slower pace in 2017 than in 2016 due to changing policies, but major fluctuations are unlikely.

02 Government issues multiple policies to support circulation industry development and facilitate supply-side reform

"Supply-side reform" is a buzz phrase in China. It was first used in November 2015 by President Xi Jinping who pointed out that the Chinese economy should be characterized by quality and efficiency under the "new normal". The term supply-side reform has also been underlined as the new development path for the country's 13th Five-year Plan, 2016-20. There is, as yet, no official definition of supply-side reform; but it refers generally to the upgrading of quality outputs to accommodate an evolving demand pattern.

The development of the circulation (or distribution) industry is a linchpin for supply-side reform. The circulation industry acts as an intermediary that links production and consumption, so it plays a crucial role in matching supply with demand. Supply-side reform, in turn, can accelerate reform and upgrading of the circulation industry, as well as support economic growth through new demand and productivity.



> *One of the major focuses of the MOFCOM in the coming year is to facilitate the upgrading and transformation of the traditional retail sector. Demand and supply optimization, business model innovation and sound administration are keys to the development of domestic trade and the circulation system."*

Zhao Tao, Deputy Director, Department of Circulation Industry Development, Ministry of Commerce of the PRC.

> *"The release of the 13th Five-year Plan for the Development of Domestic Trade and Circulation will bring about unprecedented changes to the circulation industry. I believe all these changes are positive and can guide the healthy development of the industry."*

Fu Longcheng, Vice Chairman, China General Chamber of Commerce.

Speeding up reforms in domestic trade and circulation system

The government has promulgated several major policies to support the development of domestic trade and the circulation industry over recent years. In November 2016, the Ministry of Commerce (MOFCOM) and 12 other government departments jointly released the *Opinions on Accelerating Domestic Trade Circulation and Innovation, Optimizing Supply-side Structural Reform and Improving Consumption*. The Opinions set out 13 tasks in four areas, including enhancing innovation capabilities, deepening the reform of the circulation system, adjusting the supply-demand mechanism, and optimizing the consumption environment. These expect to address the underlying issues that restrict consumption and develop experience for reform and innovation that can be expanded and popularized. Key tasks of the Opinions are summarized in Chart 1.

Chart 1: Selected major tasks of the *Opinions on Accelerating Domestic Trade Circulation and Innovation, Optimizing Supply-side Structural Reform and Improving Consumption*

- Intensifying efforts in information; pushing forward the "Internet Plus Circulation" Action Plan
- Encouraging business model innovation
- Supporting the integration of the circulation sector with various related industries
- Reforming the operations of the commercial sector
- Relaxing and abandoning various restrictions on operations
- Reforming taxation policies
- Optimizng regional planning
- Coordinating urban and rural development
- Strengthening and encouraging the use of advanced technologies
- Regularizing the consumption environment
- Improving consumption standards
- Enhancing the credit system
- Encouraging green consumption

Source: www.gov.cn; compiled by Fung Business Intelligence

Earlier, in August 2015, the government launched a comprehensive pilot program on the reform and development of the domestic trade and circulation system in nine cities, Shanghai, Nanjing, Zhengzhou, Guangzhou, Chengdu, Xiamen, Qingdao, Huangshi, and Yiwu. The pilot program aims to develop a number of replicable and scalable experiences and models in four areas, including innovation and development of the circulation industry, formation of a market regulation mechanism, infrastructure development and management reform, through a year's exploration of these factors. Chart 2 shows the major initiatives carried out in the nine cities. The year-long pilot program has been completed, and has produced the anticipated results. The next step is to push forward and promote the replicable pilot reform experiences and models nationwide.

Chart 2: Selected major tasks of the reform in domestic trade and circulation system in the nine cities

- Establishing a unified regional market mechanism
- Facilitating the transformation of offline businesses
- Accelerating the development of logistics infrastructure and facilities
- Fostering the upgrading of traditional markets
- Promoting integrated urban-rural development for the circulation industry
- Promoting openness and sharing in the circulation industry
- Focusing on legislation relevant to the circulation industry
- Establishing a new circulation management system
- Facilitating unification of domestic and foreign trade

Source: www.gov.cn; compiled by Fung Business Intelligence

"Internet Plus Circulation" provides impetus for innovation

In today's digital age, technological advances have facilitated the creation of a smart logistics distribution (circulation) system, which centers around three core areas, namely cloud computing (including big data), the Internet (including the Internet of Things or IoT), and terminals (including PC terminals, mobile terminals, wearable devices and head-mounted displays). Technology innovations, together with new management and business models, are key driving forces of competitiveness in the circulation industry. In April 2016, the General Office of the State Council promulgated the *Opinions on Implementation of the Action Plan for Internet Plus Circulation*. The Opinions specify the importance of "Internet Plus Circulation" in driving mass entrepreneurship and innovation while facilitating the transformation and innovative development of the circulation industry. Key focus areas of the Opinions are shown in Chart 3.

The 13th Five-year Plan for the Development of Domestic Trade and Circulation underpins supply-side reform

In November 2016, the MOFCOM and nine other ministries jointly released the 1*3th Five-year Plan for the Development of Domestic Trade and Circulation*, which sets out key tasks to guide the development of domestic

Chart 3: Key focus areas of the *Opinions on Implementation of the Action Plan for Internet Plus Circulation*

- Accelerating the transformation and upgrading of the circulation industry by leveraging the mobile Internet and advanced technologies; promoting the integration of online and offline business
- Developing innovative business models; encouraging the development of the sharing economy
- Supporting the construction of smart logistics and infrastructure facilities such as cold chain logistics facilities
- Encouraging the development of intellectual consumption; exploring artificial intelligence and developing intellectual products
- Creating a trustworthy environment for fair competition
- Rapidly developing rural e-commerce; facilitating the distribution of goods from urban to rural areas, and the distribution of farm products into urban areas
- Promoting green production and consumption
- Actively developing e-commerce in communities; encouraging cooperation of e-commerce companies and community stores
- Improving the administration of the circulation industry
- Setting up a development fund for "Internet Plus Circulation"
- Strengthening public services to support the development of the industry
- Establishing regulations, laws and standards for the circulation industry

Source: www.gov.cn; compiled by Fung Business Intelligence

trade and circulation in the next five years. The Plan is set to underscore supply-side reform, the *Internet Plus Circulation Action Plan* as well as strategies for upgrading and developing the circulation system. The Plan's major tasks include: promoting the innovative development of "Internet Plus Circulation", optimizing the supply structure and resolving supply and demand mismatching, promoting consumption upgrade, enhancing informatization of the circulation system, speeding up the standardization process for circulation, encouraging intensive growth and development, coordinating regional development, encouraging opening up and collaboration, and establishing a better-regulated business environment.

Meanwhile, the government is reportedly formulating the *China Circulation 2025 Action Plan*, which will focus on strengthening innovation and transformation, expanding new consumption areas, promoting entrepreneurship and employment as well as other related factors. The Action Plan is expected to provide greater impetus for the development of the circulation industry and stimulate economic growth.

Traditional retail formats accelerate reform

Over the years, traditional retail formats have faced myriad challenges, including slowing economic growth, rising operating costs, increasing competition from e-commerce players. Such retailers are in desperate need of transformation. To facilitate the innovation and transformation of physical retailers, the General Office of the State Council issued the *Opinions on Facilitating Innovation and Transformation of the Physical Retail Industry* in November 2016. The Opinions offer policy suggestions in such areas as adjusting commercial structuring, facilitating cross-sectoral collaboration, improving the business environment and strengthening policy support. Excessive inventory is also a major problem facing many brick-and-mortar retailers: supply-side reform calls for remediation of this issue.

Our experts believe that traditional retailers will be more rational in terms of expansion while emphasizing their focus on devising innovative business models and enhancing customer experience. More large supermarkets will open smaller-scale, boutique stores to cater to increasingly sophisticated and quality-driven consumers. At the same time, small format stores, chiefly specialty stores and convenience stores with precise and/or unique positioning, have gained popularity over recent years: they will accelerate expansion into urban communities as well as rural areas, while continuing to offer convenient consumer-related services.

What the experts say ?

The government released a number of major policies in 2015 and 2016 to facilitate the development of the circulation industry, underlining its importance in driving economic growth. Within the principle of supply-side reform our experts believe that the country's development themes of innovation, coordination, green development, openness and a shared economy will each play a crucial role in guiding the transformation and upgrading of the circulation industry.

That said, the ability of China's circulation industry to promote production and expand consumption still lags behind that of many other developed countries. Our experts point out that companies have to pursue innovative development by adopting appropriate strategies and improving the quality and efficiency of development. They also need to strengthen their determination to eradicate supply and demand mismatches by reducing unnecessary, excessive low-end supply and expanding mid- and high-end supply. Last but not least, it is also important for traditional retailers to speed up their pace of reform and place more emphasis on such areas as O2O integration, increasing the proportion of direct sales and reducing distribution costs.

