

Spotlight on China Retail

March 2017

General Retail

E-commerce

Department Stores

Hypermarkets/ Supermarkets

Convenience Stores

Cross-border E-commerce

Luxury Market

Retail Logistics

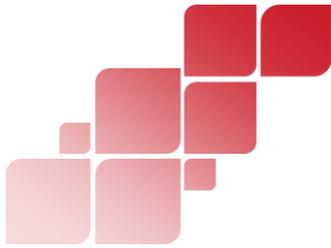


Asia Distribution and Retail

 FUNG BUSINESS INTELLIGENCE

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Issue 1 | General Retail

Executive Summary

China's retail sector sees modest growth; growing middle-class transforms the retail landscape.

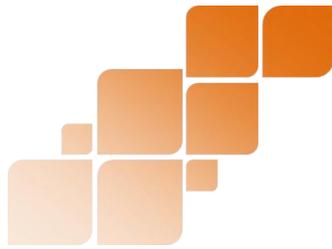
China has become the world's second largest retail and consumer market after the U.S. since 2014. Total retail sales increased nominally by 10.4% yoy to reach 33.2 trillion yuan in 2016. In real terms, retail sales of consumer goods increased by 9.6%. Consumer confidence index gradually picked up towards the end of 2016, indicating that the consumption atmosphere in China remained positive. Middle-class consumers in China, particularly the millennials, are becoming increasingly influential in the retail sector; it is estimated that more than 75% of China's urban consumers will earn between 60,000 yuan and 229,000 yuan per year by 2022.

Slowing growth of the Top 100 retail chain operations (the Top 100s). Total sales of the Top 100s in 2015 were 2.1 trillion yuan, up 4.3% yoy. The total sales of the Top 100s increased at the slowest pace since 2007, and the growth rate was slower than for national total retail sales of consumer goods over five consecutive years. Having said that, the performance of individual enterprises varied, those who can better adjust to the current environment and can cope with the changing consumer needs as well as increasing competition from online retailers demonstrated better results. Meanwhile, domestic retailers in the Top 100s outperformed foreign players.

"New Retail" regime sees emergence of new retail formats and business models. The term "New Retail" has been a buzz phrase in China's retail sector in the past year. Many 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. Another significant development under the "New Retail" regime is for more retailers to leverage Internet and advanced technologies such as Virtual Reality and Augmented Reality to offer experience- and lifestyle-driven opportunities. Physical stores are no longer just places for selling goods but also venues providing a combination of artistic, cultural, social and entertainment elements. Moreover, the deployment of online-to-offline (O2O) business strategies by retailers to enhance shopping experience is also a key development.

New consumers altering the retail landscape. China's new consumers, especially the millennials, are highly connected and digital-savvy. They are more brand-conscious and quality-oriented. At the same time, they demand personalized products and services. They also expect to have access to a "long tail" of products, with huge product choices. Meanwhile, personal experience matters considerably to them. Retailers have to constantly meet the needs of China's new, empowered customers.

New forms of business collaboration and partnership emerged in China's retail sector in 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. At the same time, more large domestic companies sought overseas expansion through M&A.



Issue 2 | Department Stores

Executive Summary

Department store sales growth continues to slow; trend of persistent store closures. The department store sector has witnessed a significant slowdown in sales, dwindling margins and massive scale of closure of underperformed stores in recent years. According to the NBS, total sales revenue for department stores grew 0.9% yoy to 384.2 billion yuan in 2015; growth rate declined by 1.9 ppts as compared with 2014. Compared with the previous year, there were more department stores closures involving both domestic and foreign operators in 2016.

Online-to-offline (O2O) being a crucial transformation elements in the “New Retail” regime. Over the years, many department store operators have been actively deploying O2O strategies to ensure seamless integration of all channels – brick-and-mortar, online, mobile and social. Examples of O2O adoptions by department store operators include: digitalization of retail outlets, launching O2O platforms, creating lifestyle scenes and introducing entertainment elements at physical stores.

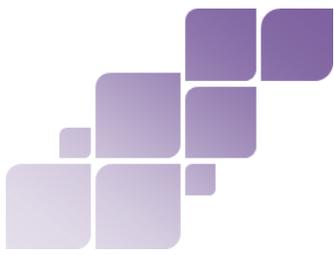
Partnering with key Internet players to roll out O2O initiatives. To stay competitive in the “New Retail” regime, some forward-thinking department store operators have proactively formed strategic alliances with Internet giants to roll out O2O initiatives. Intime Retail Group and Bailian Group’s respective partnerships with Alibaba are cases in point.

Enhancing uniqueness; focusing on product quality and service offerings. Due to the serious problem of homogenization of department stores, many department store operators have started to revamp their stores by introducing special themes and exciting elements, and expanding services offerings with a hope to better cater to the needs of different consumer segments. Providing more experiential elements and enhancing customer service become crucial means to attract more customers to the stores and prolong the duration of their stay.

Accelerating transformation and introducing new business model. In the “New Retail” regime, unique positioning with differentiated products is the key to success. Increasing numbers of department store operators have increased the proportion of merchandise direct sales, while developing private labels. Besides, many operators have stepped up their transformation efforts; major transformation strategies adopted by the department stores include: creating buyer team and setting up self-owned multi-label stores; forming closer relationships with suppliers to strengthen the supply chains; tapping into other retail formats and business sectors; and launching pop-up stores.

Overseas department stores looking for opportunities in the China market. Some foreign department store operators remain optimistic towards the future growth prospect of the China market and continue to expand their scope of business in China. Selected examples include Macy’s China, U.K.-based department store House of Fraser, Galeries Lafayette and Hong Kong-based I.T. Fashion Group, as well as Hong Kong-based Lane Crawford Department Store.

In the “New Retail” regime, the transformation of China’s department store sector is inevitable. While the department store sector is entering into the advanced phase of transformation and reinvention, a new market scene and competitive landscape are taking shape. At the same time, the government has launched a number of supportive measures to guide the development of the sector over recent years. Moving forward, department store operators should react quickly and explore their own strengths to pursue a positive future.



Issue 3 |

Hypermarkets/ Supermarkets Executive Summary

Hypermarkets and supermarkets see slowing sales growth. Many hypermarket and supermarket operators in China have been facing hard times in recent years. The sector as a whole has lost some of its share to the fast-growing e-commerce sector as well as the smaller-scale retail formats such as convenience stores, community stores and specialty stores. Slowing economic growth, weak consumer sentiment, and increasing operating costs have all hindered growth. Total sales for hypermarkets and supermarkets amounted to 496.3 billion yuan and 311.8 billion yuan, respectively, in 2015, slightly higher than that in 2014.

While **most large-scale key players in the hypermarket and supermarket sector are nationally focused, many smaller-sized domestic players operate regionally.** On the other hand, most foreign players tend to adopt a national approach when expanding, whereas domestic players generally focus on regional rollouts.

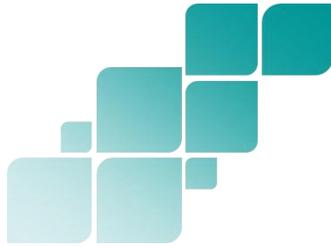
The pace of hypermarket and supermarket store openings has slowed down over recent years. The growth in the number of new store openings of the Top 100 FMCG players fell from 5.0% yoy in 2014 to 4.2% yoy in 2015. Many undertook store revamps and closed unprofitable stores.

Downsizing is trending. Hypermarket and supermarket operators move to smaller-sized formats as they can better address consumers' increasing demand for convenience, personalization, and fast services. Some hypermarket and large-scale supermarket operators such as Carrefour, Metro, China Resources Vanguard, Better Life Group, and RT-Mart have branched out into small-scale stores. In contrast, some retailers opt for a larger-sized shopping mall format that incorporates more experiential elements and services for consumers. **Premium supermarkets and membership stores are also the focus.**

Embracing online-to-offline (O2O) strategies is a common initiative adopted by hypermarket and supermarket players. Rolling out O2O mobile service platform, forming strategic alliance to drive synergies, providing O2O delivery services are some of the common practices.

Online grocery and fresh food business is gaining traction. Online fresh food and grocery market is flourishing due to changing consumer purchasing habits and a stronger desire for fresh, healthy food products. Some leading e-commerce players such as Alibaba and JD.com have forayed into the online supermarket segment in recent years. Meanwhile, many supermarket chains have put more focus on fresh food business.

Private label development and adoption of new retail technologies to enhance operation efficiency are other major development trends in the hypermarket and supermarket sector.



Issue 4 | Convenience Stores

Executive Summary

Convenience store (CVS) has been the fastest-growing retail format in recent years. Total sales revenue for the CVS sector reached 60.0 billion yuan in 2015, up 13.2% yoy. The growth momentum of CVS is expected to continue, as small retail format continues to gain in popularity in China's retail market. According to the Ministry of Commerce, the yoy growth of key retailers in the CVS and shopping mall sector reached 7.7% and 7.4% respectively in 2016, faster than the average growth of key retailers in other retail formats of 4%.

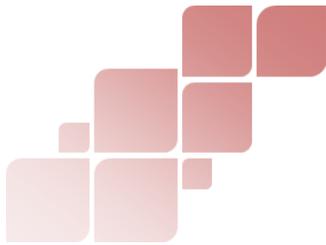
Development of CVS in China is still unbalanced. Guangdong and Shanghai have the highest concentration of CVS, each with more than 5,000 stores. Generally speaking, the development of CVS along coastal areas is more mature and concentrated than in inland areas. At the same time, the development of CVS in the southern region is more mature than in the northern region.

Currently, there is **no national leader in China's CVS sector**. Most leading players in China's CVS sector are regionally based. With the exclusion of Easy Joy and uSmile, which operate mainly forecourt stores, Meiyijia is the market leader in terms of store count, with 7,400 stores in Guangdong, followed by Tianfu, Hongqi, Sun-high, and Quik. Foreign CVS operators are more active in expanding nationally, while domestic players are mostly regionally focused.

CVS operators actively transform and re-invent. An increasing number of CVS operators have transformed their operations with a hope to stay relevant in today's rapidly evolving landscape. Many have started to roll out online-to-offline (O2O) strategies. Given its vast network of stores, CVS can better support O2O initiatives. Providing pick-up services in-store is one of the major initiatives.

Fresh food products become a major focus. In recent years, some community CVS chains have started to place greater emphasis on fresh food products to attract footfall. Selling fresh food is set to become a new growth point for CVS operators. Having said that, profit margin of fresh food products is low. Moreover, additional investments in cold chain logistics and storages are needed.

Private label is a key differentiator, but currently, the development of private labels is not very mature in China's CVS sector. 60% of CVS operators have launched their own private labels, but the share of private labels in total sales is low at around 5%.



Issue 5 | Luxury Market

Executive Summary

China's personal luxury goods market saw revitalization in 2016. Sales of personal luxury goods in China slightly fell to 17 billion euros in 2016, representing a 2% yoy contraction at current exchange rates, according to Bain & Company. However, in 2016, at constant exchange rates, the sales of personal luxury goods advanced 4% yoy, marking the first revitalization of domestic personal luxury goods consumption in three years.

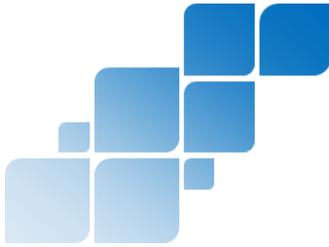
Chinese luxury shoppers remain a significant source of global luxury market despite a dip in purchases abroad. Chinese consumers scaled back buying luxury goods abroad in 2016; Chinese luxury spending accounted for 30% of global luxury purchases in 2016, down slightly from 31% in 2015. Nevertheless, China remains a major powerhouse of global luxury growth. It was the fourth largest luxury goods market in 2016, taking up 7% of global luxury sales.

Chinese government increases personal postal articles tax on luxury goods to tackle grey market. As a way to tackle the grey market and stimulate domestic consumption, the government has significantly increased the personal postal articles tax on items for personal consumption and strengthened penalties on false customs declaration. With effect from April 2016, the personal postal articles tax on various luxury items including luxury accessories, jewelry and gemstones, watches and cosmetics have been severely increased to 60%.

E-commerce becomes an influential sales channel, with mobile shopping on the rise. Chinese shoppers are more willing to purchase luxury items online nowadays. According to KPMG, 45% of luxury shoppers in China purchased over half of their luxury goods online, an increase of 28% versus 2014. Meanwhile, mobile-commerce has increasingly become a bright spot for growth; transaction value of mobile shopping is expected to advance by 45.7% yoy in 2017, representing 61% of all e-commerce sales. Some luxury players have launched mobile apps to support online transaction, while others have started selling on social media platforms.

Rising influence of digital media; social media increasingly becomes a new marketplace for e-commerce. Nowadays, the use of social media is not confined to posting comments or sharing feedback, but increasingly as a tool to carry out e-commerce transactions. An increasing number of luxury players now use social networking platforms to market or sell their products. Apart from **WeChat and Sina Weibo**, luxury retailers also use **live streaming** platforms to promote and sell their products.

Luxury players expand beyond core but saturated business. To expand their income streams, some luxury players have begun to expand beyond their core but increasingly saturated business and ventured into other industries such as food and beverages (F&B), beauty and real estate sectors in China.



Issue 6 | E-commerce

Executive Summary

China's online retail market: the largest in the world. China's e-commerce sector has and will continue to attract the world's attention with its explosive growth and transformative effect on the commercial landscape. Of which, China's online retail market, which comprises the B2C and C2C segments, is the largest in the world; it is nearly 80% bigger than the U.S. retail market and has shown resilient growth despite the slowing economy. The transaction value of China's online retail market increased 26.2% yoy to reach 5.16 trillion yuan in 2016. The fast growth of the online retail market is mainly attributable to the large population of Internet users and the quick adaptation of consumers to online shopping. China has the world's largest number of Internet users and online shoppers, contributing significantly to the phenomenal growth of the sector. As of December 2016, there were 731 million Internet users in China, of which 467 million were online shoppers; while 695 million people use mobile phones to access the Internet; of these, 441 million are mobile online shoppers.

Mobile commerce (m-commerce) takes the lead. M-commerce has gained market share at the expense of PC-based transactions over recent years, 71.6% of the online shopping transactions were made on mobile devices. The widespread use of third-party online payment and mobile payment has driven the growth of China's e-commerce market.

Rural e-commerce sees huge potential. The rural online retail market has become a new growth engine with the near saturation of the urban online market. The government has been very supportive towards the development of rural e-commerce. Recognizing the ample growth potential of the rural e-commerce market, increasing numbers of leading retailers and e-commerce players have adopted various "going rural" strategies.

Social media becomes the new marketplace for commerce. Social media is a remarkable phenomenon across the global, but it is more important in China than it is in other countries. QQ and WeChat are the leading social media platforms, each with over 800 million MAUs. The booming mobile generations and accelerated growth of social media usage have fueled the growth of social selling, or social commerce (s-commerce).

"Cewebriety economy" is gaining traction in the e-commerce space. The term "cewebriety economy" is a buzz phrase that has emerged in China over recent years and is poised to achieve tremendous growth. The market size of the "cewebriety economy" in China was estimated to reach 52.8 billion yuan by the end of 2016. Cewebrities refer to people who become famous in the Internet. Leveraging the power of their fans on social media, many cewebrities, especially fashion cewebrities have set up online stores to sell fashion items. Some have even launched their own brands.

E-commerce is not longer online only under the "New Retail" regime. It involves the **integration of online-to-offline (O2O) activities.** More retailers and e-commerce companies have ventured into O2O; they leverage mobile, social media and technologies to bridge the gap between offline, online and mobile channels. Driven by the diverse needs of consumers, the O2O concept has extended from O2O for retail businesses to lifestyle services including catering, accommodation, housekeeping, etc.

China's e-commerce landscape is increasingly consumer-driven; C2B model is gaining popularity. Advanced Internet technologies allow seamless connections between consumers and business, making it easier for consumers to articulate their needs and opinions to business. More companies now adopt a Consumer-to-business (C2B) model, with an aim to provide customized products and services to meet the needs of discerning Chinese consumers.



Issue 7 | Cross-border E-commerce (Import)

Executive Summary

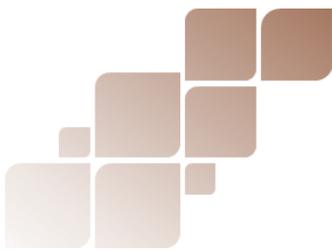
Cross-border e-commerce (CBEC) maintains solid growth momentum. Many Chinese consumers are buying foreign products via approved CBEC platforms. The number of CBEC shoppers is expected to increase from around 181 million in 2016 to 291 million in 2020. According to iResearch, the transaction value of CBEC (import) market is estimated to reach 1,900 billion yuan in 2020, up from 900 billion yuan in 2015.

Beauty and personal care products, baby and maternity products, and food and healthcare products are the best-selling categories for CBEC (import) market. It is noteworthy that the share of sales of food and healthcare supplements, and home products are on the rise, while the share of sales of apparel, footwear, and bags are decreasing. CBEC shoppers purchase most frequently from the U.S., Japan, South Korea, and Germany.

The government has rolled out numerous policies to support CBEC development over recent years. In 2012, the government rolled out a pilot program and established pilot zones for the CBEC import business. As of March 2017, there were ten pilot zones for CBEC import business across China. These pilot zones take the lead in setting new standards for CBEC transactions, payment, logistics, customs clearance, exchange settlement, inspection quarantine, etc., and facilitate the development of CBEC import business.

In April 2016, the government announced **new policies on CBEC**, aiming to better regulate the CBEC channels and reduce policy loopholes, ensure tax collection, and reduce the price gap between CBEC and general import, so as to provide a fair market environment for all players. The new policies have set forth **new tax rules for different CBEC models, new operation procedures, new tax rates for personal postal article tax and a positive list of permitted imported goods**. To ensure a smooth transition amid regulatory changes, the government has granted a one-year transition period for the implementation of new supervision regulation on CBEC imports in May 2016; the transition period has further been extended to the end of 2017.

CBEC channels provide a relatively cheaper and faster way for foreign brands and retailers to test the China market. Under the existing CBEC regulations, overseas brands and retailers without Chinese business licenses can sell in China through authorized CBEC platforms. In recent years, increasing number of foreign brands and retailers have set up stores on the two largest CBEC platforms – Tmall Global and JD Worldwide. Tmall Global reported that as of December 2016, around 14,500 international brands from 63 countries have entered its platform.



Issue 8 | Retail and E-commerce Logistics

Executive Summary

Strong growth of online retail sales fuels demand for logistics services; rural online market is a new source of growth. The phenomenal growth of China's online retail market has boosted the demand for logistics services. In particular, rural online market has contributed significantly to the growth of total online retail sales and became a major source of growth for the logistics market. Total logistics value reached a record high of 229.7 trillion yuan in 2016, up by 6.1% yoy in real terms.