03 Online retail sales growth decelerates; e-commerce players aim for new growth paths

After years of explosive growth, China has become the world's largest online retail market. That said, the growth of the online retail market has slowed over recent years. In 1-3Q16, total online retail sales of goods and services achieved 3,465.1 billion yuan, up 26.1% yoy. Online retail sales of physical goods reached 2,795.0 billion yuan, accounting for 11.7% of total retail sales of consumer goods. As shown in Chart 1, major categories including food and clothing recorded negative sales growth in 1-3Q16. Decelerating growth was due mainly to the online retail market's expanding base. As the market becomes increasingly competitive, it is harder for online players to compete solely on price as this may result in lower margins and continuous profit declines. Hence, many online retailers are shifting from competing on price to competing on services.

Chart 1: Growth of China's online retail sales, 1-3Q15 - 1-3Q16

Growth (% yoy)	1-3Q15	1-3Q16	Change (ppt)
Online retail sales of goods and services	36.2	26.1	- 10.1
- Online retail sales of physical goods	34.7	25.1	- 9.6
• Food	42.7	29.2	- 13.5
• Clothing	26.3	16.3	- 10.0
• Other commodities	37.7	28.3	- 9.4

Source: National Bureau of Statistics of PRC; compiled by Fung Business Intelligence

Rural e-commerce becomes the growth engine

The rural online retail market has become a new growth engine with the near saturation of the urban online market. In June 2016, the number of Internet users in the rural area rose to 191 million, accounting for 26.9% of the total Internet population. Rural consumers prefer shopping online because of the less developed retail infrastructure in rural areas, including shopping malls and department stores. The number of online shoppers in the rural area reached 92.5 million, according to China Internet Network Information Center. According to the *Report on China Rural E-Commerce Development (2015-2016)* by China International Electronic Commerce Center, rural online retail transactions reached 312 billion yuan in 1H16, and are expected to reach 647.5 billion yuan by the end of 2016.

The government has been very supportive towards the development of rural e-commerce. Following the announcement by the State Council of the *Guiding Opinions on Accelerating Development of Rural E-Commerce* in November 2015, the MOFCOM also released the *Notice on Specification of Services for Rural E-commerce (For trial implementation)* and the *Notice on Working Guidelines for Rural E-commerce (For trial implementation)* in July 2016. The government hopes that these policy guidelines can set the standards for and facilitate rural e-commerce development.

Indeed, the growth potential of the rural online retail market also relies critically on the development of rural logistics and infrastructure. In recent year, some leading e-commerce players have stepped up efforts to expand their distribution network in rural areas. For example, Alibaba has introduced a partnership program in rural areas. Some 20,000 partners were recruited to teach and help rural residents buy online. At the same time, JD.com has made substantial investment in rural areas to expand "last mile" delivery capabilities; for example, it has tested drone delivery services in some remote rural areas.

New market segments and new innovative practices

After years of rapid growth, many online retail segments such as apparel and home electronics products have shown some signs of saturation. Players are now seeking to tap into new market segments and extend their offline reach. Additionally, they are trying out new business practices in the hope of better meeting the needs of consumers.

Online grocery and fresh food market is the next wave

The online fresh food and grocery market is flourishing due to changing consumer purchasing habits. Leading e-commerce players such as Alibaba and JD.com have forayed into the online supermarket segment in recent years. For instance, Alibaba ventured into the supermarket segment in 2012 by launching its Tmall Supermarket. In July 2015, Alibaba invested over 1

billion yuan in Tmall Supermarket to improve product offerings and logistics efficiencies. It began offering same-day delivery and next-day delivery services to more than 340 mainland cities. In July 2016, Alibaba announced to offer 2 billion yuan worth of discounts and coupons to consumers, and earmark 2 billion yuan to upgrade the supply chain, product offerings and services. Foreign supermarket chains such as Metro and Inferno from Germany and Dia from Spain have made an early entry onto the Tmall Supermarket platform.

Additionally, JD.com has gained a foothold in the online grocery market by taking control of Yihaodian, an online grocery sales platform that Wal-mart took full ownership in July 2015. JD.com has taken over the Yihaodian brand, website and app, while Wal-mart will continue to operate the Yihaodian direct sales business and become a vendor on the Yihaodian marketplace. In exchange, Wal-mart has taken a 5% equity stake in JD.com by acquiring about 145 million shares in the e-commerce platform.

Particular attention has turned to fresh food products, with their higher margins and quicker turnover time. Large numbers of online grocery stores specializing in fresh food produce have emerged in recent years. In fact, leading e-commerce players such as JD.com, Tmall and Yihaodian (now under JD.com's control) have placed more focus on their fresh food business. For instance, JD.com established a new business unit dedicated to fresh food operations in early 2016. Apart from adopting a direct-sales model, JD.com has also invited third-party retailers to sell fresh food items on its platform, while its nationwide logistics and warehousing network provides strong impetus to its fresh food business. Additionally, JD.com has announced plans to further invest in cold chain logistics and build 20 cold chain warehouses to deliver fresh produce to 240 Chinese mainland cities.

It is noteworthy that the rapid growth of the online fresh food market has also brought challenges. Increased competition has resulted in market consolidation. A number of regional online fresh food stores were reportedly running into difficulty in 2016. Our experts believe that this trend will continue into 2017.

Online pharmaceutical market is gaining attention

China's online pharmaceutical market has huge growth potential as Chinese consumers are becoming more health conscious and demand a quicker service. However, pharmaceutical e-commerce has long been regarded as a hard nut to crack due to stringent government regulations. Changing government regulations also affect the development of the market. In July 2015, the China Food and Drug Administration (CFDA) launched a trial program for vendors to sell over-the-counter (OTC) drugs on third-party platforms for a trial period of one year. After the trial period has ended, the CFDA no longer allows vendors to sell on third-party platforms. Some players have adjusted their business model by only displaying the OTC drugs on these platforms, while the transaction is done cash-on-delivery offline.

Pharmaceutical companies operating in China have also been accused of being slow to embrace the Internet on their road to transformation. It was only until recently that more players, such as O2O platforms Dingdang Medicine Express and Kuaifang Songyao, have made some strides in the online pharmaceutical market. These O2O players have formed close relationships with offline pharmacies; when consumers order OTC drugs via their apps, the drugs are delivered to them soon after by the offline pharmacies. Dingdang Medicine Express claimed that it can complete delivery within 28 minutes, while Kuaifang Songyao provides a one-hour delivery guarantee.

Online players going offline

In 2016, increasing number of pure-clicks players expanded their offline presence through forming partnership with offline players. For instance in April 2016, Dangdang.com, China's largest online bookstore, partnered with Better Life Group to open its first physical bookstore Meixi College & Dangdang Meixi Bookstore. The bookstore is located at Better Group's shopping mall in Mexihu, Changsha city of Hunan province. With a floor area of around 5,000 sqm, the store displays around 40,000 different books and leverages data analytics to stock the right types of books that readers desire the most. The bookstore is open 24 hours a day and offers O2O lifestyle and cultural experiences. It features a café, art galleries and lecture rooms and offers various types of exhibitions and authors' sharing sessions. By forming a strategic partnership with Better Group, Dangdang can extend its reach to offline consumers without starting from scratch.

> *Online fresh food and pharmaceutical markets have "Internet Plus" DNAs. I believe these markets have huge development potential and are the 'blue oceans' of new market space."*
>
> *Wang Xiaodong, Professor, Department of Trade Economics, Renmin University of China.*

New digital marketing tools evolved

New digital marketing tools are also trending in China, particularly among mobile-savvy millennials who look for interactive, real-time content. Live streaming is a notable example. Tied closely with social media, the rapid development of live streaming is set to reshape the entire e-commerce landscape in China. Local and global brands as well as retailers increasingly leverage live streaming platforms to market or sell their products. A common approach is to hire popular Internet celebrities (also known as cewebrities) to host live streaming to market their products (see Highlight #4 for details).

Suning.com, for example, invited popular cewebrities and fashion buyers to hold live broadcasts on Suning App on its "Fashion Buyer Investigation" event in August 2016. In the same month, VIP.com also launched a live streaming program and invited a famous cewebrity to host and share tips with viewers.

Prior to the official launch of 2016 11.11 Global Shopping Festival (or the Singles' Day), Alibaba launched a key event – Tmall Global Fashion Show – to kick off the 2016 Singles' Day shopping festival. On 23 October, 2016, Alibaba live-streamed a "see now, buy now" fashion show via Taobao Live Streaming on Tmall, Youku, and Mobile Taobao, which attracted seven million viewers. Viewers were able to order the items displayed during the show in real time. Indeed, during the Singles' Day period, Alibaba launched a series of live streaming shows from 21 October through 11 November. Celebrities, cewebrities, KOLs, and athletes appeared on the shows. Alibaba hopes to create an environment that allows consumers to connect entertainment with shopping.

What the experts say ?

Amid the slowing growth of the online retail market, our experts urge e-commerce players to keep on innovating, other than solely offering heavy discounts. For instance, they should expand into different areas, explore new ways of marketing and leverage advanced technologies to penetrate the market and accommodate increasingly demanding consumers. Meanwhile, to stay competitive in the market, they should also constantly improve product quality, as well as streamline and upgrade business operations. The line between online and offline will continue to blur in the coming year. New business models backed by advanced technologies will be the keys to success.

04 Smart business models emerge; social networks become new marketplace for commerce

In today's digitized world, the wide adoption of the mobile Internet and advanced technologies in the commercial sector has facilitated the creation of new business models and new business practices. The term "Internet Plus Circulation" has become a trending phrase over recent years, and our experts expect that to continue into the coming year as well. In April 2016, the General Office of the State Council issued the O*pinions on Implementation of the Action Plan for Internet Plus Circulation* which specifies the importance of "Internet Plus Circulation" in facilitating transformation and innovation, opening up new consumption areas, and promoting entrepreneurship and employment. This has provided a sound basis for the development of "Internet Plus Circulation", and helped foster the creation of smart business models as well as innovative products and services.

> *Many e-commerce players and traditional retailers now place high expectation on VR technology, hoping that it can create a new breakthrough for commercial enterprises. VR technology is set to emerge as a powerful tool in selling and help facilitate the upgrading of shopping malls and department stores."*
>
> *Zeng Lingtong, Vice President, International Business Management Group.*

VR helps foster the creation of smart business models

2016 has marked the start of the Virtual Reality (VR) era in China. VR is a technology that uses a computer-simulated 3D environment to offer the user the virtual impression of a completely different place or situation to the one that they are actually occupying. The widespread use in China of the mobile Internet and smartphones has greatly facilitated the country's development of VR. According to iiMedia Research, the VR market in China is estimated to reach 5.66 billion yuan in 2016, and increase significantly to 55 billion yuan by 2020. A recent study conducted jointly by the State Advertising Research Institute, Chiming Consultancy and Mojing.cn showed that more than two-thirds of surveyed respondents aged 15 to 39 were highly interested in the technology

The Chinese government has been supportive towards the development of the VR industry. As specified in China's 13th Five-year Plan, VR is one of the emerging industries into which the government will put more resources, aimed at growth. In April 2016, the Ministry of Industry and Information Technology issued a White paper on VR, outlining its development prospects. The Ministry also set up a VR industry alliance in October 2016. Such initiatives have laid a solid foundation for the country's VR development.

Some large Internet and e-commerce players have strengthened investment in VR as well as its sister technology, augmented reality (AR), coming up with related initiatives or strategies. For instance, in March 2016, Alibaba set up a VR/AR technology lab, Gnome Magic Lab (GM Lab). The Internet giant also launched "BUY+" virtual shopping, rolling it out during Alibaba's 2016 11.11 Global Shopping Festival. More than 30,000 shoppers reportedly browsed the "BUY+" channel in the first hour of its launch. In October 2016, Ant Financial, Alibaba's financial service affiliate, showcased VR Pay, the first VR-based payment service in the world. Other Internet and e-commerce players have also launched their own VR strategies. Tencent has built a VR ecosystem, while JD.com has established a VR/ AR industry alliance with over 30 enterprises.

New breakthroughs in VR and AR technology also offer retailers the opportunity to transform how people shop. Increasing numbers of retailers have leveraged VR technology in their businesses. For example, Wanda Group set up its largest VR center in Beijing's Bird's Nest stadium in March 2016, and Suning announced in May 2016 that it aims to build 300 VR experiential centers across the nation. In October 2016, Hema Xiansheng, an O2O fresh food retailer, unveiled a VR experiential supermarket at China International Food Exposition.

Social selling is the next big innovation

The use of social media in the context of e-commerce is gaining traction in China. The booming mobile generations and accelerated growth of social media usage (see Chart 1) have fueled the growth of social selling, or social commerce (s-commerce). S-commerce combines product sales with consumer recommendations in a social network environment. It mainly targets users' own communities, usually their friends, who share similar interests and are able to influence others' purchasing decisions on social networks.

Increasing numbers of retailers or brands now use social networks to sell their goods. Some have set up their own micro-stores (also known as "Weidian"), while others have leveraged mobile s-commerce platforms such as WeChat, Weibo's Weimai, Weimob's Mengdian, and Koudai Gouwu to sell and market their products. According to the *Social Selling Industry Report* by Renren Inc., there were over 10 million micro-stores in China in 2016; indeed, the market for social selling is expected to reach over 1 trillion yuan by 2018.

In social selling, transactions are carried out through trusted relationships; so seller and customer bonding is a critical factor. Hence, social selling provides a fast and effective way for enterprises to reach out to their target audience and enhance customer loyalty. This sales mode also has the benefits of helping to clear excess inventory and reduce turnaround times.

It is notable that the business model for social selling is similar to that for pyramid selling schemes, of which the latter is illegal currently in China. Recently, a Guangzhou-based micro-store was accused by the State Administration for Industry and Commerce of Xianning city, Hubei province of operating a pyramid selling scheme contrary to the *Regulation on Prohibition of Pyramid Selling*. The company was fined 1.5 million yuan, in addition to confiscation of 39.5 million yuan worth of illegal revenue. The company's official WeChat account was also terminated.

Cewebrity economy gains popularity, and live streaming revolutionizes marketing

The term "cewebrity economy" is a buzz phrase that has emerged in China over recent years and is poised to achieve tremendous growth. According to Analysys, the market size of the "cewebrity economy" in China was estimated to reach 52.8 billion yuan by the end of 2016 and is set to increase to over 100 billion yuan by 2018. Cewebrities, or Internet celebrities, refers to people who

Chart 1: Fast facts on mobile and social media usage in China, as of June 2016	
People that have access to the Internet	710 million (51.7% penetration)
People that use mobile access to the Internet	656 million (92.5% of total Internet users)
Online shoppers	448 million (63.1% of Internet population)
Mobile online shoppers	401 million (61.0% of mobile Internet users)
Monthly active user accounts	
- QQ	899 million (up 7% yoy)
- Mobile QQ	667 million (up 6% yoy)
- WeChat	806 million (up 34% yoy)
- Weibo	282 million (up 33% yoy)

Source: China Internet Network Information Center; respective company websites; compiled by Fung Business Intelligence become famous on the Internet by providing product recommendations, beauty tips and other advice to their followers on social networks. Leveraging the power of fans on social media, many fashion cewebrities in China have set up online stores to sell fashion items. Some have even launched their own brands.

Recognizing the influencing power of cewebrities, some traditional brands and retailers have signed endorsement contracts with such individuals. A number of professional cewebrity agencies or incubators have also emerged. These incubators not only help maintain official accounts of cewebrities and help interact with their followers, but also operate online stores on their behalf.

One latest trend that is becoming popular with the growth of the cewebrity economy is live streaming on social networks. Live streaming platforms hosted by cewebrities are becoming a widely used marketing and distribution channel. Recently, more and more brands, retailers and e-commerce players have leveraged live streaming platforms to market or sell their products. Many have invited cewebrities to host live broadcasts.

Live streaming provides an effective way to build direct relationships with viewers. Unlike the traditional one-way communication mode, live streaming enables interactive, two-way communication. It also allows brands and retailers to provide consumers with more personalized products and better shopping experiences. During the 2016 11.11 Global Shopping Festival, Alibaba broadcast an eight-hour, interactive live fashion show on Tmall, Youku, and Mobile Taobao. Viewers not only were able to see the latest fashion brand collections, but also pre-order apparel and accessories from those collections. Several renowned international brands participated, such as Burberry, Maserati, New Balance, Guerlain, RIMOWA and Vidal Sassoon.

Live streaming is particularly useful to global brands or retailers without a physical presence in China, allowing them to engage directly with Chinese customers. For instance, U.S. department store chain Macy's launched a live streaming campaign in China, taking Chinese consumers on a virtual tour of its 34th Street store in Manhattan.

What the experts say ?

While our experts agree that the new business models and innovative distribution and marketing tools will revolutionize the ways enterprises operate their business, they also elaborate on these phenomena with the following comments.

First, there are challenges in VR development. It takes time for enterprises to configure their operations to accommodate the VR setting, not to mention the costs involved. Moreover, some users complain that they still encounter physical problems such as headaches, nausea and eye strain when they experiment with VR technology.

Secondly, large-scale consolidation is due to take place in the s-commerce market – faster and larger fish eat smaller fish, as the saying goes – with competition heating up. Meanwhile, to better regulate the development of s-commerce, the government is expected to develop new policy measures in the coming years.

Thirdly and finally, the "cewebrity economy" and live streaming will indeed continue to be invaluable marketing tools and distribution channels for brands and retailers over the coming years. But there are also challenges that lie ahead. Currently, there are too many live streaming platforms and the quality of their content varies. As well, Chinese consumers, especially millennials, constantly look for new and exciting online events and opportunities. To keep them loyal, it is important for cewebrities, brands, retailers and e-commerce players to frequently come up with fresh content and ideas, together with innovative products and services.

05 "New Retail Regime" sees emergence of new retail formats and business models

2016 was a year of change and reinvention: "Out with the old, in with the new", as the saying goes. Many store-based retailers – especially traditional ones with large physical stores – have striven hard to adapt to the new online reality by reinventing and transforming their business models and formats. The notion of retail transformation and innovation has been widespread throughout the market, and the deployment of online-to-offline (O2O) business strategies has become a key survival tool for China's retail sector. On the merchandising front, we see numerous new attempts at experimentation afoot to inject excitement in stores. At the same time, retailers have also been working hard to upgrade and renovate their supply chain systems through technological solutions.