Express delivery market scales up; growing demand for intra-city courier services. Being a critical part of e-commerce logistics, the express delivery sector has grown rapidly over the years. Total volume of completed delivery amounted to 31.3 billion pieces in 2016, up 51.4% yoy, making China's express delivery market the largest in the world in terms of delivery volume. Total sales revenue of the sector reached 397.4 billion yuan, increased by 43.5% yoy. There has been a surge in demand for intra-city courier due to the emergence of new retail practices such as O2O and large numbers of online channels selling fresh produce and healthcare products, as well as increasing demand for fast delivery.

E-commerce and logistics players actively invest in technologies; "smart logistics" see great potential. In today's rapidly evolving market, the application of advanced technologies in the logistics process has driven innovation and improved efficiency of the retail logistics sector. Many e-commerce and logistics players have invested heavily in technologies, hoping to enhance fulfilment capability and operation efficiency. "Smart logistics" and data-driven logistics operation have gained increasing attention in recent years.

Internet and e-commerce players expand nationwide logistics network while large-scale retailers develop in-house logistics capabilities. To cope with the new needs of e-commerce such as rural e-commerce and cross-border e-commerce as well as customers' desire for last delivery, some leading Internet and e-commerce players such as Alibaba, JD.com and Suning Commerce have set up a nationwide logistics network, while leading retailers have stepped up efforts to develop in-house logistics capabilities to provide more high value-added logistics services, enhance warehouse automation, improve speed to market, etc.

Strengthening "last-mile" delivery is top priority. Increasing numbers of retailers and logistics players have introduced various means to enhance "last-mile" delivery capabilities. Examples of such initiatives include: introducing "click & collect" services, setting up pick-up lockers, partnering with convenience stores or community stores to provide pick-up services, and adopting crowd-sourced delivery — a new type of web or mobile-based courier service that leverages large groups of geographically dispersed individuals to take up the delivery job.

The cover features a dark blue background with a bright blue spotlight effect from the top left. On the left side, there is a graphic of several red squares of varying sizes arranged in a stepped, ascending pattern. The text is positioned on the right side of the cover.

Spotlight on China Retail – Issue 1

General Retail

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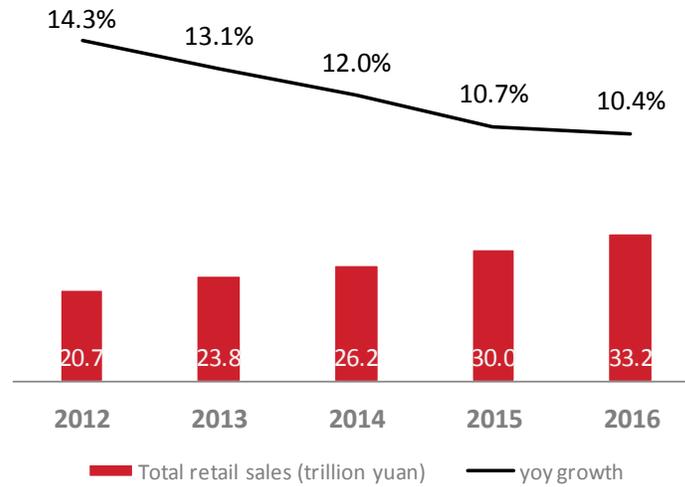
China's retail sector is undergoing a transformation. Cooling economic growth, rising costs of operation, intense competition, and changing consumer needs are all posing business challenges for retailers. At the same time, new technologies and new business models are reshaping, if not disrupting, the retail landscape. Retailers have to constantly reinvent and transform their businesses to keep pace with the needs of the rapidly changing environment.

1. Market overview

1. Retail sales see modest growth

China has become the world's second largest retail and consumer market after the U.S. since 2014. According to the National Bureau of Statistics (NBS) of the PRC, total retail sales increased nominally by 10.4% year-on-year (yoy) to reach 33.2 trillion yuan in 2016. In real terms, retail sales of consumer goods increased by 9.6% (Exhibit 1). By month, nominal retail sales growth stayed at around 10.0-11.1% yoy throughout 2016 (Exhibit 2).

Exhibit 1: Total retail sales of consumer goods, 2012–2016



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

Exhibit 2: Nominal growth of total retail sales of consumer goods by month, January - December 2016



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

Retail sales of consumer goods: Mode of sales

The retail sales of commodities of enterprises reached 29.7 trillion yuan in 2016, up 10.4% yoy; of which, retail sales of commodities for enterprises above a designated size rose 8.3% yoy to 14.5 trillion yuan. Statistics from the China National Commercial Information Centre (CNCIC) show that retail sales of 100 key large-scale retail enterprises edged down 0.5% yoy in 2016—the fifth consecutive decline since 2012. The operations of large-scale retail enterprises are under tremendous pressure.

By contrast, growth of catering sales exceeded the growth of sales of commodities in 2016. Total catering sales rose by 10.8% yoy to reach 3.6 trillion yuan in 2016, though down by 0.9 percentage points (ppt) from 2015. Of which, retail sales for enterprises above a designated size in the catering industry increased by 6.0% yoy, showing that large catering enterprises generally performed less well than small and medium-sized catering enterprises (Exhibit 3).

Exhibit 3: China's total retail sales by mode, 2015 - 2016 (yoy change, %)

<i>By mode</i>	2015	2016
Total retail sales of consumer goods	10.7	10.4
Commodities	10.6	10.4
of which, enterprises above a designated size*	7.9	8.3
Catering	11.7	10.8
of which, enterprises above a designated size*	7.0	6.0

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

* "Enterprises above a designated size" refers to enterprises with annual sales of five million yuan or more and with employee strength of 60 or more.

Retail sales of consumer goods: Commodities

In 2016, sales of building and decoration materials saw a 14.0% yoy growth in 2016, the highest among all categories, followed by sales of furniture with 12.7% yoy growth, and Chinese and western medicine with 12.0% yoy growth (Exhibit 4). It is noteworthy that most categories witnessed a decline in sales growth in 2016 compared to the previous year.

Exhibit 4: China's nominal retail sales growth of enterprises above a designated size, by product, 2015 - 2016 (yoy change, %)

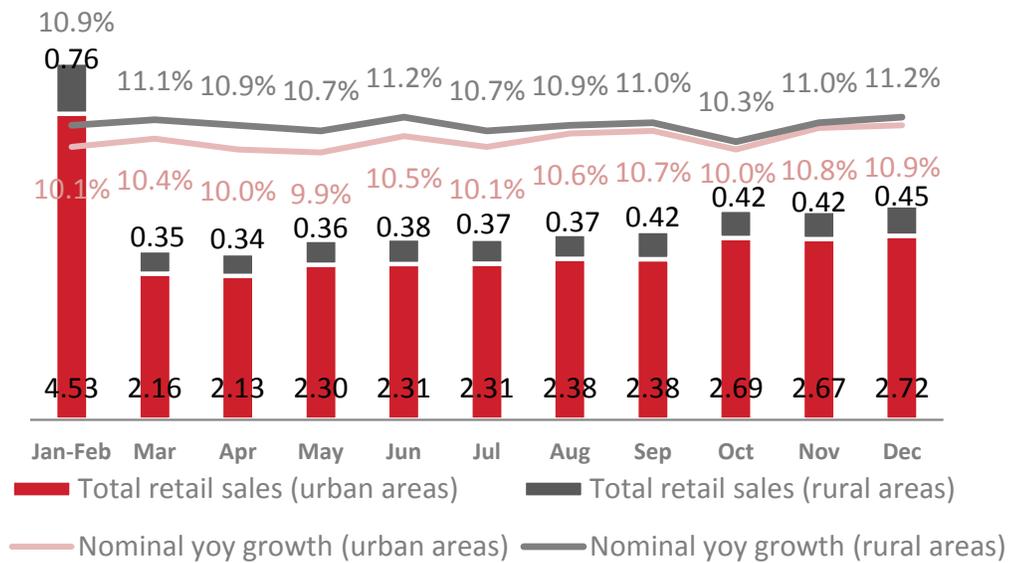
<i>By product</i>	2015	2016	Change
Grain, oil, food	15.1	10.9	↓
Beverages	15.3	10.5	↓
Tobacco and liquor	12.7	9.3	↓
Clothing, shoes, hats, and textiles	9.8	7.0	↓
Cosmetics	8.8	8.3	↓
Gold, silver, and jewelry	7.3	0.0	↓
Daily use products	12.3	11.4	↓
Home appliances and video equipment	11.4	8.7	↓
Chinese and western medicines	14.2	12.0	↓
Stationery and office accessories	15.2	11.2	↓
Furniture	16.1	12.7	↓
Telecommunications equipment	29.3	11.9	↓
Petroleum and related products	-6.6	1.2	↑
Automobiles	5.3	10.1	↑
Building and decoration materials	18.7	14.0	↓

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

Retail sales of consumer goods: Urban vs rural

Rural retail sales have been growing at a faster pace than urban retail sales over recent years, but the gap became closer in 2016. Rural retail sales increased nominally by 10.9% yoy to 4.65 trillion yuan in 2016, while urban retail sales rose 10.4% yoy to 28.58 trillion yuan (Exhibit 5).

Exhibit 5: Total retail sales of consumer goods, urban vs. rural areas, January - December 2016



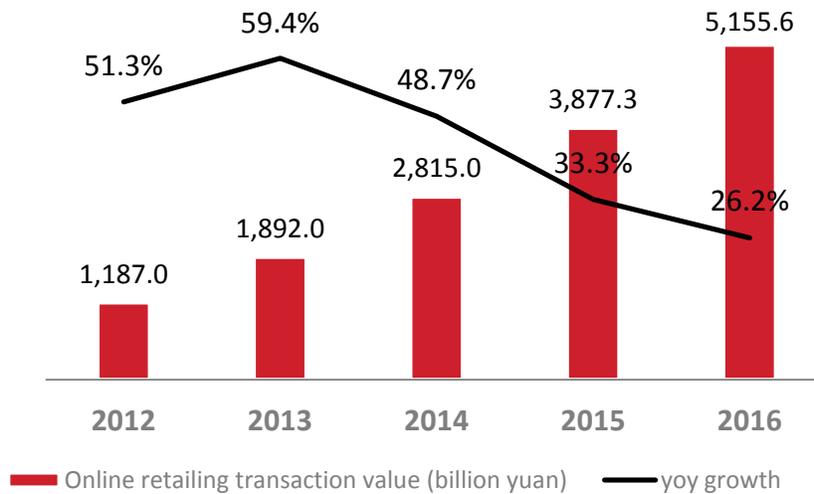
Source: National Bureau of Statistics of the PRC; compiled by Fung Business Intelligence

The fast growth of rural retail sales was partly attributable to the growth of rural household income. Per capita disposable income of urban and rural households reached 33,616 yuan and 12,363 yuan in 2016, up by 7.8% and 8.2% yoy respectively. Rural household income grew faster than that of urban households, but the per capita disposable income of urban households was still almost three times higher than that of their rural counterparts.

2. Online retail market scales up in 2016 amid slower growth

After years of explosive growth, China has become the world’s largest online retail market. That said, the growth of online retail has slowed over recent years. In 2016, the transaction value of China’s online market increased by 26.2% yoy to reach 5.16 trillion yuan. Of which, the online retail sales of goods amounted to 4.19 trillion yuan, up by 25.6 % yoy and accounted for 12.6 % of the total retail sales of consumer goods (Exhibit 6).

Exhibit 6: China's online retail market, 2012 - 2016



Source: *iResearch (2012-2014); National Bureau of Statistics of the PRC (2015-2016); compiled by Fung Business Intelligence*

The phenomenal growth of the online retail market has been driven in part by the huge Internet population and quick adaptation of consumers to online shopping. China has the world's largest number of Internet users and online shoppers. As of December 2016, there were 731 million Internet users in China; of which, 467 million were online shoppers. A total of 695 million people used mobile devices to access the Internet. The penetration rate of mobile shopping increased from 54.8% in December 2015 to 69.5% in December 2016.

M-commerce takes the lead

Over the years, mobile commerce (m-commerce) has been gaining market share at the expense of PC-based transactions. With the aid of mobile devices, consumers can have real-time interactions with retailers, and enjoy a convenient shopping experience anytime, anywhere. 71.6% of the online shopping transactions were made on mobile devices in 3Q16 and total transaction value of mobile shopping reached 820.2 billion yuan, the highest quarterly figure since 1Q15. More retailers have been actively investing in m-commerce. It is expected that m-commerce will play a more important role in driving e-commerce development in coming years.

Rural e-commerce becomes the new growth engine of online sales

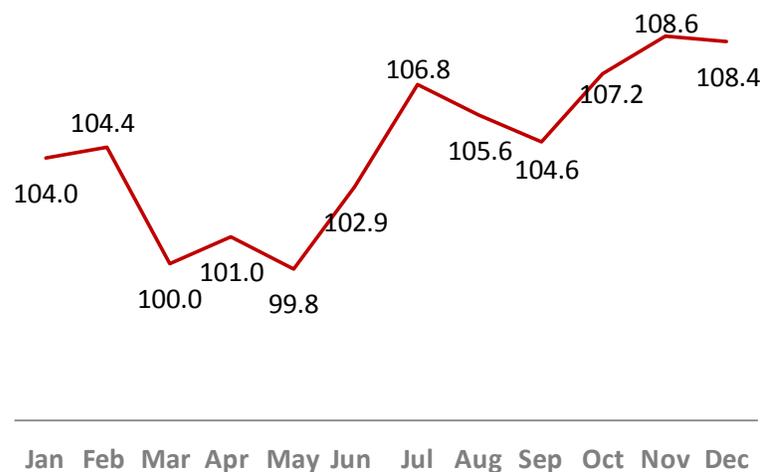
China's rural e-commerce has become a new growth engine with the near saturation of urban e-commerce. In December 2016, the number of Internet users in the rural area rose to 201 million, accounting for 27.4% of the total Internet population, according to China Internet Network Information Center (CNNIC). According to the China International Electronic Commerce Center, the transaction value of rural online market is estimated to reach 647.5 billion yuan by the end of 2016.

The growth potential of the rural e-commerce market relies critically on the development of rural logistics and infrastructure. In recent years, some leading e-commerce players and Internet companies have increased efforts to expand their distribution network in rural areas. For instance Alibaba has introduced a partnership program in rural areas and recruited 20,000 partners to teach and help rural residents buy and sell online. JD.com, on the other hand, has made substantial investment to expand "last-mile" delivery capabilities in rural areas; for example, it has tested drone delivery services in some remote rural areas.

3. Chinese consumers remain confident in 2H16

Consumer confidence index gradually picked up towards the end of 2016, up from 99.8 in May to 108.4 in December, suggesting that the consumption atmosphere in China remained positive. Indeed, the consumer confidence index in December 2016 is the highest reading since May 2015.

Exhibit 7: Consumer Confidence Index, January - December 2016

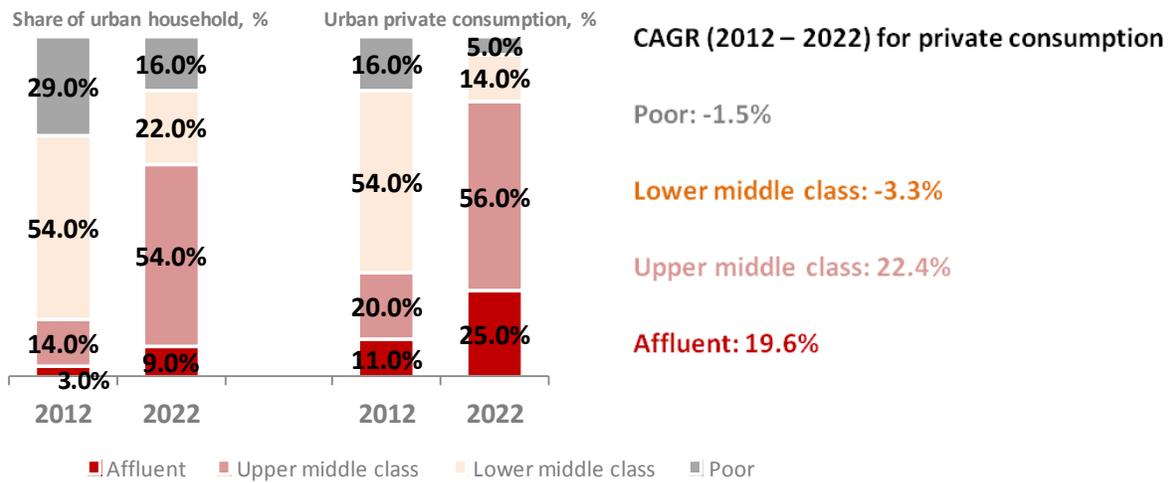


Source: National Bureau of Statistics of the PRC; compiled by Fung Business Intelligence

4. Growing middle-class transforms the retail landscape

Middle class consumers in China are becoming increasingly influential in the retail and consumer market. McKinsey & Co. predicts that by 2022, more than 75% of China’s urban consumers will earn between 60,000 yuan and 229,000 yuan per year. This middle-class segment, especially the upper middle class (those earn between 106,000 and 229,000 yuan per year), is a major consumer group in China. As shown in Exhibit 8, the upper middle class is estimated to account for over 56% of urban private consumption in 2022, up from only 20% in 2012.

Exhibit 8: Share of urban household and urban private consumption, 2012 and 2022 (estimates)



Source: Deutsche Bank; McKinsey & Co.; compiled by Fung Business Intelligence

Income segment defined by annual disposable income per urban household, in 2010 real terms; affluent, >229,000 yuan (equivalent to >US\$34,000); upper middle class, 106,000 to 229,000 yuan (equivalent to US\$16,000 to US\$34,000); mass middle class, 60,000 to 106,000 yuan (equivalent to US\$9,000 to US\$16,000); poor, <60,000 yuan (equivalent to <US\$9,000).

2. Competitive landscape

1. Slowing growth of the Top 100 retail chain operators (the Top 100s)

Growth pace of the Top 100s slowed in 2015

Total sales of the Top 100s in 2015 were 2,062.8 billion yuan, up 4.3% yoy. The total sales of the Top 100s increased at the slowest pace since 2008, and the growth rate was slower than for national total retail sales of consumer goods over four consecutive years (Exhibit 9). Having said that, the performance of individual enterprises varied, those who can better adjust to the current environment and can cope with the changing consumer needs as well as increasing competition from online retailers demonstrated better results.