A "New Retail Regime" comes into play: new retail formats and concepts emerge

In 2016, China's retail market witnessed an explosive growth of community-based small-format stores, dominated by convenience store chains, specialized stores, small-scale supermarkets and fresh produce grocery stores. Aiming to embrace the "convenience" mind-set of shoppers, who seek speed, convenience and friendly services, traditional retailers (particularly hypermarket and supermarket operators) have been shifting their focus towards smaller stores. For instance, METRO China has announced plans to massively expand its convenience stores under the MyMart brand while Carrefour's boutique supermarket, Easy Carrefour, has gained overwhelming popularity after experimenting with 10 stores in Shanghai in 1H16. Carrefour planned to open a further 40 such stores by the end of 2016.

At the same time, a large number of small-format grocery stores specializing in fresh and packaged foods have emerged in the market over recent years. Examples include Fresh-China, a supermarket offering fresh produce; CXS, a fresh produce store chain; Ledazui, a specialty snack store; Pagoda, a fresh fruit franchise store chain; LPPZ, a snack food chain store; Xianfeng Fruits, a fresh fruit chain store, Guoduomei, a fruit supermarket chain, and snack food store chain Laiyifen. These smaller-sized stores are usually located in communities to provide localized shopping convenience.

Additionally, an increasing number of concept stores aiming to enhance the shopping experience have opened recently in top tier cities such as Shanghai, Nanjing and Beijing. One example is Brookstone. Founded in the U.S., the retailer was acquired by Sanpower Group in 2014. It offers new retail concepts and trade categories for a fun, interactive shopping experience. Apart from opening standalone concept stores in shopping malls, Brookstone opened in-store shops at Sanpower's Funtalk Communications locations in Beijing and Shanghai, a move understood to represent a cross-sectional integration initiative by Sanpower Group.

Another example that showcases the emergence of a new store format is Suning which opened its first community O2O convenience store in Nanjing in 1H16 to better serve the urban community there. In addition to selling grocery products, the store features a dining area, an O2O experiential zone, a full-service area and a parcel collection counter. It also provides other value-added services such as home management as well as repair, pre-order and last-mile delivery services. The O2O convenience store facilitates the integration of Suning's online store (Suning.com) and offline stores by serving as a front end warehouse for the online store. Customers can place orders through the Suning app and take delivery within one hour, with orders dispatched from the store. As at 3Q16, there were five Suning convenience stores in operation.

Experiential shopping: more than just a store

Another significant trend under the “New Retail Regime” is for more retailers to leverage Internet technologies, to increasingly offer experience- and lifestyle-driven opportunities attracting Chinese consumers. Physical stores are no longer just places for selling goods but also venues providing a combination of artistic, cultural, social and entertainment elements. Redbaby, one of the largest Chinese B2C online retailer that sells maternal and children’s products, is a case in point. Each of Redbaby’s physical stores has dedicated a large floor area for parent-child activities, kids’ education and other activities. To further enhance the customer shopping experience, Redbaby has also set up different scenarios which resonate with customers’ daily lives. Yet another example is the Sasseur Cayman Holding’s outlet in Chongqing, creating a mix-and-match theme of western luxury and Chinese agrarian culture, integrating lifestyle, sport, leisure and cultural elements into the outlet.

O2O is here to stay

Retailers embracing O2O strategies set a key trend in last year’s *Ten Highlights of China’s Commercial Sector.* Indeed, O2O remains relevant under the “New Retail Regime”. In contrast to the past, O2O in 2016 saw an increasing number of e-tailers from different segments advancing from clicks to bricks. They aim to offer shoppers the convenience of e-commerce with the instant gratification of physical shopping. For instance, China’s largest online bookstore, Dangdang, opened its first brick-and-mortar store in Changsha in April 2016. Online nuts and snack retailer, Three Squirrels, also opened its first offline experiential store in Anhui in September 2016. Apart from providing customers with interactive shopping experiences, these experiential stores also seamlessly integrate the companies’ online and offline businesses, from merchandize to pricing and payment, warehousing and delivery services.

Remarkable cases: new retail formats and concepts

Funtalk

Unlike typical mobile phone chain stores that focus heavily on merchandise, 3C retailer Funtalk's 600-sqm-store in Beijing has incorporated entertainment, interactive and cutting-edge technologies, family life elements and play areas. Funtalk has successfully enlivened customers with memorable and pleasant shopping experiences through innovative products and interactive gaming. To enhance sales and operational capabilities, Funtalk captures customer data via O2O initiatives, games and other experiential services.

Hema Xiansheng

Hema Xiansheng, an O2O fresh food retailer which received investment from Alibaba Group, is often seen as a model company for innovation in the supermarket sector. Its unique O2O business model seamlessly integrates its mobile app and physical stores, shaping the future direction of the transformation and upgrading of the supermarket sector. Hema Xiansheng has deployed omni-channel and membership scheme strategies, with global sourcing of products directly from local suppliers to ensure premium quality, uniqueness and lower pricing of its merchandise. Its new physical concept store opened in December 2016 and largely increased the proportion of food and beverage to around 50% of total store area. Its cross-sector operation – hybrid formats of supermarkets and restaurants, supermarket and department store, supermarket and entertainment venues – is a new breakthrough in the traditional supermarket sector.

Hema Xiansheng's innovative practices include:
1) Accepting Alipay as the only means of payment to promote cashless shopping; 2) Same merchandise and pricing online and offline; 3) Adding more experiential elements and services in the physical stores; 4) Enlarging inventory volume at physical stores to support its "buy online, delivery from store" service; 5) Direct control and ownership of logistics services and promise a delivery time of no more than 30 minutes within five kilometers.

Simple Style

Simple Style is another O2O retailer which formed strategic alliances with Alibaba Group. It is among the best examples of Alibaba's advocacy on a "New Retail" concept. Positioned as a cross-sector O2O select shop featuring around 60 different "Tao-brands" (the Internet brands of Taobao), first physical stores have gained huge success since opening in Chengdu in September 2016.

The shop features a large variety of fashion and lifestyle products, including apparel, cosmetics home textile and decorations, books, high-tech gadgets, digital electronics, tea products, fresh flowers, and other products.

Simple style's innovative practices include: 1) Leveraging big data of Alibaba to select the most popular brands and styles of products to place at shop, so as to reduce inventory risk and improve cash flow; 2) Using big data and location-based technology for customer segmentation, and to identify the preferences of targeted customers and allocate a larger floor area to the most preferred products; 3) Having in place agile and nimble supply chains with high emphasis on sourcing efficiency and can support ample product categories and SKUs, small batch of production and fast replenishment (i.e. fewer inventory); 4) Creating a venue for Tao-brands to showcase their new collections at physical store and broadcast online through live streaming band; 5) Placing large digital screens in-store to allow online shopping via QR code scanning.

What the experts say ?

The “New Retail Regime” is set to continue to impact China’s retail sector in 2017. Our experts highlight the following points:

Polarization of retail

Our experts believe that in 2017, brick-and-mortar retailers will further be polarized in terms of store size. Large format stores will further expand to include more experiential elements and gain larger physical footprints, while small format stores will remain in close proximity to shoppers to provide them with personalized products and services. Further enabled by technologies, physical stores will become new social gathering places and touch points for social connection and interaction.

Small-scale services-oriented retail stores continue to flourish

Chinese consumers value convenience now more than ever. Smaller-sized stores that are closely connected to shoppers provide a large range of services to meet their daily needs, from daily consumables to value-added services such as bill payment, ticketing, cash withdrawal and parcel collection; they will continue to prosper. Broad adoption of mobile Internet and advanced technologies allow stores to become digitalized: they are equipped with touch-screen facilities, virtual product shelves, LED display and mobile payment facilities, among other facilities.

> *"I believe that in the near future, the winning formula for retailers will be based on three key criteria – 'zero lag-time,' 'zero distance' and 'zero inventory' . Many smaller-sized shops are testing the waters and gauging market responses; convenience stores and smaller-scale supermarkets will become the focus and new battleground under China's 'New Retail Regime'."*
>
> *Lai Yang, Director of Institute of Commerce and Economics, Beijing Vocational College of Finance and Commerce.*

Supermarket sector to spearhead the O2O realm

In terms of O2O, our experts believe the supermarket sector will become "the icebreaker" along the road towards a new retail regime in 2017. Differing from other retail sectors such as home appliance and department stores, the supermarket sector has a relatively mature warehousing system and a high proportion of direct merchandize sales with greater control over merchandize and profit margins. Moreover, the market is not yet saturated, leaving room for new capital and investment. Hence, the supermarket sector is likely to take the lead and enjoy better development prospects in the new O2O-oriented retail regime.

Government commits support to the development of "New Retail"

The government has been supportive towards the development of new retail ecosystems. In November 2016, the State Council issued the *Opinions on Facilitating Innovation and Transformation of the Physical Retail Industry*. The Opinions provide guidance for facilitating cross-sector collaboration and integration. Physical retailers are encouraged to deploy technologies to achieve O2O integration and adopt new business models to meet new market demand. Such government policies, coupled with the proliferation of mobile Internet and technologies , data analytics, modern logistics and cloud computing, should propel the "New Retail Regime" to create a more advanced retail scene in China over the coming year.

06 Lifestyle service sector proliferates; growth engine for the commercial sector

The lifestyle service sector has a direct bearing on people's everyday lives. The rapid development of e-commerce, the booming O2O platforms and the rise of the sharing economy have all opened up opportunities for the local lifestyle service sector. Driven by the diverse needs of consumers, the O2O concept has penetrated various segments and has extended from O2O for retail businesses to lifestyle services. According to iResearch, the gross market value (GMV) of the local lifestyle service O2O market in 2015 totaled 879.7 billion yuan, and is expected to exceed 1.6 trillion yuan by 2018.

The local lifestyle service sector in China includes eight subsectors, namely, catering, accommodation, housekeeping, massage and spa services, laundry, hairdressing and beauty, portrait photography, home appliances repair and related services. It has enjoyed impressive growth over the past year. Total sales receipts of the local lifestyle service subsectors in 2015 increased by 9.2% yoy, 0.9 percentage point higher compared to 2014. Among these, the catering sector took the lead with 51.8% of market share in 2015 (totaling 2.46 million enterprise units) and 53.6% in terms of total gross revenue (reaching 2,237.5 billion yuan), according to data from the Ministry of Commerce.

> *“Consumers’ rising discretionary spending power and increasing pursuit of a higher quality of life will continue to fuel the demand for localized lifestyle services. The localized lifestyle service sector is set to see huge development prospects in the coming year.”*
>
> *Fu Longcheng, Vice Chairman, China General Chamber of Commerce.*

Catering sector outperforms the market, mass dining drives momentum

Despite a slowing economy under the “new normal”, the catering sector maintained double-digit growth and outperformed the retail market in the past year. According to the National Bureau of Statistics, China’s retail sales of consumer goods for the first 10 months of 2016 increased nominally by 10.3% yoy. Catering revenues in the same period enjoyed a faster growth rate of 10.9% yoy to reach 2,910.5 billion yuan; catering enterprises’ income of those above a designated size rose 6.0% yoy to 740.9 billion yuan.

Mass dining was a key trend mentioned in last year’s *Ten Highlights of China’s Commercial Sector.* As a continuing trend in 2017, mass dining is still the most popular catering sub-sector and the key driver of the catering sector. Mass catering does not mean low-end dining but “best value” dining providing a wide variety of product choice, great tastes and affordable prices. Along with consumption upgrades, consumers’ preference is inclining towards a health conscious and wellness trend. Restaurants that encompass healthy diets, safe, organic and green culinary are becoming increasingly popular.

Online catering sees great potential, O2O food delivery business the catalyst

The robust development of O2O models has bolstered the online catering business. According to iResearch, the gross merchandize value (GMV) of China’s O2O catering market increased by 45.0% yoy to 161.6 billion yuan in 2015, accounting for 5.0% of the whole catering market. This is expected to rise to 289.8 billion yuan by 2018. At the same time, online food ordering apps have seen the fastest growth among all mobile applications. According to the China Internet Network Information Center, from December 2015 to June 2016 the number of online food ordering users in China grew from 113.5 million to 149.6 million, up 31.8%.

In particular, e-commerce catering platforms that provide group-buying catering and O2O food delivery services witnessed the highest growth over the past year. Currently, Meituan, Eleme, and Baidu Waimai are the top three players in the market. According to Meituan-Dianping’s food delivery data, Meituan’s total sales increased three-fold in 1H16, as compared to the same period in 2015. In July 2016, total orders received amounted to over 4.5 million. Fast-food delivery – especially branded fast food chains – showed outstanding growth.

To compete with online catering enterprises, many traditional catering service providers have already reinvented and started online businesses. Meizhou Dongpo Restaurant is a case in point. Established in 1996 in Beijing, it is a large-scale restaurant group with outlets spanning nationwide in China. In view of the growing trend of online catering services, the restaurant has launched special meal sets that are tailored to online takeaway orders and it created its own O2O food delivery app “527” to offer door-to-door food delivery services with purchases over 100 yuan.

Despite the rapid popularization of O2O food delivery services, food safety and quality issues remain huge. According to a nationwide consumer survey conducted by the China Consumer Association in November 2016, seven major problems for O2O food delivery were revealed: 1) failure to meet hygiene standards; 2) illegal operation without business licenses; 3) problems with food packaging; 4) failure to deliver on-time; 5) poor customer services; 6) no cancellation of orders; 7) no official receipts to customers.

O2O food delivery involves online ordering, food preparation and production, packaging, distribution and delivery, payment, after-sales service. Any problems happen in the process will affect the consumer experience. Improvements on food quality, efficient delivery and overall customer experience become the core directions for the O2O food delivery industry to transform and upgrade.

Accommodation and housekeeping: new chapters for O2O lifestyle services

The O2O concept in China was seen as a new form of retail model and strategy for retailers and brands to integrate online and offline resources in the past. But the concept has evolved and extended to services beyond retailing. It is regarded as an important trend that is imperative for the socio-economic development of society. In particular, accommodation and housekeeping service industries have rapidly

What the experts say ?

Our experts believe that the lifestyle service industry will play a significant role in China’s supply-side reform, tightly bound up with all aspects of daily life. The reform’s emphasis on cutting overcapacity and increasing effective supply implies the provision of more consumption-related services directly related to lifestyle questions such as catering, accommodation, education and housekeeping. This will further push China’s transition towards a more consumption-driven, service-based economy.

Lifestyle service companies can seize a large share of the market by providing comprehensive experience to impress consumers, especially millennials (also known as post-1980s and post-1990s generations). They are typically more digital-savvy and discerning on service quality, convenience and experience. O2O services companies that can master consumer habits and deliver services promptly on doorsteps may excel. They can strive to provide consumers with a truly integrated experience throughout their entire developed since 2015. The traditional accommodation industry has actively embraced O2O as a powerful tool to upgrade and transform. Many companies have ventured online via e-commerce platforms such as Ctrip, Meituan and Elong. Social selling on social media platforms and WeChat stores has also changed the traditional sales and marketing approach of the accommodation industry. On the other hand customers' changing needs have resulted in development of new hotel formats, including boutique hotels, themed hotels, short-term property rental, and rural lodges. These new formats reportedly accounted for 44.2% of the market share of the accommodation industry in 2015.

Similarly, the housekeeping service industry has also entered a new O2O era. With the implementation of O2O initiatives, the industry has taken a great leap forward to streamline operational procedures, optimize human resources and reduce costs. Many traditional housekeeping companies have established online platforms, or ride on third-party services platforms to effectively match demand and supply.

During a discussion with deputies to the 12th National People's Congress from East China's Shandong province on 6 March, 2016, Premier Li Keqiang said: "Do not underestimate housekeeping services and elderly caregiving services. These are sunrise industries … they have been transformed into new kinds of business formats under the "Internet Plus" strategy, and become new growth engines to drive the economy." So, the housekeeping service industry is set to be a major focus in O2O lifestyle services.

shopping journey – from product research, to purchase, payment, delivery and after-sales.

Our experts urge the government to issue systematic policy measures to promote the development of the lifestyle service sector and to encourage more people to enter the industry, in tandem with industry trends. The healthy future of the industry will be highly important to the entire socio-economic development of China.

07 Building a trustworthy business credit system

China has witnessed extraordinary progress in economic development and commerce over several decades. At the same time, exponential growth has also been accompanied by business malpractices. Food safety issues, corporate fraud, fake products, tax evasion, illegal crowdfunding, "brushing" orders on e-commerce platforms and raised prices before sale are among just some of the malpractices carried out in the commercial sector. E-commerce, in particular, is often susceptible to such malpractices in the Internet-driven marketplace. A sound, trustworthy business credit system is needed to improve online credibility while facilitating commercial sector growth.

> *The establishment of a trustworthy business credit system is crucial for the development of the commercial sector. It is one of the major initiatives of the Ministry of Commerce in 2017."*
>
> *Qiu Zhongyi, Deputy Director, Department of Market Supervision, Ministry of Commerce of the PRC.*

E-commerce: a breeding ground for fake products and fraud

China's e-commerce market has experienced mushrooming growth over the years; yet, fake and shoddy products remain a serious problem. Sales of cosmetics products online is one example. According to China's State Administration for Industry and Commerce, over 40% of cosmetics products sold online are counterfeit. The Korea Consumer Agency reported that fake Korean cosmetics products in China have hampered distribution of genuine products there. Most fake products are sold through online stores (55.8%), social media (23.8%) and small-scale cosmetics specialty stores (13.2%).