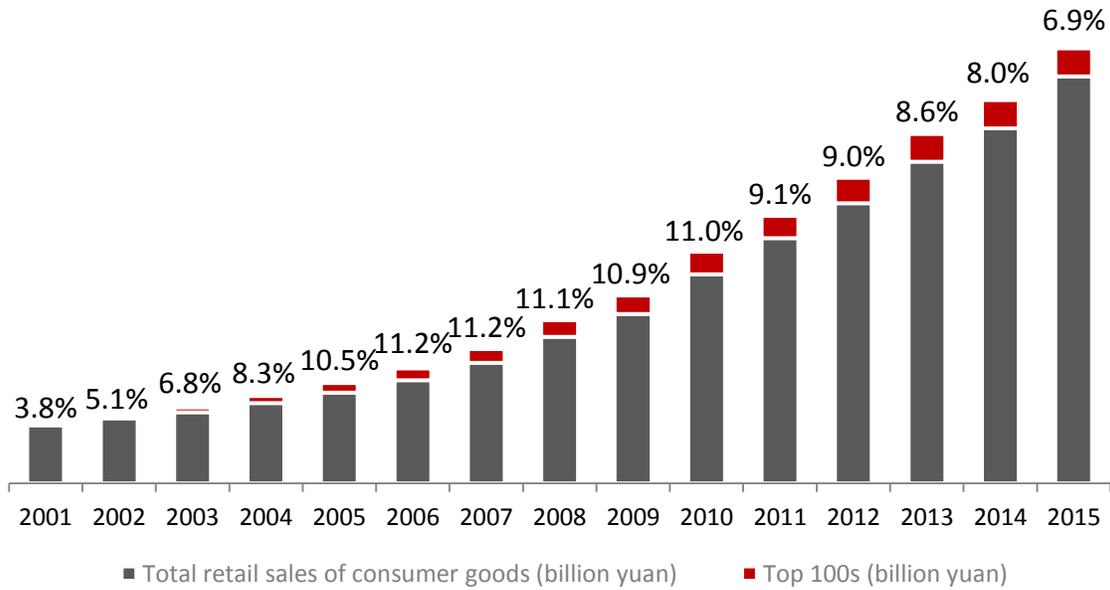
Exhibit 9: Performance of the Top 100 retail chain operators, 2008 - 2015



Source: *China Chain Store and Franchise Association; compiled by Fung Business Intelligence*

As shown in Exhibit 10, total sales of the Top 100s accounted for 6.9% of total retail sales of consumer goods in 2015. China's retail market remains highly fragmented.

Exhibit 10: The Top 100s' share in national retail sales, 2001 - 2015



Source: *China Chain Store and Franchise Association; compiled by Fung Business Intelligence*

Exhibit 11 shows the Top 10 retail chain operators ranked by retail sales in 2015. Suning Commerce Group ranked the top with total sales of 158.6 billion yuan, followed by Gome Electrical Appliances and China Resources Vanguard.

Exhibit 11: Top 10 chain retailers, 2015 (Ranked by retail sales)

Rank	Name of company	Place of origin	Sales, pre-tax (million yuan)		Number of stores	
			In absolute terms	yoy change (%)	In absolute terms	yoy change (%)
1	 Suning Commerce Group Co., Ltd.		158,600*	24.4	1,577	-4.4
2	 Gome Electrical Appliances Holding Ltd.		153,686	4.1	1,932	3.9
3	 China Resources Vanguard Co. Ltd. ¹		109,400	5.2	3,397	-17.7
4	 Sun Art Retail Group Ltd. ²		107,906	4.8	409	9.9
5	 Wal-mart (China) Investment Co., Ltd. ³		73,547	1.6	432	5.1
6	 Shandong Commercial Group Co., Ltd.		63,721	-0.3	740	7.6
7	 Lianhua Supermarket Holdings Co., Ltd. ⁴		60,474	-2.1	3,912	-9.5
8	 Chongqing General Trading (Group) Co., Ltd.		59,438	-3.3	340	1.5
9	 Yum! Brands Inc., China Division		51,700	2.0	7,000	7.7
10	 Yonghui Superstores Co., Ltd.		49,309*	14.8	394	16.9

Source: China Chain Store and Franchise Association; compiled by Fung Business Intelligence

*Note: Estimated value

¹Sales of China Resources Vanguard Co. Ltd. included sales of Suguo Supermarket.

²Sales of Sun Art Retail Group Ltd. included sales of RT-Mart Shanghai and Auchan.

³Sales of Wal-Mart (China) Investment Co., Ltd. excluded sales of YHD.

⁴Sales of Lianhua Supermarket Holdings Co., Ltd. included sales of Carrefour in Shanghai.

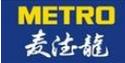
The average gross margin for the Top 100s was 18.6% in 2015, up 0.5 ppt from 2014. Net profit margin was 1.8%, down 0.1 ppt from the 2014. 55% of the Top 100s recorded negative growth for net profit margin in 2015.

The yoy growth of total number of stores of the Top 100s in 2015 was 4.7%, increased slightly from 4.2% in 2014. Rising rental and labor costs continued to exert huge pressure on the Top 100s. The yoy growth of rental costs was 8.6%, while the yoy growth of labor costs was 4.2% in 2015.

Domestic retailers in the Top 100s outperformed foreign players

Among the Top 100s, domestic players performed better than their foreign counterparts in 2015 in terms of sales growth. Foreign enterprises achieved 0.5% yoy growth in 2015, down from 4.7% in 2014 and lagged behind the sales growth of 4.3% for the Top 100s in general. In 2015, there were 18 foreign enterprises in the Top 100 list, down from 19 in 2014. Exhibit 12 shows the foreign retail chains among the Top 100s in China in 2015.

Exhibit 12: Foreign retail chains among the Top 100s in China, 2015

Rank	Name of company	Place of origin	Sales, pre-tax (million yuan)		Number of stores	
			In absolute terms	yoy change (%)	In absolute terms	yoy change (%)
1	 Sun Art Retail Group Ltd. ¹		107,906	4.8	409	9.9
2	 Wal-mart (China) Investment Co., Ltd. ²		73,547	1.6	432	5.1
3	 Yum! Brands Inc., China Division		51,700	2.0	7,000	7.7
4	 Carrefour China Inc.		40,102	-12.3	234	-1.3
5	 Metro Jinjiang Cash & Carry Co., Ltd.		19,100	1.1	82	1.2
6	 A.S. Watson & Co., Ltd. (Guangzhou)		18,110*	9.0	2,483	18.9
7	 Parkson Retail Group Ltd.		18,100*	-6.9	58	1.8
8	 Zhengzhou Dennis Department Store Co., Ltd.		18,000	4.7	378	67.3
9	 Lotte Mart		17,000*	-5.6	120	-2.4
10	 CP Lotus		13,690	-0.7	82	6.5
11	 IKEA China		13,070	27.9	18	12.5
12	 New World Department Store China Limited		12,800	-7.2	43	0.0
13	 AEON Co., Ltd.		10,652	9.1	54	8.0

14	 McDonald's Corporation (China)		10,000*	-13.0	2,300	9.5
15	 Ito-Yokado Co., Ltd		6,500	-10.6	11	-8.3
16	 Shanghai FamilyMart Co., Ltd.		4,940	17.1	1,501	17.2
17	 Park'n Shop (China)		3,882	-1.0	64	-8.6
18	 Emart China		1,250*	-30.6	8	-20.0
Total			440,350	0.5	15,277	11.1

Source: China Chain Store and Franchise Association; compiled by Fung Business Intelligence

*Note: Estimated value

¹CCFA classifies Sun Art Retail Group as foreign retail chain in their study.
Sales of Sun Art Retail Group Ltd. included sales of RT-Mart Shanghai and Auchan.

²Sales of Wal-Mart (China) Investment Co., Ltd. excluded sales of YHD.

2. E-commerce players expanding fast

E-commerce players in China have been growing extraordinarily fast. Alibaba has become the world's largest retailer with annual gross merchandise volume (GMV) over 3 trillion yuan in 2016, overtaking Wal-mart. According to Alibaba, as of March 31, 2016, the company has "become the largest retail economy in the world as measured by GMV on its China retail marketplaces." Alibaba's goal is to reach 6 trillion yuan in GMV by 2020.

Some other e-commerce companies have also seen rapid growth over the years. Deloitte has followed the fastest-growing retailers with compound annual revenue growth (CAGR) over the five-year period from 2010–2015, two of China's largest e-commerce players, VIP.com and JD.com topped the list of the 50 fastest-growing retailers, with CAGR of 184.6% and 81.3% respectively.

3. Store closures are here to stay

China's retail sector has witnessed a trend of store closures amid the tough market environment. Over-expansion in the previous years, together with rising rental and labor costs, have posed huge challenges to many physical retailers, forcing them to close stores that are not making a profit and revamp or suspend expansion plans. According to Linkshop, a domestic media agency, there were 185 and 56 store closures in China in 2016 involving large-scale supermarkets and department stores respectively. Marks & Spencer, a U.K.-based department store chain, is a case in point. The company announced in November 2016 to withdraw from the Chinese mainland market by closing all of its 10 stores in China amid continuing losses.

4. Smaller-scale retail formats sees higher growth

In recent years, smaller-scale retail formats has recorded higher growth compared with other larger-scale retail formats. An increasing number of retailers have opened smaller-scale retail formats to serve residents in neighborhoods. For example, Carrefour opened its first convenience store “Easy Carrefour” in China in November 2014. Currently there are 26 “Easy Carrefour” stores in Shanghai; the retailer further set up a new company dedicated to the management of its convenience store business in China in February 2017, aiming to better facilitate the brand’s expansion plan in this sector.

5. Analysis by major retail formats

Department stores

The department store sector has witnessed a slowdown in sales in over recent years; but in 2016, there were some signs of gradual improvement with growing net profits and lowering operating costs of key department store operators. According to a survey conducted by the China Commerce Association for General Merchandise with 85 key department store operators, total sales proceeds increased 5.5% yoy to 656,689.5 million yuan in 2016 and core operating profits down 0.7% yoy to 15,376.3 million yuan. Total expenses and operating expenses dropped 3.2% and 5.7% yoy to 22,563.4 million yuan and 11,519.1 million yuan respectively. Net profits soared 12.0% yoy to 4,003.7 million yuan and ratio of sales surged noticeably by 10.0% yoy.

Hypermarkets and supermarkets

Many hypermarket and supermarket operators in China have been facing hard times over recent years. Slowing economic growth, rising operating costs, and increasing competition have all hindered growth. The NBS reported that total sales for hypermarkets and supermarkets amounted to 496.3 billion yuan and 311.8 billion yuan respectively in 2015, slightly higher than that in 2014 (464.7 billion yuan and 298.2 billion yuan respectively). The pace of hypermarket and supermarket store openings has also slowed down over recent years. The growth in the number of new store openings of the Top 100 fast-moving consumer goods (FMCG) players fell to 5.3% in 2015 from 7.6% yoy in 2013.

Convenience stores

Convenience store (CVS) is the fastest-growing retail format in China. Total sales revenue for the CVS sector reached 60.0 billion yuan in 2015 with 13.2% yoy growth. The growth momentum of CVS is expected to continue, as the small retail format continues to gain in popularity in China’s retail market. According to the Ministry of Commerce (MOFCOM), the yoy growth of key retailers in the CVS and shopping mall sector reached 7.7% and 7.4% respectively in 2016, faster than the average growth of key retailers in other retail formats of 4%.

*Other emerging formats: pop-up stores and factory outlets**Pop-up stores*

Pop-up store is increasingly becoming a popular channel for brands and retailers to test the waters in the market. According to commercial property research agency RET CN, the number of pop-up stores in China has seen a CAGR of over 100% since 2015, and the total number of pop-up stores may reach over 3,000 by 2020.

Pop-up store is an easier option for businesses whom do not want to commit to an expensive, long-term lease. It allows them to connect customers in a more direct and dynamic way. Pop-up store also helps both local and foreign designer brands to gain access to the mass market. For instance, Intime Retail Group has earlier set up its first pop-up discount store in its Hangzhou branch selling luxury goods from various brands.

Factory outlets

Factory outlets have enjoyed rapid growth at around 20-30% over recent years. However, the growth rate has slowed down since 2015, due to rising competition from e-commerce. More luxury brands have launched their own online stores, and more third-party resellers are selling luxury goods online. Moreover, retailers now offer more discounts, hence, price gap between physical stores and factory outlets narrows.

Currently there are more than 300 self-proclaimed outlet malls in China, but only around one tenth of them are reportedly operating to an international standard. Selected key players in the sector include Shanghai Bailian Group, Wangfujing Group, and Yansha Outlet.

In China, factory outlets are not as mature as those in many other countries where consumers can easily find first-tier brands and good quality products at big bargains. Many smaller-scale factory outlets sell mostly low-tier brands. Besides, unlike factory outlets in developed countries which usually locate in outskirts of the city; in China, some factory outlets appear in city center and pose direct competition to the physical stores of the brand.

3. Key highlights

1. “New Retail” regime sees emergence of new retail formats and business models

The term “New Retail” has been a buzz phrase in China’s retail sector in the past year. Many 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. For instance, some traditional retailers (particularly hypermarket and supermarket operators) have been shifting their focus towards small-format and community-based stores. Carrefour and Metro China are cases in points.

Another significant development 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.

Moreover, the deployment of online-to-offline (O2O) business strategies by retailers to enhance shopping experience is also a key development 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. Examples include the launch of a brick-and-mortar store in Changsha city, Hunan province by Dangdang, China’s largest online bookstore in April 2016. Online nuts and snack retailer, Three Squirrels, also opened its first offline experiential store in Anhui province in September 2016. Apart from providing customers with interactive shopping experiences, these experiential stores also seamlessly integrate the companies’ online and offline businesses, from merchandise to pricing and payment, warehousing and delivery services.

2. Advanced technologies facilitate the creation of new business models and practices

In today’s digitized world, the wide adoption of the mobile Internet and advanced technologies has facilitated the creation of new business models and business practices. Recently, increasing numbers of Internet and e-commerce players have strengthened investment in Virtual Reality (VR) and Augmented Reality (AR), while some retailers have leveraged these latest technologies in their businesses.

For instance, in March 2016, Alibaba set up a VR/AR technology lab, Gnome Magic Lab (GM Lab). It also launched “BUY+” virtually 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. In March 2017, Alibaba announced the setup of an independent R&D department to house all of its R&D projects, including machine learning and AI. The plan, named the NASA project, is expected to cover core technologies such as machine learning, chips, Internet of Things (IoT), operating system and biometric identification.

Increasing numbers of retailers have also applied latest VR and AR technology in their stores, with a hope to enhance customer shopping experience. For example, South-Korean beauty brand Innisfree set up an in-store VR experience zone in its Shanghai Disneyland store. Customers can put on a head-mounted display and mount a bike to go on a virtual visit to Innisfree’s home base on Jeju Island in South Korea, and they can collect samples of natural ingredients when they pedal.

3. New consumers alter the market landscape

China’s millennials, or the so-called post-80s and post 90s generation, currently form the backbone of China’s working population and are replenishing China’s future middle class. These young consumers are set to power the growth of China’s consumer sector, as they have huge consumption intention with wealth accumulated and inherited from previous generations. According to Nielsen, consumers aged 20–30 years will contribute 35% to China’s total consumption in 2020, up from 15% in 2014.

Owing to rising income levels, China’s new consumers are more brand-conscious and quality-oriented. At the same time, they want the best possible value for their money. They also expect to have access to a “long tail” of products, with huge product choices. Meanwhile, personal experience matters considerably to them. They are finding greater satisfaction in experience, rather than material possessions.



Box 1:
Characteristics of Chinese millennials – the post-80s and post-90s generation

Well-educated, have strong desire to spend on upgrades

Many of them are well-educated. According to a survey by Credit Suisse, more than 50% of the young generation has attained at least a college degree. They have sustainable earning power and have a strong desire to spend on upgrades. They usually save less and spend most of their income on entertainment, advanced electronics, and other trendy products.

Internet savvy

This new generation has grown up with the Internet, and they constitute the majority of the online shoppers. According to CNNIC, online shoppers aged 20–29 accounted for around 50% of the total online population. A survey conducted by Peking University in 2015 showed that 62% of the surveyed consumers born in 1985–95 said that they like to spend their time surfing the Internet at home during their leisure time.

Highly mobile and highly social

Chinese consumers have adopted mobile phones as the dominate device to access the Internet and conduct product research. They rely heavily on social media platforms to discover and research brands, and share opinions on purchasing experience. The use of social networks such as WeChat is an integral part of their shopping journey. As of June 2016, there were 806 million active monthly users on WeChat. Chinese consumers like to share opinions on purchasing experience. According to Anslsys, a domestic research agency on Internet sector, 89.1% of the post-90s will share their purchasing experience. They are also easily influenced by key opinion leaders.

Individualistic

The Chinese millennials are determined to think about their own lives in ways that are specific, idiosyncratic, and infused with personal choice. They appreciate their own style and want to be unique. According to Analysys, 89.9% of the post-90s online shoppers think that “What I like” is the most important criteria for purchasing, followed by price (57.5%) and quality (50.9%).

Source: *Fung Business Intelligence*

4. New forms of business collaboration emerge; outbound M&A activities become prevalent

New forms of business collaboration and partnership emerged in China's retail sector in 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 (Exhibits 13 and 14). At the same time, China's "Go Global" strategy and the Belt and Road initiative have prompted large domestic companies to seek overseas expansion through M&A (Exhibit 15). Through acquiring well-established overseas brands, Chinese companies could adopt advanced technologies, brand-building know-how and strategic repositioning opportunities.