Fake orders form another prevalent malpractice in the e-commerce space. Numerous e-tailers reportedly create fake orders, or "brushing" as it is called in China, to boost sales and raise their ranking on online marketplaces. A typical "brushing" process involves merchants paying brushers the product cost plus a fee. The brusher then acts as a regular customer and places an order online; the merchant will ship an empty box to the brusher to complete the transaction. The brusher then writes a positive review online to benefit the merchant; by inflating positive ratings and reviews, the merchant is able to attract more customers.

Concerted effort to curb unfair and illicit practices

In recent years, the government has made considerable efforts to improve online credibility and curb unfair and illicit practices. But government regulations alone are not enough to effectively regulate the market; leading e-commerce platforms also need to take responsibility to ensure their vendors' credibility.

Government increases effort to improve regulatory regime and combat counterfeiting

The government has launched a series of legislative measures to better protect the rights of consumers and create a fair and better-regulated environment for the e-commerce sector. The Ministry of Commerce says it has launched a series of measures to facilitate healthy development of e-commerce over recent years. It issued the *Provisions on the Procedures for Formulating Transaction Rules of Internet Retail Third-party Platforms*, with effect from April 1, 2015. The Provisions specify that when a third-party platform operator formulates or revises its transaction rules, it must elicit public comment on these in a prominent position on it's website home page, and ensure relevant stakeholders fully understand the rules and can express opinions in a timely manner.

Furthermore, the State Council set up a task force in 2014 to combat IP infringement as well as the manufacture and sale of fake products. Headed by Vice Premier Wang Yang, and comprising more than 30 ministries and government departments, the task force has achieved positive results in areas such as strengthening supervision of key websites and online marketing platforms, punishing companies that infringe regulations by facilitating the sharing of interdepartmental and cross-regional information and cooperative law enforcement.

Prior to Alibaba's 2016 11.11 Global Shopping Festival, the National Development and Reform Commission together with seven other ministries and departments jointly released the *Action Plan for Implementing Joint Enforcement and Punishment System for Conducting Fake Orders in E-commerce and Shared Economy Arena*. This action plan calls for all such ministries and departments to work closely to strengthen supervision of online sales platforms and ensure companies that submit fake orders – as well as their legally-appointed representatives – receive appropriate punishment. The action plan also encourages e-commerce players, logistics companies and other relevant parties to cooperate in sharing information.

E-commerce players take part in information sharing and facilitate the building of an e-commerce credit system

In October 2016, eight e-commerce players, Alibaba, Tencent, JD.com, 58.com, Didi Chuxing, Baidu's nuomi.com, Qihoo360 and SF Express, signed a joint agreement to share information in order to combat online fraudulent practices. The companies will jointly establish a data-sharing platform to facilitate blacklisting of entities that have committed trade fraud. This is an open platform; all e-commerce players are welcome to join. As of mid-October 2016, 32 provincial level e-commerce entities have reportedly joined the data- sharing platform and linked up with 37 ministries. A total of 1,500 complaints about companies engaged in illicit practices were reported, involving some 190,000 companies.

What the experts say ?

Building trust is no easy matter in China. The lack of a sound, credible business credit system, an imperfect law enforcement mechanism and an immature market are among major challenges that need to be overcome.

Our experts believe that the creation of a business credit system will be a major step forward in 2017, as a result of increasing efforts by the government, e-commerce platforms and related trading partners to fight infringement in the digital age. Moreover, the draft *China E-commerce Law* has been completed; our experts expect that upon implementation the *China E-commerce Law* will better regulate the industry and further improve the regulatory regime, while encouraging industry self-discipline. More importantly, as online and offline retail becomes ever more closely connected in the "New Retail Regime", the *China E-commerce Law* will provide a level playing field for brick-and-mortar retailers and e-commerce players.

08 Strengthening agricultural produce circulation; contract farming gains attention

China's 13th Five-year Plan specifies that agriculture is "the foundation for building a moderately prosperous society in all aspects and to achieve modernization". Against this backdrop, restructuring circulation in the agriculture sector is key. In fact, implementation of the government's "Internet Plus" strategy substantially boosts upgrading and transformation of agricultural circulation. The rise of rural e-commerce, in particular, offers a new distribution channel for farm produce. At the same time, agricultural production through contract farming, carried out according to prior agreement, has gained increasing acceptance as an innovative move.

> *Rural e-commerce development will take a great leap forward in 2017. "Internet Plus Agriculture" will help facilitate transformation in the agricultural sector"*
>
> *Qiu Zhongyi, Deputy Director, Department of Market Supervision, Ministry of Commerce of the PRC.*

Rural e-commerce facilitates sales of farm produce; "Internet Plus Agriculture" to flourish

2016 has been a fast growing year for rural e-commerce. Recognizing increasing saturation in the urban e-commerce market, e-commerce giants like Alibaba, JD.com and Suning Commerce have stepped up efforts to form "going rural" strategies. They have set up village-level and county-level service stations across the country to support farmers and rural households to sell products online, as well as provide delivery services in rural areas. By the end of 2015, there were reportedly 250,000 such service stations across 1,000 counties in China; some 1,311 "Taobao Village" clusters (consisting of online countryside entrepreneurs who opened stores on Taobao) were in operation by August 2016, creating over 840,000 job opportunities. According to the Ministry of Commerce, there are more than one million companies and stores selling rural products online; the annual transaction value is estimated to exceed 220 billion yuan in 2016.

Despite the rapid growth of rural e-commerce, some experts have pointed out that this market still faces challenges in logistics, payment systems and product diversity while suffering from low standardization. "Last mile" delivery is also a major issue in rural areas. Only a limited number of large e-commerce players have set up nationwide logistics networks able to provide acceptable services to rural customers. Moreover, high logistics costs also hamper the development of rural e-commerce, while the development of cold chain logistics in rural areas lags far behind cities.

Our experts believe the advent of "Internet Plus Agriculture" will propel the agricultural sector into considerable transformation in 2017. Companies or distributors selling only fresh agricultural or processed agricultural products are set to give way to companies that embrace the "Internet Plus" strategy and the Internet of Things (IoT). Those that leverage the Internet and advanced technologies will provide specialized and personalized services such as express delivery in rural areas and offline experiential shops to display selected products. Popularization of the Internet in the agrarian sector is expected to nurture the growth of entrepreneur-driven companies and facilitate development of large-scale companies.

Contract farming sees rapid development

Contract farming is a result of China's industrialized agricultural initiatives. It has made significant progress since emerging some 20 years ago. Contract farming involves agricultural production through agreement between farmers or affiliated farmers' cooperatives and buyers (usually large companies). Farmers commit to producing a given product in a certain quantity. Often, buyers provide farmers with technical assistance, seeds, fertilizers, and other inputs on credit while offering a guaranteed price for the output.

This type of demand-driven production provides the standard to manage the production process with greater precision, so avoiding excessive production and eliminating waste of resources. Indeed, local governments realized the potential of contract farming in transforming the agricultural sector and raising farmers' incomes; some have been urging local companies to work cooperatively with farmers in this regard. For example, Huocheng county, northwest of the Ili River in northwestern China, views contract farming as a guiding principle for its rural development. A company in that county has reportedly signed more than 300 farming contracts, hoping that these will help speed up the county's rural development and enhance farm produce quality. Wenhenzhen in Liancheng County, Fujian province has also encouraged local food processing companies to work collaboratively with farmers and adopt contract farming.

Contract farming is not without challenges; there are potential disadvantages and risks. Breaches of contract are common problems in China. Examples include a farmer selling the same products to different buyers, or a company refusing to buy products at the agreed price. Uncontrollable factors such as natural disasters will also result in failures to fulfill contracts. The existence of a sound legal framework and system of law is therefore crucial for the successful implementation and long-term sustainability of contract farming operations.

Upgrading traditional wholesale agricultural markets

Traditional wholesale agricultural markets play a significant role in the circulation of agricultural produce. Currently there are over 4,000 such markets across China, while more than 80% of farm produce is sent to distributors or consumers via these markets. However, many wholesale markets comprise only individual farmers and small-scale companies. They are somewhat disorganized and facilities tend to be backward. Most wholesale markets have no cold chain facilities to store or process farm produce, so products spoil easily. A lack of modern logistics facilities, advanced technologies and sound management systems not only affect product and service quality but also hinder wholesale market upgrading.

The rise of e-commerce and changing needs of customers have increasingly posed a threat to traditional wholesale agricultural markets. Many suffer losses and some have even ceased operation. In view of this, increasing numbers of wholesale markets have started to upgrade. Many have opened online platforms to complement physical operations. Some have set up online stores while others have chosen to partner with e-commerce players or online platforms that conduct online fresh food businesses. At the same time, some wholesale agricultural markets have sought to expand into new areas. Beijing's Shenghua Honglin Oil and Grain Wholesale Market is a case in point. It extended its scope of operation in 2016 by opening a new wholesale market for fresh fruit and vegetables.

What the experts say ?

"Internet Plus Agriculture" is set to become a key theme for the sector in 2017. Our experts believe that China's agriculture sector will adapt to greater change and flourish over the coming years thanks to "Internet Plus" strategic implementation. The development of rural e-commerce will not only help boost entrepreneurship and employment, but also facilitate circulation as more traditional wholesale agricultural markets go online and embark on e-commerce.