Exhibit 13: Selected major M&As in China's retail sector, 2016

Date of announcement	Bidder company	Target company	Deal Value (USD million)	Remarks
11 January	Mogujie.com	Meilishuo.com	n/a	<ul style="list-style-type: none"> The two Internet companies merged to form a new company (valued at around USD 30 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 April	Maoye International Holdings Ltd.	Inner Mongolia Victoria Commercial (Group) Ltd.	225	<ul style="list-style-type: none"> Acquired 70% share of target company.
2 June	Taobao	Suning Commerce Group	4,280	<ul style="list-style-type: none"> Taobao became the second largest shareholder of Suning with a stake of under 20%.
5 July	Alibaba Group	Wandoujia	200	<ul style="list-style-type: none"> 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

Exhibit 14: Selected major business alliances in China's retail sector, 2016

Date of announcement	Companies involved	Features/ objectives of collaboration
20 June	<ul style="list-style-type: none"> • JD.com • Wal-mart 	<ul style="list-style-type: none"> • 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 July	<ul style="list-style-type: none"> • Internet Plus Holdings Ltd. ("Meituan-Dianpin") • China Resources (CR) Enterprise Alliance Fund 	<ul style="list-style-type: none"> • 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 July	<ul style="list-style-type: none"> • Gome Online • Feiniu.com 	<ul style="list-style-type: none"> • 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 August	<ul style="list-style-type: none"> • 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 September	<ul style="list-style-type: none"> • 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! Brands China.
4 October	<ul style="list-style-type: none"> • 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 October	<ul style="list-style-type: none"> • Wal-mart • New Dada 	<ul style="list-style-type: none"> • 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

Exhibit 15: 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 January	Wanda Group	Legend Pictures LLC	U.S.	Entertainment	3,500	100%
15 January	Haier Group	General Electric Co-Appliance	U.S.	Home appliances	5,400	100%
2 February	Chem China	Syngenta AG	Switzerland	Agribusiness	43,000	100%
17 February	HNA Group	Ingram Micro Inc	U.S.	Technology	6,067	100%
3 March	AMC Entertainment (of Wanda Group)	Carmike Cinemas	U.S.	Entertainment	1,200	100%
14 March	Anbang Insurance Group Co.	Strategic Hotels & Resorts Inc.	U.S.	Finance	6,500	100%
30 March	Midea Group	Toshiba Lifestyle Products & Services Corporation	Japan	Home appliances	473	80.1%
6 June	Suning Commerce Group	Inter Milan	Italy	Soccer	307	70%
21 June	Tencent Holdings	Supercell Oy	Finland	Technology	8,600	84%
12 July	AMC Entertainment (of Wanda Group)	Odeon & UCI Cinemas Group	U.K.	Entertainment	1,210	100%
30 July	Giant Interactive Group Inc.	Playtika Ltd.	Israel	Entertainment	4,400	100%

Source: Internet resources; compiled by Fung Business Intelligence

5. Cross-border e-commerce is a new way for retailers to bring overseas brands into China

Over recent years, there has been strong demand for imported goods such as cosmetics, maternal and baby products, and healthcare products. Cross-border e-commerce (CBEC) offers a new channel for customers to purchase overseas products in China. It also offers an easy option for foreign retailers to tap the China market via authorized CBEC platforms such as Tmall Global, JD Worldwide, and Suning Overseas. Foreign brands and retailers do not need to obtain Chinese business license or register a company in China, nor do they need a physical presence in the country.

The government has been very supportive towards the development of CBEC. It has rolled out a number of favorable policies since 2012 to regulate and promote cross-border import e-commerce. It has set up comprehensive e-commerce pilot zones that are designated exclusively for the development of the CBEC industry, featuring a slew of preferential tax policies and streamlined customs clearance procedures compared with general import.

In April 2016, China implemented new tax policies for cross-border B2C import e-commerce. From April 8, 2016 onwards, CBEC imported goods will no longer be charged the personal postal articles tax¹. Instead, for orders within the transaction limit of 2,000 yuan, the new tax will include import tariff, VAT, and consumption tax, where the actual tax payable will be 70% of the calculated taxable amount. Import tariff is temporarily set at 0%. The new policies are intended to better regulate the CBEC channel and reduce policy loopholes, ensure tax collection, and reduce the price gap between CBEC and general import, so as to ensure a fair market environment for all players across online and offline channels.

4. Major challenges

1. Costs of operation are ever-increasing

Costs of doing business in China's retail market are continuously increasing. According to a survey on Chinese enterprises by the Chinese Enterprises Survey System, labor costs and expenditure on environmental protection are increasing particularly fast. At the same time, new technologies and new business models are reshaping, if not disrupting, the retail landscape. Retailers have to increase their investments in technologies and data analytics to keep pace with the needs of the rapidly changing environment.

¹ Before April 8, 2016, when purchasing on authorized CBEC platforms, personal postal articles taxes were being levied if the imported goods were classified as personal consumption items. Four tax rates were applied (10%, 20%, 30%, and 50%) for different product categories.

2. Success of business transformation is obscure

Despite the huge investments made in transformation and upgrading of business operations, not many retailer operators have obtained satisfactory results. The success of O2O strategy is elusive. Some retailers have put overwhelming emphasis on hardware upgrade, but have neglected the needs to enhance software and merchandise mix. Lack of differentiation in O2O strategy also remains a challenge.

3. Changing consumer demand brings new challenges to retailers' supply chain

While consumers become more discerning and demanding, they are also more conservative in their spending. They look for products with affordable pricing, and at the same time, value for money. Moreover, their demand for standardized products decreases, while demand for personalized products and services increase. To cope with these new demands, a mature supply chain that can react quickly is crucial. However, many operators are still in the early stage of rebuilding their supply chains. Besides, the rise of new delivery and fulfillment options such as “click & collect” and same-day delivery is also putting a strain on the supply chains of retail operators.

5. Concluding remarks

In recent years, the government has issued a number of major policies to facilitate the development of the retail industry and promote consumption and economic growth. The MOFCOM and nine other ministries jointly released the *13th Five-year Plan for the Development of Domestic Trade and Circulation* in November 2016, which sets out key tasks to guide the development of domestic trade and circulation in the next five years. The Plan encourages integrated development of commerce, tourism, culture and recreation with emphasis on experience and service, as well as the use of big data, Internet of things (IoT), and other information technologies to facilitate targeted marketing and provide personalized services and experiences. Enterprises are encouraged to strengthen brand awareness, increase the added value of their products and enhance soft power to meet the demand of an upgraded consumption structure.

In the same month, the General Office of 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.

The government has also been eager to push forward supply-side reform to solve retail supply-demand mismatch. In China, the supply structure has long been failing to meet the demand

structure. Serious supply-side problems such as excess capacity, repetitive products, lack of safe and high-quality products in the market have appeared for years. In November 2016, the MOFCOM and 12 other government departments jointly released the *Opinions of Accelerating Domestic Trade Circulation and Innovation, Optimizing Supply-side Structural Reform and Improving Consumption*. The Opinions aim to address the underlying issues that restrict consumption, further push forward supply-side reform and guide the transformation and upgrading of the circulation industry.

The supportive government policies, coupled with the proliferation of mobile Internet and technologies such as data analytics, modern logistics and cloud computing, will propel the “New Retail” regime to create a more advanced retail scene in China in the coming years.

Spotlight on China Retail – Issue 2

Department Stores

Asia Distribution and Retail

 FUNG BUSINESS INTELLIGENCE

March 2017

China's department store sector has entered a "deep-water zone" of business transformation and reached a tipping point in 2016. Increasing numbers of department store operators have actively explored new business models and retail formats with online-to-offline (O2O) retailing as the cornerstone. Alongside, a new round of elimination of underperformed players, adjustments and reorganization of the sector has begun. In the "New Retail" regime, embracing technologies and developing new business models to fully connect physical stores, online platforms and logistics services have become industry consensus.

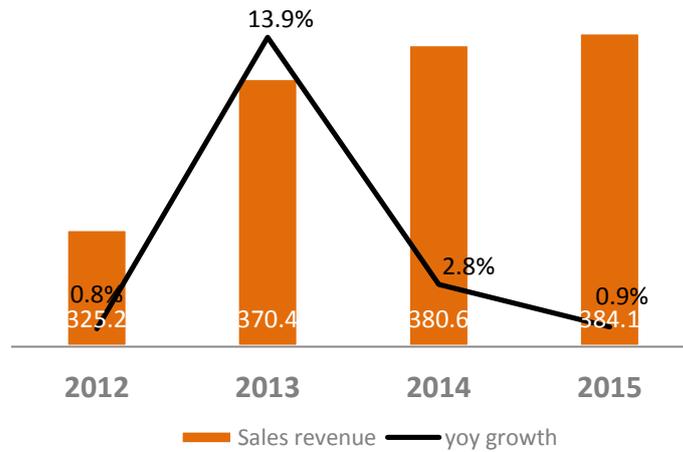
1. Market overview

1. Department store sales growth continues to slow

Despite the gradual improvement in China's macroeconomic environment and relatively stable growth of the retail market in 2016, China's department store sector still exposed to considerable threats and pressure. A number of key sector players have witnessed a significant slowdown in sales, dwindling margins and massive scale of closure of underperformed stores.

According to National Bureau of Statistics of the PRC (NBS), total sales revenue for department stores grew 0.9% to 384.2 billion yuan in 2015; growth rate declined by 1.9 percentage points (ppts) as compared with 2014 (Exhibit 1).

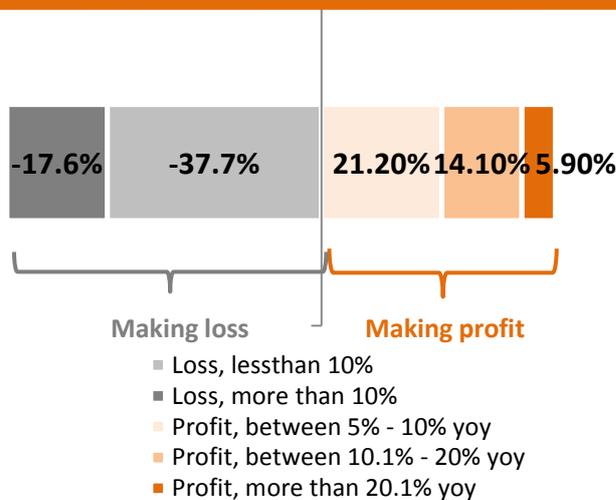
Exhibit 1: Department store total sales revenue, 2012 - 2015



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

According to the survey conducted by the China Commerce Association for General Merchandise (CCAGM) with 85 key department store operators to understand their annual sales and financial performance in 2016, more than half of the sample (55.3%) witnessed a drop in sales revenue in 2016, while 44.7% of the sampled department stores enjoyed positive yoy sales growth. Among those who have registered positive sales growth, only 5.9% enjoyed exceptional sales growth of more than 20.0% yoy in 2016; around one-quarter of the sampled department stores recorded a single-digit yoy growth of less than 10.0% in 2016 (Exhibit 2).

Exhibit 2: Yoy changes in sales revenue of 85 sampled department store operators, 2016



Source: CCAGM; compiled by Fung Business Intelligence

2. Trend of persistent store closures

China has entered a new era of consumption upgrade, demand for high-quality and innovative products and services increased tremendously. Some traditional department stores failed to meet the changing needs of the market and resulted in dropping foot traffic. This, together with persistent competition from e-commerce players and declining sales growth, has led to the closures of more department stores in 2016, compared with the previous year. Recent significant closures include the shutdown of Pacific Department Store in Huaihai Road, Shanghai. U.K.-based Marks & Spencer also announced in November 2016 its plan to close all of its ten stores in China. It is expected that closure of underperformed stores will continue in the coming year, while the pace of new store opening will slow down.

Selected department stores closures in China are shown in Exhibit 3.

Exhibit 3: Selected department store closures in China, 2016

Department Store	City	Closing month
Parkson Department Store	Chongqing	March 2016
	Xian	June 2016
	Chongqing	August 2016
	Jiangxi	October 2016
Rainbow Department Store	Beijing	October 2016
Rainbow Department Store	Shenzhen	February 2016
Novo Department Store	Chongqing	February 2016
Jiuguang Department Store	Hangzhou	July 2016
	Shenyang	March 2016
New World Department Store	Dalian	September 2016
	Beijing	January 2016
Pacific Department Store	Shanghai	December 2016
Maoye Department Store	Shenyang	June 2016
Tianhe Department Store	Guangzhou	August 2016
Mo Mall	Chengdu	February 2016
Hualian Department Store	Chengdu	June 2016
	Chengdu	October 2016

Source: *Linkshop.com.cn*; compiled by *Fung Business Intelligence*

3. Regional differentiation is obvious

From the regional point of view, the department store sector in China is getting more and more differentiated in terms of sales performance and operation capabilities. Sales growth of department stores in first-tier cities and the more developed eastern region have rebounded, while that in third-tier cities have still been lingered at low single-digit growth. In terms of transformation initiatives and effectiveness, the first-tier cities and the eastern coastal areas took the lead. In lower-tier cities, people's purchasing power is rising gradually; yet, with oversupply of commercial properties, the flourishing e-commerce and the weak consumer sentiment in high-end consumption, department store operators in the lower-tier cities are facing heavier pressure and stronger competition.

4. Domestic players dominate the department store sector

China's department store sector is dominated by domestic players. As shown in Exhibit 4, the top 10 department stores in terms of total sales revenue are all domestic department store operators.

Exhibit 4: Top 10 department store operators among the Top 100s, 2015 (Ranked by retail sales)

Rank	Name of company	Place of origin	Sales, pre-tax (million yuan)		Number of stores	
			In absolute terms	yoy change (%)	In absolute terms	yoy change (%)
1	 百联集团 BAILIAN GROUP Bailian (Group) Co., Ltd.		59,436*	-0.7	40	0.0
2	 欧亚集团 EURASIAGROUP Changchun Eurasia Group Co., Ltd.		33,457	12.4	34	9.7
3	 银座INZONE Yingzuo Group		22,978	-0.9	73	1.4
4	 大商集团 DASHANG GROUP Dalian Dashang Group Co., Ltd.		21,451*	-5.2	92	12.2
5	 振华集团 ZHENHUA GROUP Zhenghua Department Store Development Co., Ltd.		21,262	4.0	34	3.0

6	 武商集团 Wuhan Department Store Group Co., Ltd		20,907	5.8	11	10.0
7	 王府井百货 Wangfujing Beijing Wangfujing Department Store (Group) Co., Ltd.		20,866	-3.7	31	10.7
8	 CBEST Chongqing Department Store Co., Ltd.		19,887	-5.3	56	3.7
9	 银泰百货 Intime Retail Group Co., Ltd.		18,649	1.8	45	2.3
10	 RAINBOW 天虹 Rainbow Department Store Co., Ltd.		18,128	6.2	65	-3.0

Source: China Chain Store and Franchise Association; modified by Fung Business Intelligence

*Note: Estimated value

2. New developments and key trends

1. O2O being a crucial transformation elements in the “New Retail” regime

The term “New Retail” has been widely discussed over the past year. Under the “New Retail” regime, the line between online and offline businesses is blurring. E-commerce is no longer online only; many online activities can be translated into offline purchases, and vice versa.

Over the years, many department store operators have been actively deploying O2O strategies to ensure seamless integration of all channels – brick-and-mortar, online, mobile and social. Many operators have demonstrated growing sophistication with regard to O2O adoptions, with digitalization of retail outlets, launching O2O platforms, creating lifestyle scenes and introducing entertainment elements at physical stores being the key strategies.

Department Stores

The essence of O2O retailing is to create a consistent and engaging experience at every stage of the shopping journey whether in a physical store, on the web, or on the mobile devices. Some leading department store operators are already on their transformation journey towards being an O2O retail enterprise. Wangfujing Group is a case in point. It established an O2O centre by merging its marketing department, e-commerce company and O2O project team in November 2016. By integrating its offline resources with e-commerce business, Wangfujing Group hopes to strengthen its capabilities in drawing and retaining customers.

Golden Eagle Retail Group is another leading department store operator which has actively embraced O2O strategies. In 2016, Golden Eagle linked up all its channels, including retail stores, mobile app, WeChat social network platform and the “Electronic VIP Card” in order to create a seamless shopping experience for customers.

2. Partnering with key Internet players to roll out O2O initiatives

To stay competitive and grasp the opportunities created in the “New Retail” regime, some forward-thinking department store operators have proactively formed strategic alliances with Internet giants to roll out their O2O initiatives. Intime Retail Group and Bailian Group are cases in point.

Intime Retail Group formed partnerships with Alibaba Group

Intime has formed strategic partnerships with Alibaba since 2013. Since then, the two companies have worked together on a number of O2O initiatives, including the introduction of Tao-brands to Intime's physical stores, the launch of Intime's first online supermarket on Tmall Supermarket (chaoshi.tmall.com), and the adoption of Alibaba's one-stop shopping and location-based mobile app “Miao Street” in all Intime physical stores. Apart from these collaborations, Intime also adopted the “same price strategy” between its Tmall flagship store and offline stores so as to enhance customer shopping experience.

To put the “New Retail” concept into action, Intime and Alibaba joined forces to launch a lifestyle-themed homeware store “House Selection” in Hangzhou, the capital city of Zhejiang, in December 2016. House Selection aims to bring seamless O2O shopping experience for shoppers by enabling “offline shopping for online transaction” – customers can enjoy hassle-free shopping by directly scanning the products for self-service transactions. After making the purchase, consumers can enjoy door-to-door express delivery.

In January 2017, Alibaba Group announced to privatize Intime Retail Group. Upon the successful privatization of Intime, Alibaba will obtain 74% stake of Intime, and take over Intime's physical networks across the country, including 29 department stores and 17 shopping malls. This signifies Intime's determination to implement O2O strategies, and ride on Alibaba's resources and support to fully integrate its online and offline businesses.

Bailian Group and Alibaba Group announced strategic alliance

The strategic alliance between Bailian Group and Alibaba is another significant case to illustrate the close collaboration between department store operator and e-commerce giant in the “New Retail” regime. In February 2017, Bailian Group and Alibaba Group announced the formation of a strategic partnership to explore new forms of retail opportunities across each other’s ecosystem. The two companies will leverage big data capabilities to achieve integration across brick-and-mortar stores, merchandise, logistics and payment tools with the aim to deliver a better overall customer experience.

For Bailian, partnering with Internet companies such as Alibaba is a fast way to reinvent and revamp its businesses, as well as to roll out O2O strategies amid the challenging times facing traditional retailers. Although Bailian has launched its O2O e-commerce platform “iBailian” through its online transactional website “bl.com”, as well as a mobile app “iBailian App” and a WeChat public account, these platforms are unable to draw much customer traffics. The partnership will hopefully enable Bailian to leverage Alibaba’s huge traffic sources as well as its Big Data and logistics capabilities to provide better O2O services.

3. Enhancing uniqueness; focusing on product quality and service offerings

In recent years, the problems of homogenization of department stores have become more serious, resulting in dwindling margins and price wars amongst competitive players. To enhance uniqueness, many department store operators have revamped their stores by introducing special themes and exciting elements, and expanding services offerings with a hope to better cater to the needs of different consumer segments.

Department store operators endeavor to provide more experiential elements

In 2016, a variety of experiential elements appeared in department stores across the country. Many department stores have placed strong emphasis on upgrading lifestyle and service offerings, and adding experiential elements such as food and beverages (F&B), children’s playground, cinemas, leisure facilities, etc. to their physical stores. It has become a crucial transformation strategy for department store players to draw customers’ patronage and drive sales.

For instance, Rainbow Department Store opened three new stores in 2016 – Shenzhen Junshang 3019 Store, Rainbow Xinsha Shopping Centre and Zhuhai Rainbow Department Store. In order to bring innovative shopping experience to customers, the new stores are decorated in different special themes and lifestyle scenes; they encompass a wide range of leisure and entertainment elements, including F&B, bookstores, boutique supermarket, KTV, beauty salon, DIY workshops, etc. In addition, latest technology for self-checkouts is being

used in its supermarket. Consumers can scan the barcode of the merchandise with their Rainbow mobile app for self-checkouts.

Selected examples of lifestyle and shopping experience enhancement by other department store operators are shown in Exhibit 5.

Exhibit 5: Selected examples of lifestyle and shopping experience enhancement by department store operators in 2016

Department stores	Experiential elements
 <p>Golden Eagle Department Store</p>	<p>The Group transformed all its department stores into “Complete lifestyle centres” by expanding categories that enjoy greater growth potential, including sports, leisure and children-related categories. As of June 2016, the Group allocated 32.4% of the total operation area to lifestyle and experiential-related categories; total revenue of lifestyle and experiential-related categories reached 149.2 million yuan, up 38% yoy.</p>
 <p>Maoye Department Store</p>	<p>As of June 2016, the company has transformed more than 10 stores into shopping centres. Areas for F&B, entertainment and leisure facilities have been enlarged, resulting in a surge in foot traffic and higher rental revenue. Rental income from the transformed stores increased by 57% yoy.</p>
 <p>New World Department Store</p>	<p>New World Department Store enlarged the area for F&B to approximately 30% of the gross operation area. The company has also partnered with Tao-brands such as Inman to open six experiential stores in different branches; prices are the same online and offline.</p>
 <p>Beijing Modern Plaza</p>	<p>Modern Plaza transformed itself from a traditional department store to a lifestyle centre. It opened a boutique cinema with 33 different houses with special themes in May 2016.</p>
 <p>Reel Department Store</p>	<p>With the opening of “Zhongshu Books” bookstore (which claimed to be China’s most beautiful bookstore) in August 2016, Reel Department Store successfully created a strong cultural and artistic atmosphere and attracted higher customer traffics.</p>

Source: Respective company websites; various Internet sources; compiled by Fung Business Intelligence

Proliferate customer service to a new level

Apart from improving the overall shopping experience of customers by introducing experiential elements, many department store operators have stepped up their efforts to enhance customer service quality and enrich the content of VIP customer services so as to improve their core competencies.

To better understand the needs and preferences of customers, New World Department Store launched a “Chief Officer Experience Program” in August 2016. Store managers and senior management are required to spend no less than 30 minutes a day to conduct interviews with customers to collect their opinions on how the department store can better meet their needs. The program has thus far interviewed more than 10,000 customers, and collected a vast number of suggestions on how the department stores can improve further.

Maoye Department Store has also placed great emphasis on improving customer service in 2016. It has upgraded its Customer Relationship Management (CRM) system to facilitate targeted marketing. The operators launched promotions, discounts, in-store facilities, and customization service that are exclusive to members.

4. Accelerating transformation and introducing new business models

In the “New Retail” regime, unique positioning with differentiated products is the key to success. Increasing numbers of department store have increased efforts to introduce new brands to the market, adopt merchandise direct sales and develop private labels. By adopting these new business models, department store operators hope to gain competitive advantage and build a versatile product range to meet the diversified needs of customers.

Increase the proportion of merchandise direct sales and develop private labels

Recognizing the drawbacks of the concessionary model, many department store operators have been actively exploring the operation model of merchandise direct sales, developing their own private labels or being the exclusive distributor of brands.

Examples of merchandise direct sales business and private label development of selected department stores are shown in Exhibit 6.

Exhibit 6: Selected department stores that have engaged in merchandise direct sales and private label development

Department Stores	Merchandise direct sales and private label development
 <p>Hefei Department Store</p>	<p>To speed up its transformation towards merchandise direct sales business, in 2016, the Group enhanced the operation capabilities of women's apparel and gold and jewellery, which are operated under the merchandise direct sales model. The Group's supermarket has also endeavoured to increase the proportion of merchandise direct sales and private label products.</p> <p>By the first half of 2016, merchandise direct sales and private labels reached a total sales value of 410 million yuan, up 14.5% yoy.</p>
 <p>New World Department Store</p>	<p>New World Department Store recently established an in-house procurement team responsible for direct product procurement and acquisition of brand distribution rights. The company hopes to expand its direct sales business to more categories, including lifestyle products, fashion apparel and F&B.</p> <p>Earlier in 2015, the company obtained the sole distributor rights of Italian high-end fashion brands MOSCHINO, LOVE MOSCHINO and REDValentino in China.</p>
 <p>Anhui Andeli Department Store</p>	<p>Over 80% of its merchandise are sourced by the company's in-house buyers. The proportion of merchandise direct sales of large home electronics reached 100%, small home electronics goods reached 80%, leather shoes reached 100%, while apparel and jewellery reached 70% to 80%.</p>
 <p>Golden Eagle Department Store</p>	<p>To enrich distinctive merchandise offerings, the Group has formed close relationships with brand suppliers from different countries, including Germany, France, South Korea and Australia.</p> <p>The Group has also been eager to develop private labels. In 2016, it developed a series of premium quality men's shirts under the brand name "Aquila Doro Uomo". As of June 2016, the Group's private label products were sold in 242 counters across its branches nationwide. Total sales generated by merchandise direct sales and private labels reached 168.5 million yuan, up 20.1% yoy.</p>

Source: Respective company websites; various Internet sources; compiled by Fung Business Intelligence

Create buyer team and set up self-owned multi-label stores

To enhance uniqueness and differentiate themselves from their peers, some department stores have created their own buyer and sourcing team; some have even set up multi-label stores selling directly-sourced products. These multi-label stores usually comprise a large variety of unique brands and merchandise; they can retain customers and prolong duration of each stay.

Beijing Hualian Group's SKP Beijing is a case in point. In recent years, the company has transformed itself from a traditional department store to a boutique department store which features unique and exclusive designer brands, and multi-label stores as anchor shops. SKP Beijing has also established its own self-operated "SKP Select" concept store, and set up a professional buyer team which is responsible for sourcing, retail operation and visual display. The SKP Select



SKP Select at SKP Beijing

Source: *Fung Business Intelligence*

concept store sells merchandise of over 200 new and up-and-coming designer brands, including Alexander Wang, MM6, Opening Ceremony, Public School, Self Portrait, etc.

Another significant example is Bailian Group's Oriental Department Store (Xuhui branch). The store underwent upgrading and transformation in 2016. With a new brand name "Huaihai 755", the new store has adopted the "buyer model" for the first time, and became a "buyer incubator" for Bailian Group. It has set up a professional buyer team, and recruited experienced buyers from Lane Crawford and Galeries Lafayette. In the new store, there is a dedicated area to display overseas products sourced by the buyer team, especially the latest fashion items bought at large fashion events.

Rainbow Department Store is another department store operator which is keen to build its own buyer team and develop multi-label stores. It has set up a "buyer platform", known as "Rain" to coordinate all of Rainbow Department Store's self-owned multi-label stores, including fashion multi-label store "Rain&Co", womenswear multi-label store "Rain&Color", kidswear multi-label store "Rain&Kids", and home products multi-label store "Rain&Home".

Form collaborations with suppliers and brands; strengthen domestic and foreign supply chains

Increasing numbers of department store operators have formed stronger partnerships with players along the supply chain in order to build synergies, reduce cost and outperform their

competitors.

In 2016, Golden Eagle Retail Group sourced directly from its foreign upstream partners, including German department store KARSTADT and pharmacy chain STERN APOTHEKE. It also strategically cooperated with healthcare brands such as BLACKMORES from Australia and GNC from the U.S. to launch experiential counters in selected Golden Eagle's stores. The stores not only showcase the products of these brands, but also enable direct customer interactions and provide after-sales services to customers.

Diversify retail formats, tap into other business sectors

Over the years, more and more department store operators have sought to expand their scope of business and diversify their retail business.

To strengthen their core competencies, many operators have engaged in multiple retail formats, such as supermarket, hypermarket, convenience store and shopping mall. For example, Parkson Department Store has been diversifying its businesses over recent years. In 2016, the company set up a self-owned boutique supermarket, Parkson Supermarket. In 2017, the company will open a beauty concept store, Parkson Beauty to sell beauty and skincare products with personalized beauty advice offered to customers.

Another example is Bailian Group. The Group has also ventured into different retail formats, especially shopping mall and factory outlet over recent years; it has also announced development plans for the two segments:

- **Regional development of shopping malls** – the Group will further develop more prominent community-based shopping centres in Shanghai and Yangtze River Delta region in the future.
- **National expansion of factory outlets** – the Group has devised a nationwide expansion plan, and identified Changsha, Jinan, Chengdu, Hefei and other places to be the new factory outlet destinations. The Group targets to build 15 factory outlets nationwide by 2020.

As of the end of 2016, Bailian Group has 24 department stores, 16 shopping centres and five factory outlets.

Launch pop-up stores and concept stores

In the past year, the trend of setting up pop-up stores has mushroomed in the department stores sector. With interesting and innovative settings, shop designs and merchandise, pop-up stores can enhance shopping ambiance and customer experience, and thus get more foot traffics and generate higher short-term revenue. It has become a popular channel for department store operators to attract and engage customers. According to RET Property, a

Chinese commercial real estate research centre, pop-up stores could bring an extra 10% to 15% of sales turnover for shopping malls and department stores.

In 2016, Intime Department Store has cooperated with different brands to set up pop-up stores or concept stores. In September, Intime Department Store's Hangzhou Chengxi branch collaborated with British motor vehicle brand, Mini Cooper to launch a pop-up store for only three days to promote the brand. In December, Intime Department Store set up a multi-label luxury concept store in its Hangzhou Wulin branch. In January 2017, the company partnered with a popular blogger Dongdaodashu to launch a pop-up store in its Hangzhou West Lake branch.

As part of its China market expansion strategies, Galeries Lafayette has also partnered with different overseas brands to roll out pop-up stores. Examples of brands that have collaborated with Galeries Lafayette include Japanese luxury brand Comme des Garçons, snowboarding brand Burton and French affordable luxury brand Longchamp. Through regularly bringing in exclusive overseas brands in the form of pop-up stores, Galeries Lafayette has successfully established its unique positioning of a stylish and trendy department store.

5. Cross-sector integration and partnerships open up new opportunities

Today's new market dynamics have prompted department store operators to gear up and fully equip themselves. An increasing number of department store operators has formed partnerships and alliances with leading sector players to build synergies, create stronger business ecosystems, access to new technologies and talents, expand business areas, and enhance overall competitiveness.

For instance, Beijing Wangfujing Dongan Group and Sanpower Group formed a strategic partnership in May 2016. The two companies will work together in areas such as sourcing, private labels development, supply chain management and data sharing. Business assets from Sanpower's overseas acquisition, such as House of Fraser, Brookstone and Hamleys, will be incorporated into the business of Wangfujing Dongan Group.

Another example is Parkson Group. In August 2015, Parkson Group joined hands with Korea's E-Land Group to form a joint venture (JV) in Shanghai to build large-scale department stores. The JV company unveiled the Parkson Newcore Citymall in January 2016. The mall features a Korean-themed outlet concept, comprising numerous Korean fast fashion brands, discount stores and branded off-price stores. As of June 2016, Parkson Newcore Citymall enjoyed more than doubled sales as compared to pre-transformation.

6. Overseas department stores looking for opportunities in the China market

Despite the fact that China's department store sector has witnessed a trend of store closures over the past few years, some foreign department store operators still remain optimistic towards the future growth prospect of the China market and continue to expand their scope of business in China. Following the debut of Macy's China through Tmall in 2015, several other foreign department stores have entered or expanded their presence in China. A prominent case is House of Fraser. Acquired by Chinese conglomerate Sanpower Group in 2014, House of Fraser opened its first store in China in Nanjing, the capital city of Jiangsu province, in December 2016. The store is operated under a "merchandise direct sales + buyer" model, with more than 20 exclusive and self-owned brands.

Some other foreign department store operators have also expressed their intentions to further expand in the country. Examples include Galeries Lafayette and I.T. Fashion Group, the two companies plan to jointly launch five stores in China in the next three years. Lane Crawford Department Store also plans to kick-start their China expansion plan in 2017.

3. Concluding remarks

In the "New Retail" regime, the transformation of China's department store sector is inevitable. A new round of elimination of underperformed players, adjustment and reorganization of the sector has begun. While the department store sector is entering into the advanced phase of transformation and reinvention, a new market scene and competitive landscape are taking shape. Moving forward, department store operators should react quickly and explore their own strengths to pursue a positive future.

Against the background of consumption upgrading, especially the emerging middle class increasingly looking higher-quality products and better shopping experience, department store operators should think outside the box to actively promote innovations and embrace new technologies to drive the growth of business. They should also fully venture into O2O retailing with full connections across physical stores, online platforms and logistics services. O2O is and will continue to play a crucial role in driving the development of the department store sector.

Back to the basics of retailing is crucial. The essence of retailing is all about providing desirable goods and service offerings to a specific target market. Increasing numbers of department stores now adopt the hybrid model of "merchandise direct sales, private labels and concessionary". This new type of business model is set to become mainstream in the coming years.

Hypermarkets/ Supermarkets

Asia Distribution and Retail

 FUNG BUSINESS INTELLIGENCE

March 2017

The growth of hypermarkets and supermarkets in China has slowed down over recent years amid a slowing economy and retail sector. On the one hand, high rental and labor costs have prompted retailers to rethink their store expansion strategies. On the other hand, fast-growing online grocery platforms have posed increasing threats to their offline counterparts. Indeed, the year 2016 was a significant year of revamp for many traditional retailers. This trend is set to grow and continue well into 2017 and beyond. Hypermarkets and supermarkets, without exception, have been quick to embrace the online medium and are adopting new business models to better adapt to the digital era.

1. Market overview

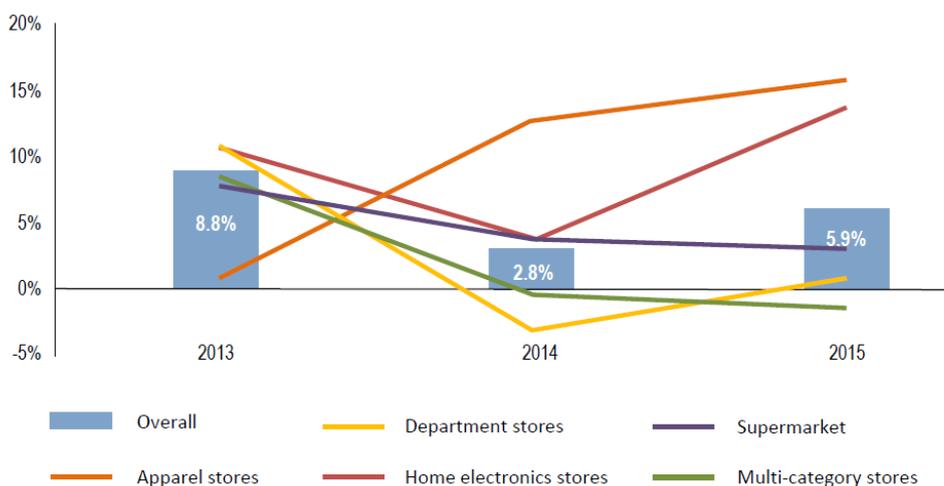
1. Hypermarkets and supermarkets see slowing sales growth

Many hypermarket and supermarket operators in China have been facing hard times in recent years. The sector as a whole has lost some of its share to the fast-growing e-commerce sector as well as the smaller-scale retail formats such as convenience stores, community stores and specialty stores. Slowing economic growth, weak consumer sentiment, and increasing operating costs have all hindered growth.

- The National Bureau of Statistics of the PRC (NBS) reported that total sales for hypermarkets and supermarkets amounted to 496.3 billion yuan and 311.8 billion yuan, respectively, in 2015, slightly higher than that in 2014 (464.7 billion yuan and 298.2 billion yuan, respectively).
- Sales growth of the hypermarket and supermarket sector as a whole has decreased gradually over recent years. According to a report by China Chain Store and Franchise Association (CCFA) and PricewaterhouseCoopers (PWC), sales growth of the supermarket sector was slower than that of apparel stores and home electronics stores in 2015 (Exhibit 1).
- According to the annual list of “Top 100 fast-moving consumer goods (FMCG) chain

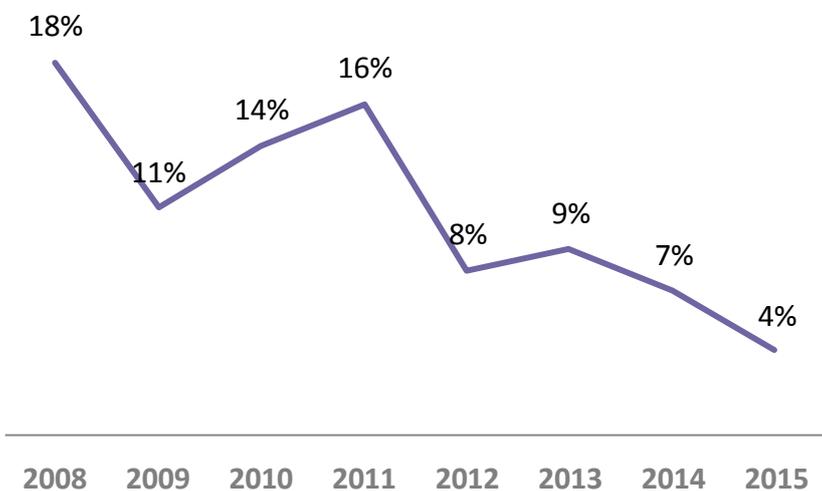
operators in China” released by the CCFA, FMCG chain operators that topped the list achieved sales growth of 4.1% year-on-year (yoy) in 2015 (Exhibit 2) and reached 105.7 billion yuan. The growth rate was 0.2 percentage points (ppt) lower than that of the “Top 100 retail chain operators” (the Top 100s) in general.

Exhibit 1: Sales growth by retail formats, 2013 - 2015



Source: CCFA; PWC; compiled by Fung Business Intelligence

Exhibit 2: YoY sales growth of FMCG chain operators among the Top 100s in China, 2008 - 2015

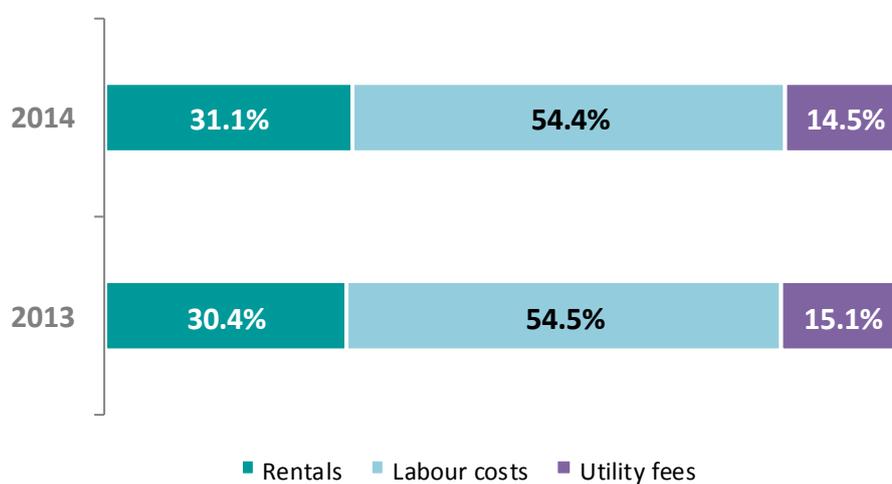


Source: China Chain Store and Franchise Association; compiled by Fung Business Intelligence

2. Labor costs increase rapidly

A survey conducted by the CCFA and Deloitte on the financial performances of 103 listed companies in the hypermarket and supermarket sector in China showed that hypermarkets and supermarkets spent the most on wages. As shown in Exhibit 3, labor costs accounted for 54.4% of total costs of surveyed enterprises in 2014, while rentals accounted for 31.1%, and utilities represented 14.5%. Exhibit 4 shows the major KPI of the surveyed hypermarkets and supermarkets in 2013 and 2014. Total number of staff decreased by 0.5% yoy in 2014, while labor costs increased by 6.7% yoy, indicating that the increase in wages was still significant.