Equally, our experts think that contract farming provides another viable way for China to modernize its agricultural system and improve rural incomes. This enables farmers and farming households to turn into active market participants, in contrast to the passive production units typical of the planned economy. Contract farming will continue to serve as a broad-based strategy for rural development. To further harmonize supply and demand in the agriculture sector, the government is increasing efforts to support the development of different types of agricultural organization, including farmer cooperatives and agricultural enterprises, while encouraging them to form cooperative relationships with farmers.

09 New forms of business collaboration emerge; outbound M&A activities prevalent

New forms of business collaboration and partnership emerged in China's commercial sector over 2016. To strengthen their industry positions, increasing numbers of companies used mergers and acquisitions (M&A) to expand into related businesses. Many of these M&A activities appeared not only within the same industry but also between companies of different sectors, different channels and between traditional rivals (see Chart 1 & 2).

At the same time, China's "Go Global" strategy and "One Belt One Road" initiative have prompted large domestic companies to seek overseas expansion through M&A (see Chart 3). Through acquiring well-established overseas brands, Chinese companies could adopt advanced technologies, brand-building know-how and strategic repositioning opportunities.

Chart 1: Selected major M&As in China's commercial sector, 2016

Date of announcement	Bidder company	Target company	Deal Value (USD million)	Remark
11 Jan	Mogujie.com	Meilishuo.com	n/a	• The two Internet companies merged to form a new company (valued at around USD 3 billion) by means of stock swap (valuing Mogujie.com at twice Meilishuo.com). • Tencent Holdings, a shareholder of Meilishuo.com, increased its stake in the new company.
5 Apr	Maoye International Holdings Ltd.	Inner Mongolia Victoria Commercial (Group) Ltd.	225	• Acquired 70% share of target company.
2 Jun	Taobao	Suning Commerce Group	4,280	• Taobao became the second largest shareholder of Suning with a stake of under 20%.
5 Jul	Alibaba Group	Wandoujia	200	• Alibaba Group merged with Beijing-based Wandoujia, a major Android app store. • Wandoujia would be incorporated into Alibaba Group's mobile business unit.

Source: Internet resources; compiled by Fung Business Intelligence

Chart 2: Selected major business alliances in China's commercial sector, 2016		
Date of announcement	Companies involved	Features/ objectives of collaboration
20 Jun	• JD.com • Wal-mart	• To better serve consumers across China through a powerful combination of e-commerce and retail. • JD.com will take ownership of the Yihaodian marketplace platform assets, including the Yihaodian brand, website and app. • Wal-mart will continue to operate the Yihaodian direct sales business and remain a seller on the Yihaodian marketplace. • Wal-mart received nearly 145 million newly issued JD.com Class A ordinary shares, amounting to about 5% of total shares outstanding.
18 Jul	• Internet Plus Holdings Ltd. ("Meituan-Dianpin") • China Resources (CR) Enterprise Alliance Fund	• CR Enterprise Alliance Fund, a consumer-focused fund established by China Resources, has invested an undisclosed sum in Meituan-Dianping, China's leading online-to-offline (O2O) services platform. • Retail stores controlled by China Resources, including CR Vanguard, Suguo Supermarket, Tesco LeGou, Ole, Vango Convenient Stores, Pacific Coffee, CR Care, etc., will explore cooperation with Meituan-Dianping's online food delivery platform via Meituan, Meituan Waimai, and Dazhong Dianping mobile apps.
26 Jul	• Gome Online • Feiniu.com	• Gome Online will introduce the proprietary brand Feiniu.com on its platform. • Feiniu.com will sell Gome's electrical appliances in its Home Appliances channel. • The two parties will become strategic suppliers for each other and share resources such as information systems capabilities, sales data and inventory.
19 Aug	• JD.com • Tencent	• Tencent increased its holdings of JD.com's shares from 15% in March 2014 to 21.25%, making it JD.com's largest shareholder.
2 Sep	• Yum! Brands • Ant Financial Services Group • Primavera Capital Group	• Ant Financial Group and Primavera Capital Group invested a total of USD 460 million in Yum China.
4 Oct	• JD.com • Wal-mart	• Wal-mart increased its stake in JD.com from 5.9% to 10.8% of shares, which gave Wal-mart an observer status at JD.com's board meetings.
23 Oct	• Wal-mart • New Dada	• Wal-mart invested USD 50 million in New Dada, a fresh produce O2O e-commerce platform. The investment is an extension of Wal-mart's broader partnership with JD.com. • New Dada will offer its customers two-hour delivery for groceries ordered from Wal-mart stores through the JD Daojia Dada application.

Source: Internet resources; compiled by Fung Business Intelligence

Chart 3: Selected major China outbound M&A, 2016

Date of announcement	Bidder company	Target company	Country of target company	Industry of target company	Deal value (USD million)	% of stakes acquired
11 Jan	Wanda Group	Legend Pictures LLC	U.S.	Entertainment	3,500	100%
15 Jan	Haier Group	General Electric Co-Appliance	U.S.	Home appliances	5,400	100%
2 Feb	Chem China	Syngenta AG	Switzerland	Agribusiness	43,000	100%
17 Feb	HNA Group	Ingram Micro Inc	U.S.	Technology	6,067	100%
3 Mar	AMC Entertainment (of Wanda Group)	Carmike Cinemas	U.S.	Entertainment	1,200	100%
14 Mar	Anbang Insurance Group Co.	Strategic Hotels & Resorts Inc.	U.S.	Hotel	6,500	100%
30 Mar	Midea Group	Toshiba Lifestyle Products & Services Corporation	Japan	Home appliances	473	80.1%
6 Jun	Suning Commerce Group	Inter Milan	Italy	Soccer	307	70%
21 Jun	Tencent Holdings	Supercell Oy	Finland	Technology	8,600	84%
12 Jul	AMC Entertainment (of Wanda Group)	Odeon & UCI Cinemas Group	U.K.	Entertainment	1,210	100%
30 Jul	Giant Interactive Group Inc.	Playtika Ltd.	Israel	Entertainment	4,400	100%

Source: Internet resources; compiled by Fung Business Intelligence

> *The pace of domestic and outbound M&A is set to accelerate in 2017. Cross-sectoral M&A and strategic partnerships involving traditional brick-and-mortar companies and pure-clicks will become a norm."*
>
> *Song Ze, Research Fellow, Institute of Finance and Trade Economics, Chinese Academy of Social Sciences.*

Integration of physical entities and e-commerce businesses intensified

Retailers' eagerness to pursue digital transformation amid an O2O push has resulted in more partnerships between offline and online companies. For traditional retailers, forming strategic alliances with e-commerce companies will help them further transform and upgrade. The strategic alliance of Wal-mart and JD.com in June 2016 is a case in point. Their strategic partnership signified a move of offline and online retailers to leverage on each other's competitive advantage to cooperate in various areas including e-commerce, logistics, and O2O initiatives. Through a powerful combination of e-commerce and retail, Wal-mart could leverage JD.com's online customer base and extensive same-day delivery network; while JD.com could benefit from easy access to a wide range of new and imported items from Wal-mart and Sam's Club. Another example of partnership between traditional retailer and Internet company is the strategic cooperation of China Resources and Meituan-Dianping in July 2016 to jointly develop a new business model of "Internet Plus Retailing" on Meituan's takeaway platform. In view of the buoyant e-commerce market, it is expected that domestic M&A and strategic partnerships between traditional retailers and Internet companies will become more frequent in the coming year.

National and regional champions using M&A to open up new territory

In recent years, increasing numbers of large Chinese corporations such as Alibaba Group, Wanda Group, China Resources, and JD.com have formed business partnerships with other leading companies to expand their business territory. In many cases, these big conglomerates were involved in mega M&A deals worth more than a billion yuan. For example, in April 2016, Maoye International Holdings purchased Inner Mongolia Victoria Commercial (Group) Ltd. for 1.5 billion yuan; in June 2016, Taobao acquired 1.861 billion shares from Suning Commerce Group for 28.2 billion yuan. For large-scale regional companies, successful regional M&As allowed them to gain market share and consolidate their position in their respective industries.

Outbound M&A witnesses dramatic growth

On account of a plethora of favorite macro factors, including better regulatory and financial environment, and companies' pursuit of long-term and sustainable growth, China outbound M&A activities reached a record high in 2016. According to PricewaterCoopers (PwC), there were 671 China outbound M&A deals in the first three quarters of 2016 with transaction volumes reaching around 1.1 trillion yuan, doubling that in full year 2015. Outbound M&A activities had the following distinctive features:

Private enterprises took the lead

Unlike the past where Chinese state-owned companies, especially conglomerates, dominated outbound M&A activities, such activities in 2016 saw the involvement of more private and listed companies. These companies have set their sights on becoming market leaders globally; M&A could be a feasible means to achieve their goals. According to PwC, the first three quarters of 2016 saw 449 outbound M&A deals initiated by Chinese privately owned companies, roughly five times higher than state-owned companies.