Exhibit 3: Cost structure for hypermarkets and supermarkets in China, 2013 - 2014



Source: China Chain Store and Franchise Association; Deloitte; compiled by Fung Business Intelligence

Exhibit 4: Major KPI for hypermarkets and supermarkets, 2013 - 2014

	2013	2014	yoy change (%)
Sales revenue (billion yuan)	11.1	11.4	+2.6
Store number	430	440	+1.4
Operating area (sqm)	734,000	797,000	+8.6
Number of staff	10,200	10,200	-0.5
Rentals (million yuan)	142	155	+9.2
Labor costs (million yuan)	254	271	+6.7
Utility fees (million yuan)	70	72	+2.9

Source: China Chain Store and Franchise Association; Deloitte; compiled by Fung Business Intelligence

2. Competitive landscape

1. Key hypermarket and supermarket players among the Top 100s

Exhibit 5 shows the key FMCG operators in terms of sales among the Top 100s in 2015. Most of them are engaged in hypermarket and supermarket businesses. Topping the list in this category is China Resources Vanguard, followed by Sun Art Retail Group, Wal-mart (China), Lianhua Supermarket, and Yonghui Superstores.

Exhibit 5: Top 10 FMCG players among the Top 100s, 2015 (Ranked by retail sales)

Rank	Name of company	Place of origin	Sales, pre-tax (million yuan)		Number of stores	
			In absolute terms	yoy change (%)	In absolute terms	yoy change (%)
1	 China Resources Vanguard Co. Ltd. ¹		109,400	5.2	3,397	-17.7
2	 Sun Art Retail Group Ltd. ²		107,906	4.8	409	9.9
3	 Wal-mart (China) Investment Co., Ltd. ³		73,547	1.6	432	5.1
4	 Lianhua Supermarket Holdings Co., Ltd. ⁴		60,474	-2.1	3,912	-9.5
5	 Yonghui Superstores Co., Ltd.		49,309*	14.8	394	16.9
6	 Carrefour China Inc.		40,102	-12.3	234	-1.3
7	 Better Life Commercial Chain Share Co., Ltd.		31,017	14.7	577	9.9
8	 Nonggongshang Supermarket (Group) Co., Ltd.		28,511	-3.0	2,493	-2.8
9	 Wumart Stores Inc.		26,255	19.5	552	-2.3
10	 Easy Joy Convenience Store (Sinopec Group)		24,800	44.8	25,000	4.2

Source: China Chain Store and Franchise Association; modified by Fung Business Intelligence

*Note: Estimated value

¹Sales of China Resources Vanguard Co. Ltd. included sales of Suguo Supermarket.

²Sales of Sun Art Retail Group Ltd. included sales of RT-Mart Shanghai and Auchan.

³Sales of Wal-mart (China) Investment Co., Ltd. excluded sales of YHD.

⁴Sales of Lianhua Supermarket Holdings Co., Ltd. included sales of Carrefour in Shanghai.

While most large-scale key players in the hypermarket and supermarket sector are nationally focused, many smaller-sized domestic supermarkets and hypermarkets operate regionally. On the other hand, most foreign players tend to adopt a national approach when expanding, whereas domestic players generally focus on regional rollouts.

2. Performance of major hypermarket/ supermarket operators

In 2016, the performance of hypermarkets and supermarkets was mixed. A few key operators such as Wal-mart (China), Yonghui Superstores and Sun Art saw a rebound in sales, while many still saw declining sales. Exhibit 6 showed the performance of selected major hypermarket/ supermarket chains in China in 2016.

Exhibit 6: Performance of selected hypermarket/ supermarket chains in China, 2016

Name of company	Performance
 <p>Wal-mart (China) Investment Co., Ltd</p>	<ul style="list-style-type: none"> Wal-mart (China) announced that it recorded a 5.4% yoy sales growth in 4QFY17 (November 2016 – January 2017). Comparable store sales increased by 2.3% yoy and comparable average ticket size grew by 5.2% yoy. The growth in sales was contributed mainly by its hypermarkets and Sam's Club stores. In terms of product categories, fresh produce and dried food performed the best in the period. In 2016, Wal-mart (China) opened 24 new stores, including 21 hypermarkets and three Sam's Club stores. In 2017, it will open 30-40 new stores, including three to five Sam's Club stores, invest in its logistics distribution centres, enhance its private labels and direct import products portfolio, as well as speed up the implementation of its e-commerce integration plan. For its e-commerce business, Wal-mart (China) will strengthen collaboration with JD.com. Both companies will work closely both online and offline in the provision of products and services as well as the extent of its coverage and strengthen its fresh produce express delivery capability.
 <p>Sun Art Retail Group Ltd.</p>	<ul style="list-style-type: none"> Revenue amounted to 100.4 billion yuan in 2016, up by 4.2% yoy. Revenue from the sales of goods amounted to 97.1 billion yuan, up by 4.1% yoy. Same-store sales growth was -0.34%, up from -3.6% in the previous year. Improvement in same-store sales growth was attributed to the efforts made by the Group in promoting fresh products, differentiating the business and integrating online and offline operation. GMV of RT-Mart's Feiniu.com for the period was 2.1 billion yuan, doubled that of the previous year. As of December 31, 2016, the Group had a total of 446 hypermarket complexes in China.

 <p>Yonghui Superstores Co., Ltd.</p>	<ul style="list-style-type: none"> • Total sales revenue is estimated to 49.2 billion yuan, up by 16.79% yoy, while net profit was 1.24 billion yuan, up by 105.23% yoy. • The sharp rise in net profit in the financial year of 2016 was due to the non-operating profit contributed by Yonghui's sale of its stakes of Lianhua Supermarket Holdings. • As of March 2017, there were 477 branches of Yonghui Superstores.
 <p>New Huadu Supercenter Co., Ltd.</p>	<ul style="list-style-type: none"> • In 2016, total revenue reached 6.71 billion yuan, up 3.42% yoy. • As of September 2016, there were 121 supermarkets and 9 department stores under New Huadu.
 <p>Lianhua Supermarket Holdings Co., Ltd.</p>	<ul style="list-style-type: none"> • Total revenue dropped by around 440 - 480 million yuan in 2016. • In December 2016, Yonghui Superstore sold all the shares it held in Lianhua Supermarket, 21.17% of the issued shares of Lianhua, to Yiguo.com at HK\$950.5 million. After the transaction, Yiguo.com became the second largest shareholder of Lianhua Supermarket.
 <p>C.P. Lotus Corporation</p>	<ul style="list-style-type: none"> • Total revenue was 10.1 billion yuan in 2016, down 5.4% yoy. • CP Lotus will reportedly focus business in Guangdong. It closed 4 stores outside Guangdong and opened 3 stores in Guangdong in 2016.
 <p>Better Life Commercial Chain Share Co., Ltd.</p>	<ul style="list-style-type: none"> • Total revenue was 15.5 billion yuan in 2016, up 0.29% yoy. • Store expansion pace was faster than in 2015, with 34 new supermarkets and 5 new department stores opened in 2016.
 <p>Renrenle Commercial Group Co., Ltd.</p>	<ul style="list-style-type: none"> • Total revenue was 10.2 billion yuan in 2016, down 9.14% yoy.

Source: *Winshang.com*; compiled by *Fung Business Intelligence*

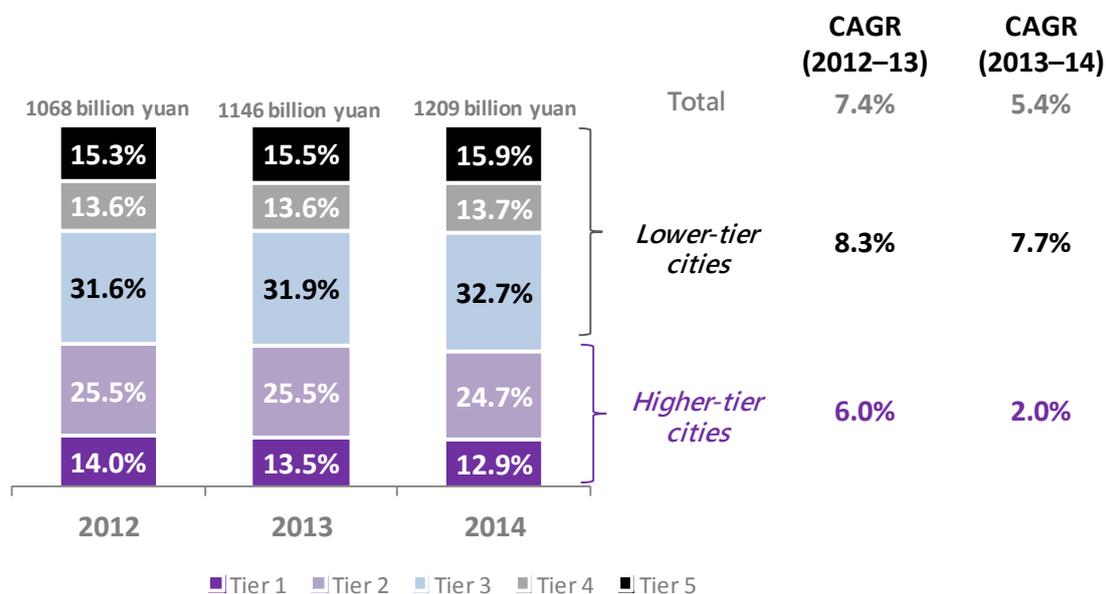
3. Domestic players remain the dominant force, but foreign players expand fast

Over recent years, domestic retailers have increasingly become the dominant force. Among the FMCG players in the Top 100s, sales growth of domestic retailers was 7.5% yoy in 2014, while sales growth of foreign retailers was 4.4% yoy. However, foreign players led in terms of expansion; foreign retailers saw a 16.8% yoy growth in the number of stores compared with 4.4% yoy for domestic retailers.

4. Lower-tier cities are the focus

While higher-tier cities remain a critical market for many FMCG players, growth in lower-tier cities has been phenomenal over the past few years. According to Bain and Co., the value of the overall urban FMCG retail market (tier 1 and tier 2 cities) only rose by a compound annual growth rate (CAGR) of 2% in 2014, compared with 7.7% CAGR for lower-tier cities (tier 3 to tier 5 cities) (Exhibit 7). Some hypermarket and supermarket operators have been actively expanding in lower tier cities. For example, in 2015, Wal-mart (China) opened stores in a number of counties in tier 4 and 5 cities, including Chifeng in Inner Mongolia, Lijiang in Yunnan, Xiapu in Fujian, and Pingyang in Zhejiang.

Exhibit 7: Value share in urban FMCG retail market by city tier, 2012 - 2014



Source: Kantar World Panel; Bain & Co.; compiled by Fung Business Intelligence

5. Pace of new store openings has slowed

The pace of hypermarket and supermarket store openings has slowed down over recent years. The growth in the number of new store openings of the Top 100 FMCG players fell from 5.0% yoy in 2014 to 4.2% yoy in 2015. Many undertook store revamps and closed unprofitable stores. Exhibit 8 shows the store closures of selected hypermarket and supermarket players in 2016. Major reasons for store closures include wrong store location, excessive supply of hypermarkets in certain areas, and high rental and labor costs.

Exhibit 8: Store closures of selected hypermarkets and supermarkets, 2016



Hypermarket/Supermarket	Store closures in 2016
Wal-mart (China)	13
China Resources Vanguard	12
Yonghui Superstore	11
ParknShop China	8
Carrefour China	5
Hualian Supermarket	3
Aeon Stores	1
RT-Mart	1
CP Lotus	1

Source: Linkshop; compiled by Fung Business Intelligence

3. Development trends

1. Accelerating format evolution

Hypermarket and supermarket operators move to smaller-sized format

Small format shops have gained popularity over the years as they can better address consumers' increasing demand for convenience, personalization, and fast services. Some hypermarket and large-scale supermarket operators such as Carrefour, Metro, China Resources Vanguard, Better Life Group, and RT-Mart have branched out into small-scale stores.

Carrefour expanded into the convenience store format by opening its first "Easy Carrefour" convenience store in November 2014 in Shanghai. The pilot store has a gross floor area of

300 sqm, spread on two levels, and features a stylish design, with a large area selling fresh fruits and fresh produce as well as imported private label products. There is a large seating area with benches, tables, and chairs on the second floor. The store offers free Wi-Fi services and other value-added services such as utility bill payment, purchase of train tickets, lottery tickets or insurance via self-service kiosks located in the store. As of January 2017, there were 26 Easy Carrefour stores in China.

Metro has also launched a convenience store format “Hemaijia” in November 2014 in Shanghai. It plans to open more stores close to schools, residential communities, and hospitals. China Resources Vanguard is another retailer that has shifted its focus to a smaller-sized retail format. Toward the end of 2015, it had over 1,500 stores in the smaller-sized retail format. Domestic leading retail chain Better Life Group has rolled out its “YunhouWifi convenience stores” program in June 2015. “YunhouWifi convenience stores”, located in residential communities, sell not only goods but also provide courier services, fresh breakfast foods and services, and offline payment services, among others. We expect an increase in the number of smaller-scale supermarket stores and convenience stores in 2017.

Hypermarket and supermarket operators tap the shopping mall sector

In contrast, some retailers opt for a larger-sized shopping mall format that incorporates more experiential elements and services for consumers. For example, Wal-mart (China) has invested 600 million yuan to build its first shopping mall “The Mall” in Zhuhai. The 100,000 sqm mall was opened in May 2016, housing a Sam’s Club store as its anchor store. Following the Zhuhai project, Wal-mart (China) would invest over 600 million yuan to build an international shopping center in Nanchang, Jiangxi Province. The shopping center, which is designed to cover a construction area of 100,000 sqm, is set to open for business in 2017.



“The Mall”, a shopping center in Zhuhai launched by Wal-mart (China). (Source: Sina)

Supermarket operators open premium supermarkets

Premiumization is a focus for many supermarket operators. With increasing incomes, some consumers, especially the middle class, are more willing to pay a premium for higher quality products. A number of supermarket operators have tapped the premium segment in recent years. For example, RT-Mart launched its first premium supermarket “RH Lavia” in September 2015. Suguo also opened its premium supermarket “SG life” in November 2015. Fresh food products account for 40% of the total products in the store, while other food items account for 40% and non-grocery goods account for 20%. In December 2014, Greenland Group opened a premium supermarket, “DIG Supermarket,” in Shanghai, focusing largely on imported goods. There is an area selling cross-border imported products. It intends to open 50 stores by 2018 in Shanghai, Hangzhou, Ningbo, Nanjing, and other cities.

Membership stores become the next focus

Wal-mart (China) is the first-mover to introduce the membership-based hypermarkets in China. Its Sam’s Club has been one of the major contributors in terms of sales in 2016 for Wal-mart (China). There are currently 14 Sam’s Clubs in China, and three of them were opened in 2016. CP Group also launched their membership-based hypermarket Chia Tai Club in September 2016. CP Group plans to open 22 Chia Tai Club by 2022, focusing on the Pearl River Delta region and Yangtze River Delta region.



Storefront of Chia Tai Club, a membership-based hypermarket by CP Group. (Source: Retail Observer)

2. Embracing O2O strategies

Rollout O2O mobile service platform

Online-to-offline (O2O) is a common initiative adopted by hypermarket and supermarket players. A typical example is Wal-mart (China). It launched an O2O service platform for its hypermarkets since May 2015 in various cities such as Shenzhen, Guangzhou and Dongguan. The mobile shopping app “Wal-mart to Go” offers service centers for product pick-ups, and multiple O2O e-payment options. Customers can shop online via the mobile app, and they can choose to have their online orders delivered to their home or opt for self pick-up at selected physical store. Currently, the mobile app offers more than 10,000 items, including fresh produce, dairy, frozen food produce, health and beauty products, and household cleaning products. All products sold online are of the same quality and price as the ones in physical stores. In December 2015, Carrefour China also launched a mobile app for its online platform, which provides delivery and pick-up services for consumers. As of the end of 2016, the app is available in cities including Beijing, Shanghai, Chengdu, Kunming, and Suzhou.

Another example is China Resources Network, a subsidiary of China Resources Group which operates over 6,000 physical stores, including Vanguard supermarkets, the Mixc shopping malls, Ole’, BLT, and V+ high-end supermarkets and Vango convenience stores. The company launched a mobile app, which is positioned as an integrated e-commerce platform offering scenario-based services. The mobile app facilitates the O2O connection between China Resources Group, the Group’s external partners, and consumers. The mobile app also offers a joint membership scheme that combines membership data from all business partners of China Resources Group.

Form strategic alliance to drive synergies

An increasing number of traditional grocery players have formed partnerships with Internet companies to better equip them with tools, such as payment tools, social media, and big data analytics, to facilitate online and offline shopping. In turn, Internet companies could leverage hypermarkets or supermarkets to reach consumers through physical touch points. For example, in June 2016, Wal-mart (China) announced a partnership with JD.com and further increased its stake in JD.com to 12.1% by the end of 2016 and became the third largest shareholder of JD.com. JD.com will help further push Wal-mart (China)'s e-commerce and O2O strategy. In October 2016, Sam's Club entered JD.com. In March 2017, Wal-mart (China) announced that selected retail branches of Wal-mart (China) will start working with JD Daojia, an O2O service platform under JD.com which provides fresh food delivery services. The platform has over 30 million registered users. Wal-mart (China) estimated that over 180 of its retail stores across more than 20 cities in China will be connected to the JD Daojia online platform by end of 2017. Currently, Wal-mart (China) sells over 1,200 SKUs on JD Daojia, including products such as fresh produce, dried food, maternity and baby products.