More cross-sector M&A deals

Notably, outbound China M&A deals in 2016 were not confined to horizontal integration, which involves the acquisition of additional businesses within the same industry, but also stretched beyond the existing business boundaries towards cross-sectors. Suning Commerce Group's acquisition of Italian soccer club Inter Milan for US$307 million in June is a case in point. In taking over Inter Milan, Suning hoped to create a global sports empire stretching from soccer clubs to online broadcasting.

Technology, consumer-related and media & entertainment industries attracted biggest dollars

In the past, the majority of outbound M&A deals mostly occurred in the sectors of mining, energy and natural resources; in 2016, large numbers of outbound M&A deals spanned various other sectors. Technology, consumer-related and media and entertainment industries are among popular industries that have attracted Chinese investors. Some prominent examples include Chinese household appliance firm Haier Group's acquisition of the U.S.-based General Electrics' iconic home appliance business; Dalian Wanda's merger with the world's leading media company Legend Pictures, LLC; and Tencent's pursuance of the Finland-based technology company Supercell Oy.

What the experts say ?

Our experts expect both domestic and outbound M&A activities to remain prevalent in 2017. Domestically, companies are expected to continue to face lower margins amid the challenging business environment under the "new normal". To opt for new growth engines and gain a firmer foothold in the market, they will actively explore M&A and strategic partnership opportunities. More cross-sectoral collaborations and online and offline integration of capital is expected.

In December 2016, the Ministry of Commerce and six other government departments jointly released the *Guidance on Strengthening International Cooperation and Raising Chinese Industries' Position in Global Value Chains.* The Guidance proposes to further encourage Chinese companies to combine the "Go Global" and "Bring Back" strategies, promote international cooperation, actively explore new routes for expansion and construct innovative global value chains. Our experts believe that the Guidance will further heighten Chinese enterprises' awareness of the importance of participating in global value chains. Both vertical and horizontal expansion of enterprises towards full value chains through outbound M&A is to be manifested by a wider scope and perspective in the coming year.

10 Financing through public listing; smart logistics bring new opportunities to logistics sector

China's logistics sector has enjoyed rapid growth in terms of market size and new service offerings in 2016. Thanks to the unprecedented growth of e-commerce and consumption upgrading, demand for e-commerce logistics, in particular, has increased dramatically. Total logistics value for the first 10 months of 2016 reached 187.2 trillion yuan, up 6.1% yoy. The express delivery market also saw total volume growth of completed deliveries increase by 54.2% yoy to 24.1 billion pieces in the same period, according to the State Post Bureau. Alibaba's 11.11 Global Shopping Festival (or the Singles' Day) in 2016 fully reflected how e-commerce and logistics, especially express delivery, are closely intertwined. To enhance competitiveness, many key e-commerce players, including Alibaba, JD.com, VIP, Suning.com, and GOME have stepped up efforts to enhance "last mile" logistics capabilities. Additionally, increasing numbers of brands and retailers now sell their products in their own "Weidian", or micro-store on social media platforms. This has further driven demand for logistics services.

In 2017, we expect to see four major trends for the China logistics sector.

> *China's logistics sector has entered a phase of transformation and upgrading. The integration of express delivery market will be expedited by mergers and acquisitions and restructuring, as more and more companies are embracing the capital markets."*
>
> *Song Song, Deputy Director, Department of Market Operations and Consumption Promotion, Ministry of Commerce of the PRC.*

A burst of IPO listings among leading Chinese private express delivery companies

In 2016, a number of key domestic express delivery players went public either in China or overseas as a means of business expansion. Significant examples include IPO listings of Alibaba-backed YTO Express on the Shanghai Stock Exchange and Shanghai-based ZTO Express on the New York Stock Exchange in October 2016. Going forward, more Chinese express companies are expected to follow suit to expand their business through public listing. China's largest integrated logistics company SF Express is expected to complete its IPO on the Shanghai Stock Exchange in 2017. Another integrated logistics company, Deppon Logistics, is also pending a listing. Furthermore, other key players including, Best Express and STO Express have announced their intentions to go public. In the face of keen competition, going public would enable enterprises to gain a stronger foothold in the market in the longer term.

Smart and autonomous logistics see great potential

Developing smart logistics has become one of the most important strategies for businesses to outperform competitors. In a highly competitive and rapidly evolving market, the adoption of advanced technologies such as data analytics, Radio Frequency Identification (RFID), and Global Positioning System (GPS) to improve operational efficiency and provide more high value-added services have become winning strategies for the logistics sector. A typical example is Wuhan-based real estate developer Zall Group. Its core businesses include sale and lease of wholesale shopping malls and other commercial property units, and provision of property management, marketing services and logistics services. In November 2016, the company adopted an intelligence-based business ecosystem strategy that integrates smart logistics, finance, data, software and services. It also set up a logistics information platform to enable real-time monitoring of its order status.

The development of smart logistics is a national priority. In November 2016, the Ministry of Commerce (MOFCOM) and nine other ministries jointly issued the *13th Five-year Plan for the Development of Domestic Trade and Circulation*. The plan advanced key tasks to guide development of domestic trade and circulation, while highlighting the importance of lowering circulation costs and accelerating the establishment of an efficient, fast and smart logistics system to reduce enterprises' difficulties. The establishment of smart logistics centers, autonomous warehouses, and innovative logistics management systems have been highly encouraged.

While the logistics sector has been undergoing rapid transformation and upgrading, autonomous logistics has undoubtedly created the largest media attention over the past year. This transformation can effectively reduce logistical costs, and at the same time supplement insufficient labor, especially for deliveries in rural areas. JD.com is a pioneer in introducing unmanned distribution vehicles and drones. In June 2016, it started to deploy unmanned distribution vehicles and self-developed drones in Suqian city, Jiangsu province to handle "last mile" distribution. Rather than using drones to deliver goods directly to shoppers, JD.com uses them to transport goods from rural distribution stations to couriers based in villages. The couriers then pass the goods to online shoppers. Meanwhile, large players such as Alibaba, SF Express and STO Express have unveiled successful initiatives in developing autonomous warehouses during the 2016 Singles' Day. In 2017, smart logistics is expected be a new battleground for the express delivery sector.

Rural logistics is the next growth engine

In view of growing rural demand, both online and offline businesses view the rural market as a key growth area. Thanks to enhanced express delivery capabilities, advances in technology and improvements in rural infrastructure, China's rural logistics market is expected to see huge growth potential in 2017. The introduction of unmanned distribution vehicles and drones by key players is a major breakthrough for the logistics sector and will greatly impact the development of rural logistics. Moreover, the government's determination to support rural e-commerce also fuels the development of rural logistics. Indeed, "going rural" is one of the key development priorities in the *13th Five-year Plan for the Development of Domestic Trade and Circulation*.

Strengthening efforts to reduce logistics costs

Reducing logistics costs has long been a major sectoral task. Standardization of logistics is seen as an effective way to lower such costs. According to industry analysis, logistics standardization can increase efficiencies of loading and unloading of goods by more than three times, while reducing product damage by between 20% and 70%; overall, logistics costs can be reduced by 10% on average.

In 2016, the Chinese government increased efforts to implement commercial logistics standardization, mobilize the motivation of local governments to carry out and stimulate initiatives of relevant associations to promote logistics standardization. For instance, in October 2016, the MOFCOM issued *Regulations for the Operation of Pallet Pooling System* and six other industrial standards to further improve standardization in the logistics sector. Increasing numbers of logistics enterprises, including key national enterprises and other local pilot enterprises, have raised awareness in adopting those industrial standards. The *13th Five-year Plan for the Development of Domestic Trade and Circulation* in November 2016 also reinforced the imminent needs for logistics standardization. The plan highlights the needs to strengthen standardization of enterprises, distribution and logistics infrastructure.

What the experts say ?

Today's Chinese consumers expect fast delivery with more options to suit their busier lifestyles. Advances in mobile connectivity, data analytics and location-based services have all enabled the creation of flexible, on-demand express delivery services. Our experts believe that logistics and express delivery companies that can offer innovative value-added services to cope with the changing needs of the market will prevail. Innovation will be one of the key focal points in the future development of China's logistics sector. The express delivery market will continue to grow rapidly as the concept of a sharing economy flourishes in the O2O era.

Fung Business Intelligence, Member of the Fung Group

Authors

Teresa Lam and Lucia Leung (Asia Distribution and Retail, Fung Business Intelligence)

Contributors

Christy Li and Renne Chan (Asia Distribution and Retail, Fung Business Intelligence)

Administrator

Yu Di (Deputy Secretary General, Expert Committee of the China General Chamber of Commerce)

For more information

Secretariat of the Expert Committee of the China General Chamber of Commerce

25 Yuetan North Street, Beijing, China; Postcode: 100834

Phone: (010) 6606 2250 Fax: (010) 6606 2250

Email: yd20051123@126.com http://www.chinabt.net

Fung Business Intelligence

10/F, LiFung Tower, 888 Cheung Sha Wan Road, Kowloon, Hong Kong

Phone: (852) 2300 2470 Fax: (852) 2635 1598

Email: fbicgroup@fung1937.com https://www.fbicgroup.com