Another significant strategic alliance is the partnership between Alibaba and Sanjiang Shopping Club. Hangzhou Zetai, Alibaba's subsidiary announced in November 2016 that it would invest 2.1 billion yuan in Sanjiang. Alibaba now holds 32% stake in Sanjiang. Meanwhile, the two companies signed an agreement to establish a joint venture company Ningbo Zetai Technology Service Co., Ltd. to run a fresh produce store. Ningbo Zetai is responsible for store set-up and daily operations, including operations of the mobile app, supply chain and logistics.

Earlier in August 2015, JD.com entered into an agreement with Yonghui Superstores. The strategic partnership provides Yonghui a cost-effective way to acquire online customers and improve inventory turnover, leveraging on JD.com's strong online platform. While Yonghui's extensive physical store network plays an important role in the distribution of fresh food products and deployment of O2O strategies.

Supermarkets provide O2O delivery services

Some grocery retailers have cooperated with third-party operators to provide faster O2O delivery services to consumers. For example, in December 2015, Yonghui allied with JD Daojia to provide fresh food delivery services. The service promises delivery under two hours within a three-kilometer zone of the Yonghui store. Another example is RT-Mart. It has officially joined Meituan, an O2O delivery platform, in January 2017. Over 200 RT-Mart outlets in five regions in China – East China, North China, Central China and South China – are linked with Meituan. Consumers can order RT-Mart's merchandise via Meituan's mobile

and users can either search for “RT-Mart” or click on “Supermarket” to enter RT-Mart online after opening Meituan’s app via their mobile app and enjoy fast delivery services.

3. Focusing on fresh food products

In recent years, increasing numbers of supermarket chains have put more focus on fresh food business. For example, Jingkelong, a domestic supermarket chain based in Beijing, has established a new brand Jingjie Fresh Food in June 2016 which focuses on fresh food products. In the meantime, Jingkelong has started to revamp its supermarkets in the community and convert them into a new brand Jingjie Fresh Food. According to Jingkelong, fresh foods in these stores account for one-third to half of the product mix.



Jingjie Fresh Food, a new format developed by Jingkelong which mainly sells fresh food products.
(Source: cszk.com.cn)

Despite the rapid development of the fresh food business, there still remain some major challenges. In particular, fresh food products require high-level merchandising and supply management capabilities and have more stringent cold chain logistics requirements.

4. Online grocery 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 (China) took full ownership in July 2015. JD.com has taken over the Yihaodian brand, website and app, while Wal-mart (China) will continue to operate the Yihaodian direct sales business and become a vendor on the Yihaodian marketplace. In exchange, Wal-mart (China) 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.

5. Taking part in direct procurement

In general, direct procurement from manufacturers accounts for less than 10% of hypermarkets and supermarkets' total procurement value. Many retailers realize that direct procurement will lead to margin improvement and enhance supply chain efficiency, and thus are keen to improve the proportion. For example, Yonghui and CJ Freshway Corporation (a South Korean food giant) have reached a strategic cooperation agreement to jointly develop a global procurement platform for fresh food products in November 2015.

6. Putting more efforts in private label development

An increasing number of hypermarket and supermarket players have launched their private labels in recent years. According to the aforesaid survey by CCFA and Deloitte, 42% of the 103 surveyed enterprises have launched private labels; however, sales of private labels accounted for only 6.4% of the total sales. The development of a private label is much slower in China than in other developed countries. According to Nielsen, U.K., Spain, and Switzerland had value shares of more than 40% in 2015 for private labels.

It is generally believed that private label development is one of the winning tools to differentiate from other retailers and earn higher profit margins. A survey by CCFA on the profitability of private labels showed that profit margin for hypermarket and supermarket chains with their own private labels was 15% higher than those without their private labels.

7. Leveraging new retail technologies

The rise of new retail technologies is having profound implications for hypermarkets and supermarkets. For example, Guangzhou's first large-scale lifestyle, intelligence and experiential supermarket FreshMart officially opened in November 2016. It is located at Mall of the World in the North District of Zhujiang New City, Guangzhou, with an area of 3,000 sqm. FreshMart adopts the new business model of "Intelligence Internet + New Retail". It deploys the RFID system to fully integrate its online and offline inventory system; it accepts online payment, and adds experiential and leisure elements inside the supermarket, including a cross-border shop-in-shop of 891WORLD, a children's playground, a floral display area, and a dessert-tasting area.

3. Concluding remarks

China's hypermarket and supermarket sector is in the midst of a challenging time given the fierce competition, increasing costs of operation, and lower profits margins. Pure retail elements are no longer the focus for the sector; by contrast, online grocery has become more popular. However, the hypermarket and supermarket format is still doing well in less competitive regions and cities, or places where last-mile delivery is not that efficient. Retailers certainly need to adjust their expansion strategies in order to take advantage of the opportunities. Also, they have to make their brands stay relevant in the digital era by adopting innovative technologies and business models, and more importantly, to enhance customer's shopping experiences.

The cover features a dark blue background with a bright blue spotlight effect on the left side. A cluster of teal-colored squares of various sizes is arranged in a stepped pattern, resembling a staircase or a modern logo. The text is positioned on the right side of the cover.

Spotlight on China Retail – Issue 4

Convenience Stores

Asia Distribution and Retail

 FUNG BUSINESS INTELLIGENCE

March 2017

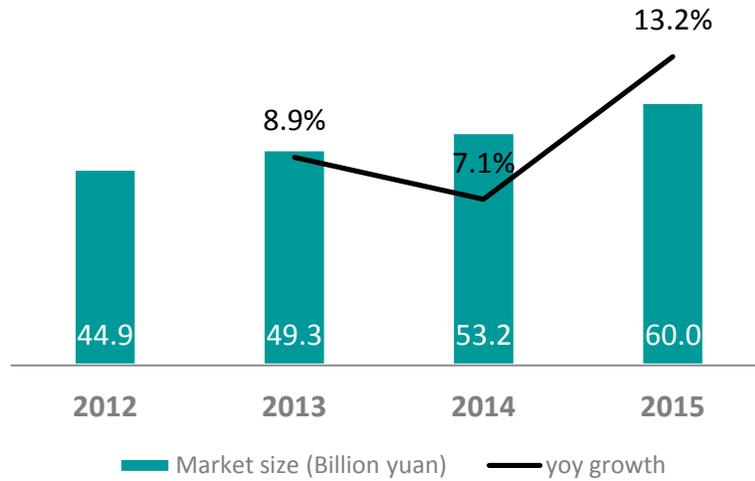
Small format shops, especially convenience stores (CVS) and community stores, have gained popularity over the years as consumers are getting more mature and have higher spending power. As small-scale retailers, CVS has the advantage of being more accessible to customers, while offering quicker services and better experience. As with other retail formats, the CVS sector has undergone rapid transformation and reinvention in the rapidly evolving retail environment.

1. Market overview

1. CVS sector sees rapid sales growth

CVS has been the fastest-growing retail format in China in recent years. Total sales revenue for the CVS sector reached 60.0 billion yuan in 2015, up 13.2% year-on-year (yoy) (Exhibit 1). The growth momentum of CVS is expected to continue, as small retail format continues to gain in popularity in China's retail market. According to the Ministry of Commerce (MOFCOM), the yoy growth of key retailers in the CVS and shopping mall sector reached 7.7% and 7.4% respectively in 2016, faster than the average growth of key retailers in other retail formats of 4%.

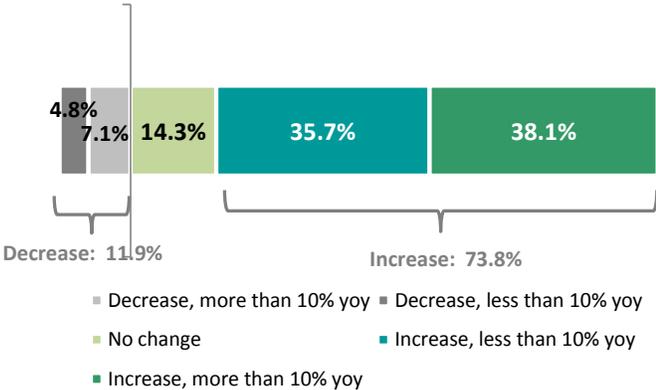
Exhibit 1: Total sales revenue for CVSs, 2012 - 2015



Source: Kantar Worldpanel, Bain Analysis; compiled by Fung Business Intelligence

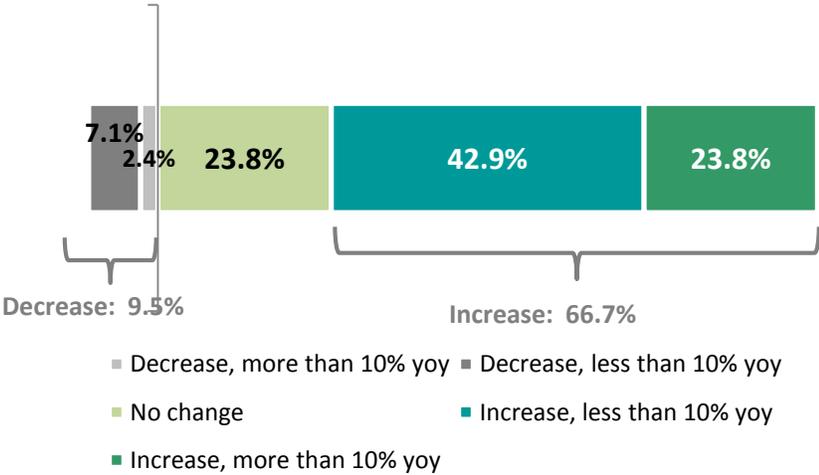
According to a survey by China Chain Store and Franchise Association (CCFA), 74% of the sampled CVS recorded growth in sales revenue in 1H16; of which, 38% achieved sales growth of over 10% yoy. Also, 67% of the surveyed CVS recorded positive same-store sales growth; of which, around 24% of the respondents reported over 10% yoy same-store sales growth (Exhibit 2 and 3). Exhibit 4 shows that 62% of the respondents expected slightly better performance of CVS compared with 2015.

Exhibit 2: Growth of sales revenue of sampled CVS, 1H16



Source: China Chain Store and Franchise Association; compiled by Fung Business Intelligence

Exhibit 3: Same-store sales growth of sampled CVS, 1H16



Source: China Chain Store and Franchise Association; compiled by Fung Business Intelligence

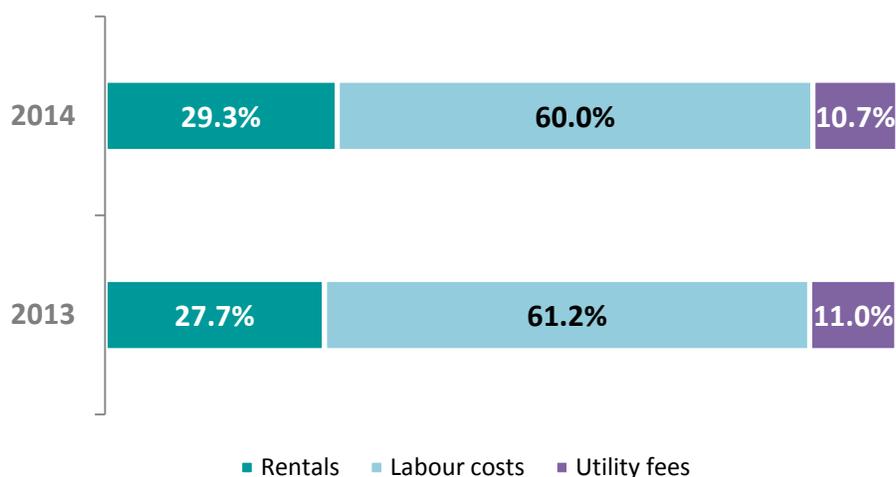
Exhibit 4: Expectation of the development of CVS sector in 2016 compared with in 2015


Source: China Chain Store and Franchise Association; compiled by Fung Business Intelligence

2. Labor costs make up a high proportion of total costs, while rental costs increase significantly

Labor costs have increased rapidly over recent years and account for a high proportion of total operating costs. CVS operators spent the most on wages. According to a survey by CCFA and Deloitte, labor expenditures accounted for 60.0% of total costs of the surveyed enterprises in 2014, down from 61.2% in 2013 (Exhibit 5). As shown in Exhibit 6, total number of staff decreased by 2.2% yoy in 2014, while labor cost increased by 7.6% yoy, indicating that the increase in wages was still significant in 2014. High labor costs were attributed largely to the long operating hours of CVS, usually more than 16 hours per day.

Rentals, on the other hand, accounted for around 30% of the total operating costs and contributed the largest increase in total costs at 15.9% yoy, compared to 7.6% yoy increase in labor costs and 6.7% yoy increase in utilities in 2014.

Exhibit 5: Cost structure for CVS, 2013 - 2014

Source: China Chain Store and Franchise Association, Deloitte; compiled by Fung Business Intelligence

Exhibit 6: Major KPI for CVS, 2013 - 2014

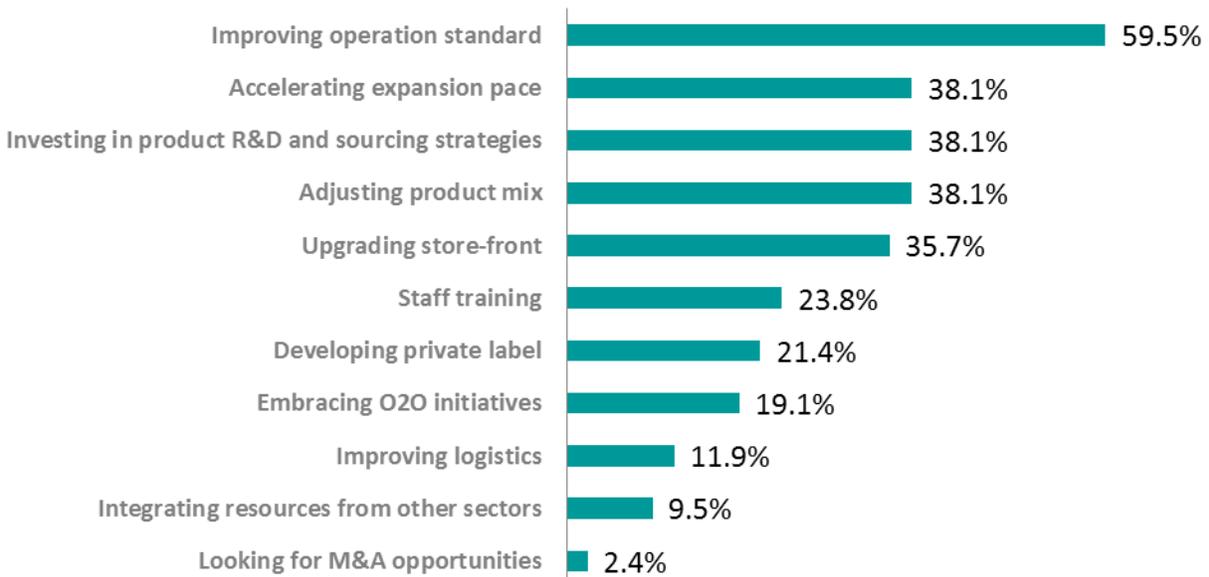
	2013	2014	yoy change (%)
Sales revenue (billion yuan)	4.5	4.7	+4.4
Store number	1,490	1,580	+6.0
Operating area (sqm)	417,000	429,000	+2.9
Number of staff	7,220	7,060	-2.2
Rentals (million yuan)	168	194	+15.9
Labor costs (million yuan)	370	398	+7.6
Utility fees (million yuan)	67	71	+6.7

Source: China Chain Store and Franchise Association, Deloitte; compiled by Fung Business Intelligence

3. Improving operation standards is the major focus of CVS sector

According to the survey by CCFA, improving operation standard is the number one focus of the CVS chains in 2016 (Exhibit 7). Given a better operation standard, CVS chains can adjust quickly to the fast-changing retail environment.

Exhibit 7: Major focuses of the development of CVS in 2016



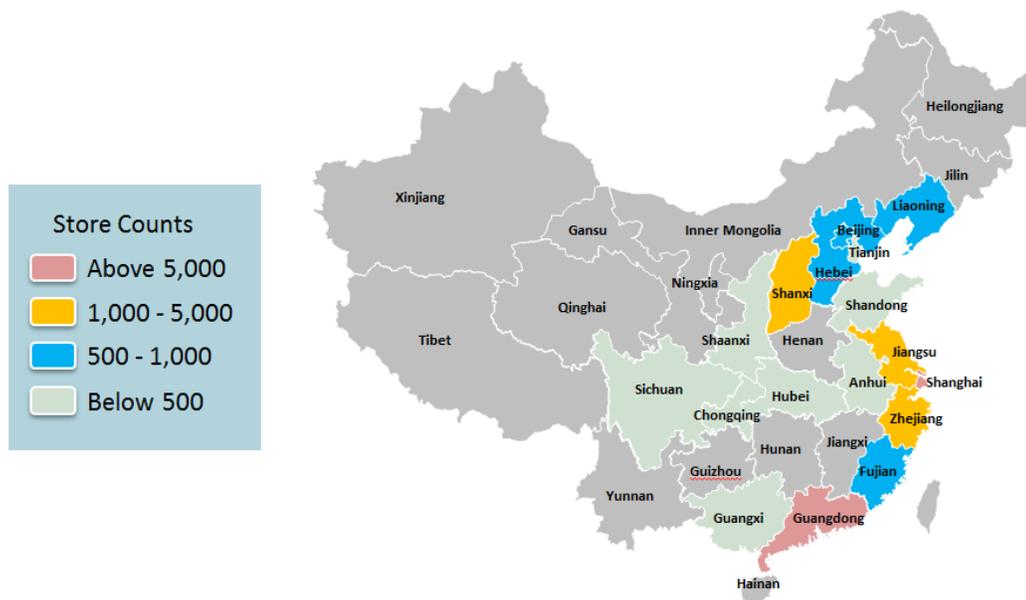
Source: China Chain Store and Franchise Association; compiled by Fung Business Intelligence

2. Competitive landscape

1. Unbalanced development

The development of CVS in China is still unbalanced. Guangdong and Shanghai have the highest concentration of CVS, each with more than 5,000 stores. Exhibit 8 shows the store count of CVS by province. Generally speaking, the development of CVS along coastal areas is more mature and concentrated than in inland areas. At the same time, the development of CVS in the southern region is more mature than in the northern region.

Exhibit 8: Store count of CVS by province, February 2015



Source: Kantar Retail; compiled by Fung Business Intelligence

According to the “Convenience Store Service Index 2016” released by the CCFA in May 2016, CVS in the southern region and coastal areas has a higher service level than in other regions. The index is a ranking of service level of CVS in different cities. It is compiled based on store density, sales growth of store, convenience level, and supportive policies in the city. As shown in Exhibit 9, Shenzhen ranked first, followed by Xiamen, Changsha, Dongguan, and Beijing.

Exhibit 9: Convenience store service index, 2016

Rank	City	Index
1	Shenzhen	94
2	Xiamen	87
3	Changsha	87
4	Dongguan	83
5	Beijing	81
6	Taiyuan	81
7	Shijiazhuang	80
8	Guangzhou	80
9	Changchun	80
10	Shenyang	80
11	Nanchang	80
12	Wuhan	79
13	Shanghai	78
14	Nanning	78
15	Guiyang	78

Source: China Chain Store and Franchise Association; compiled by Fung Business Intelligence

2. Leading players: No national leader, most are regionally focused

Currently, there is no national leader in China's CVS sector. Most leading players in China's CVS sector are regionally based. With the exclusion of Easy Joy and uSmile, which operate mainly forecourt stores, Meiyijia is the market leader in terms of store count, with 7,400 stores in Guangdong¹, followed by Tianfu, Hongqi, Sun-high, and Quik (Exhibit 10).

Exhibit 10: Top convenience store operators by number of stores, 2015

Rank	CVS brand	No. of stores	Parent company	Place of origin	Yoy change (%)
1	 汽车生活的驿站 Easy Joy	25,000	Sinopec Group		+5.4
2	 昆仑好客 uSmile	17,000	PetroChina Co., Ltd.		+13.3
3	 美宜佳 Meiyijia	7,400	Dongguan Sugar & Liquor Group Meiyijia Convenience Store Co., Ltd.		+15.8
4	 天福 Tianfu	2,830	Guangdong Tianfu Chain Business Co., Ltd.		+10.2
5	 红旗连锁 Hongqi	2,274	Chengdu HongqiChainstore Co., Ltd.		+44.2
6	 便利店 Sun-high	2,200	Guangdong Sun-high Convenience Store Co., Ltd.		+6.3
7	 快客 Quik	1,650	Shanghai LianhuaQuik Convenience Stores Co, Ltd.		-4.0
8	 Shizu; Zhishang	1,633	C&U Group		+4.9
9	 FamilyMart	1,501	Shanghai FamilyMartCo.,Ltd.		+17.2

¹Excluding the stores of forecourt retailers Easy Joy and uSmile

10	 Kedi; Alldays	1,500*	Nonggongshang Group		-9.5
11	 Tangjiu	1,390	Shanxi Taiyuan Tangjiu Supermarket Co., Ltd.		+3.7%
...					
19	 Lawson	652	Lawson (China) Holdings, Inc.		+28.3%
...					
34	 Wumart Convenience Store	293	Wumei Holdings, Inc.		+12.7%
...					
44	 7-Eleven	192	Seven-Eleven (Beijing) Co., Ltd.		+12.9%

Source: China Chain Store and Franchise Association; modified by Fung Business Intelligence

*Note: Estimated value

3. Most foreign players have a national footprint, while domestic players are region-based

Foreign CVS operators are more active in expanding nationally, while domestic players are mostly regionally focused. For example, Japanese CVS chain Lawson has established its presence in Shanghai, Hangzhou, Ningbo, Wuxi, Suzhou, Beijing, Dalian, and Chongqing. FamilyMart, another Japanese CVS chain, has opened stores in Shanghai, Guangzhou, Suzhou, Wuxi, Chengdu, Hangzhou, Beijing, Dongguan, and Shenzhen. By contrast, domestic players tend to focus their operations in areas near their place of origin. For instance, Tianfu operates mainly in Guangdong, Chengdu Hongqi in Sichuan, and Suguo in Nanjing (Exhibit 11).

Exhibit 11: Major operating regions for selected CVS operators

	CVS brands	Regions of operation
Foreign	 FamilyMart	Shanghai, Guangzhou, Suzhou, Shenzhen, Hangzhou
	 7-Eleven	Guangzhou, Beijing, Shenzhen, Shanghai, Foshan, Tianjin, Sichuan
Domestic	 Meiyijia	Dongguan, Shenzhen, Guangzhou, Huizhou, Foshan
	 Tianfu	Shenzhen, Guangdong, Hunan, Fujian, Guangzhou
	 Tangjiu	Taiyuan, Xi'an
	 Quik	Shanghai
	 Kedi; Alldays	Shanghai, Suzhou

Source: China Chain Store and Franchise Association, Bain & Co.; compiled by Fung Business Intelligence

4. National and regional players have different expansion strategies

Generally speaking, national players and regional players have different focus in their expansion strategies. National players such as FamilyMart and 7-Eleven often require higher initial franchise fees and deposits from franchisees and impose strict operational guidelines for store decoration, product fulfillment, product pricing, display and promotional activities. By contrast, the investment requirements for franchisees to open a store are usually lower in regional CVS, such as Meiyijia and Tianfu, than the national players.

3. Trends

1. Embracing O2O initiatives

An increasing number of CVS operators have transformed their operations with a hope to stay relevant in today's rapidly evolving landscape. Many have started to roll out online-to-offline (O2O) strategies. Given its vast network of stores, CVS can better support O2O initiatives. That said, many CVS operators are still testing the waters for O2O services. Providing pick-up services in-store is one of the major initiatives. Many CVS chains have partnered with e-commerce players to provide in-store pick-up services for online customers. Examples include FamilyMart, Meiyijia, Tangjiu, and Quik. CVS chains can benefit from the potential increase in customer flow, while e-commerce players can offer additional pick-up options for customers and enjoy lower logistics costs.

Meanwhile, some players launched offline convenience stores as an extension of their online platforms. For example, RT-Mart's Feiniu.com has invested in Fadaojia, an O2O CVS chain. The first physical store was opened in Huai'an Jiangsu province in August 2016. It will open other stores in other parts of the country through franchising. On its WeChat channel and mobile app, Fadaojia displays and sells over 10,000 SKUs of fast moving consumer goods and fresh produce from RT-Mart. Currently, customers can opt for store pick-up for their purchases, or the one-hour or half-day delivery service provided by the store.

Participating in cross-border import e-commerce is another means for CVS to tap the O2O market. Kintetsu, a major Japanese airfreight forwarding company, and Lawson, a convenience store chain in Japan, have both reached a partnership agreement with a Chinese e-commerce platform Yhopu.com in May 2016. Kintetsu will help Yhopu.com reduce delivery time by providing logistics services in areas such as transportation and customs clearance. Meanwhile, some of the products sold on Yhopu.com will be displayed in around 110 Lawson stores in Chongqing. Lawson customers can scan the barcode on the products with their smart phones to reach the relevant product pages on Yhopu.com to make the purchase. The collaboration will help Yhopu.com explore a new model of cross-border import e-commerce.

2. Offering more fresh food products

In recent years, some community CVS chains have started to place greater emphasis on fresh food products to attract footfall. For example, in April 2015, the CP Group, a Thailand-based conglomerate, opened several "CP Fresh Mart" stores in Shanghai, Chengdu, Wuhan, Zhengzhou, and Beijing. The stores focus on selling fresh foods such as eggs and meat, and frozen seafood. Light meals are also offered and customers can also eat in-store. CR Vanguard's Tesco Express

has also increased its fresh food offerings; around 30% of the operation area is dedicated for selling fresh food products.



Storefront of “CP Fresh Mart”. (Source: Retail Observer)

Selling fresh food products is set to become a new growth point for CVS operators. Having said that, profit margin of fresh food products is low. Moreover, additional investments in cold chain logistics and storages are needed.

3. Private label is a key differentiator

Currently, the development of private labels is not very mature in China’s CVS sector. According to the CCFA, 60% of CVS operators have launched their own private labels, but the share of private labels in the total sales is low at around 5%. However, some CVS operators are stepping up efforts to launch private labels or sell unique products, with a hope to differentiate themselves. Examples include FamilyMart and 7-Eleven. The former has launched its own brand “YUMMY” in China, while the latter has introduced its own private label series “Seven Select,” offering snacks and other personal care products. CP Fresh Mart has also launched a number of private label products including fresh meat, eggs, wine, and tea. The store can leverage CP Group’s sourcing and production capabilities to bring in fresh food products.

4. Providing tailored services for local communities

CVS is the most relevant format serving local communities. Instead of offering standardized products and services, CVS can better understand its target customers and provide tailor-made services for them. Specifically, CVS can provide goods and services suitable for the elderly, families, or university students in nearby areas. Many CVS players also partner with third-party

catering services companies such as BaiduWaimai, MeituanWaimai, and Ele.me to provide O2O food delivery services.

5. Retailers of other formats to tap the CVS sector

Eying the success of small format shops, some traditional retailers have branched out into smaller-scale stores. By adopting a multi-format strategy, they hope to expand their business scope and create multiple income streams.

Compared with large-scale stores, smaller outlets provide a quicker and more convenient shopping experience for customers. An increasing number of retailers, especially supermarket and hypermarket players, have opened community stores recently to serve residents in neighborhoods. Carrefour is a case in point. It opened its first CVS “Easy Carrefour” in China in November 2014. This is a unique format only for the China market. Currently, there are 26 “Easy Carrefour” stores in Shanghai. Most of them are located in communities; each store not only offers daily necessities but also other services such as dining and rest areas, ATM services, free WIFI, QR code to support online order at Carrefour’s website, etc. The average store size of the “Easy Carrefour” is around 400 sqm, selling approximately 4,000 SKUs. In February 2017, Carrefour China set up a new company dedicated to the management of its CVS business, aiming to better facilitate the brand’s expansion plan in this sector. Carrefour China said that all current CVS are grouped under the newly registered company, which will be the major vehicle going forward in the management and investment related to the CVS sector.



Storefront of an “Easy Carrefour” in Shanghai. (Source: Fung Business Intelligence)

Yonghui Superstore also launched its CVS format "YH Select" in November 2016 in Chongqing. There were four "YH Select" stores in Chongqing as of January 2017. The operating area of these stores is around 300-800 sqm, with 80% of the product offerings are fresh foods. "YH Select" partners with JD Daojia, an O2O delivery platform under JD.com to provide delivery services for consumers who place orders online through JD Daojia.



"YH Select" from Yonghui Superstore which focuses on selling fresh foods. (Source: gegugu.com)

Another example is Better Life Group. The retailer has long been operating supermarkets, department stores, and electric appliance specialty stores. It ventured in the CVS segment by launching "YunhouWiFi Convenience Store" in residential communities in June 2015. These CVS not only sell goods, but also provide courier services, breakfast, offline payment services, etc. to local residents.

6. Foreign players partner with regional players to capture market share

For foreign players, partnering with strong regional players is a fast way to gain market shares in regional markets. For example, Zhongbai Chain Storage Supermarket, a wholly-owned subsidiary of Zhongbai Group, has signed a cooperation agreement with Lawson in February 2016. Zhongbai is now the only franchised operator of Lawson convenience stores in Hubei Province. Through its regional master franchise agreement with Lawson, Zhongbai can take reference from Lawson's store display, marketing campaign and operation model, etc. to standardize and upgrade its store operation, and capture market share of Wuhan's CVS sector. Zhongbai plans to open 150 Zhongbai Lawson Convenience Stores in 2017, with 70% of which opened through franchise agreement. It hopes to open up to 500 stores in three years.

4. Concluding remarks

The CVS sector is set to continue its high growth momentum in the coming years, given its eagerness to roll out various O2O initiatives and its willingness to innovate and change according to the needs of the market. In particular, CVS chains that have established precise and unique positioning, particularly those targeting local communities, are expected to see rapid development.

The growth of the sector, however, is not without challenges. Some CVS operators reflected that there is insufficient government support for the development of the sector in some cities, making it difficult for them to launch new services. In addition, high labor costs, including turnover and training costs, remain a significant burden for many CVS players.



Spotlight on China Retail – Issue 5

Luxury Market

Asia Distribution and Retail

 FUNG BUSINESS INTELLIGENCE

March 2017

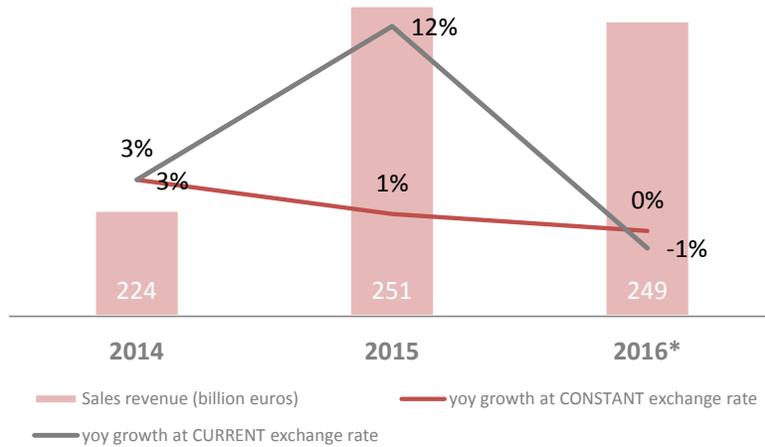
The year 2016 was fairly complicated for China's luxury market. Economic slowdown and government's ongoing campaign against corruption and lavish spending have impeded the growth of the luxury market. Besides, thriving demand for grey market and cross-border luxury goods have also created a ripple effect on the market. Nevertheless, driven by a number of positive factors such as rising household disposable incomes, increasing numbers of millionaires and super-rich individuals, as well as the government's initiatives to boost domestic consumption, China is set to remain as one of the most lucrative markets for global luxury retailers.

1. Market overview

1. China's personal luxury goods market sees revitalization

Personal luxury goods sales worldwide came in at 249 billion euros in 2016, representing a 1% dip at current exchange rates and staying flat at constant exchange rates, according to Bain & Company (Exhibit 1). The modest performance was mainly the result of significant uncertainty and lower consumer sentiment led by a slew of significant geopolitical events - Brexit, the U.S. presidential election and intermittent terrorist attacks.

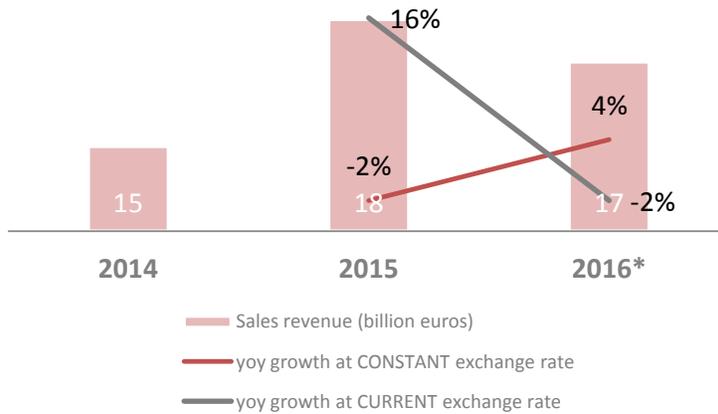
Exhibit 1: Global personal luxury goods sales, 2014 - 2016



Source: Bain & Co; compiled by Fung Business Intelligence
 * Note: Estimated value

In China, sales of personal luxury goods slightly fell to 17 billion euros in 2016, representing a 2% yoy contraction at current exchange rates. However, in 2016, at constant exchange rates, the sales of personal luxury goods advanced 4% yoy, marking the first revitalization of domestic personal luxury goods consumption in three years.

Exhibit 2: Mainland China personal luxury goods sales, 2014 - 2016



Source: Bain & Co; compiled by Fung Business Intelligence
 * Note: Estimated value

2. Chinese consumers remain a key driver of global luxury growth albeit a dip in luxury purchases made overseas

Chinese consumers made less luxury purchases abroad in 2016. Chinese luxury spending accounted for 30% of global luxury purchases in 2016 (Exhibit 3), down slightly from 31% in 2015, according to Bain & Co.

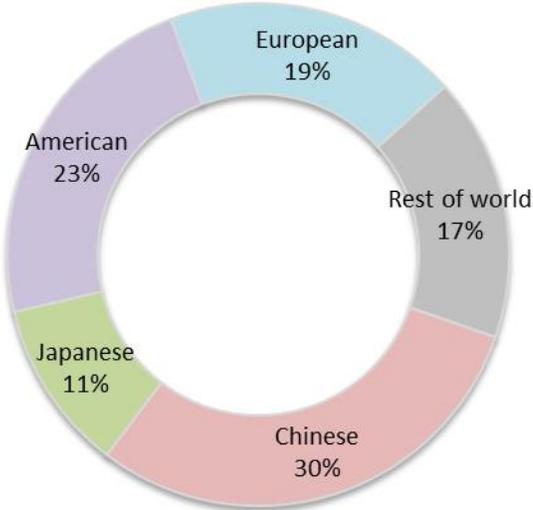
This has been due to several reasons, with the major ones being the changes in tariff policies for travelers and cross-border online sellers, and luxury retailers' decisions to harmonize their China prices with those globally. As a way to tackle the grey market and stimulate domestic consumption, the government has significantly increased the personal postal articles tax on items for personal consumption and strengthened penalties on false customs declaration. With effect from April 2016, the personal postal articles tax on various luxury items including luxury accessories, jewelry and gemstones, watches and cosmetics have been severely increased to 60%, according to Savills. The revised personal postal articles tax not only apply to items ordered online then shipped to China from elsewhere, but also to purchases brought back by Chinese travelers abroad.

Luxury retailers' move to close their retailing price gaps between their luxury goods sold in China and abroad has also prompted Chinese luxury shoppers to buy luxury goods in their home market.

Moreover, the government's support for the development of domestic duty-free sector has also helped stimulate domestic luxury consumption. As a case in point, the government announced in January 2016 that it will double the duty-free allowance to 16,000 yuan for mainland nationals at Duty Free Group's shopping mall in Hainan.

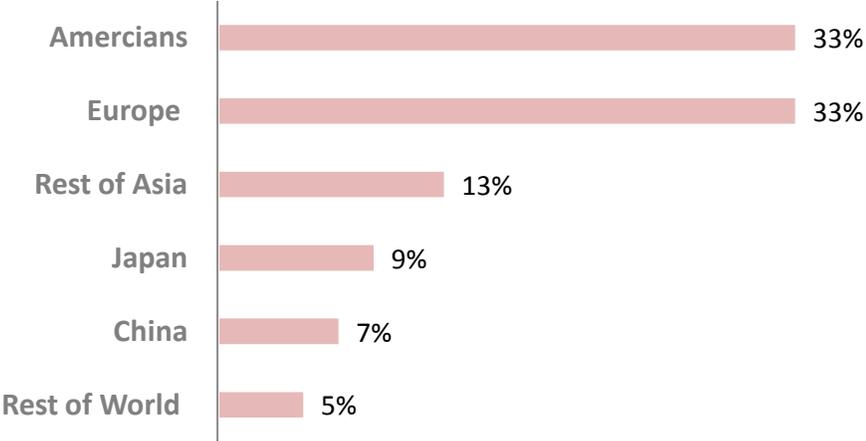
Nevertheless, China remained a major powerhouse of global luxury growth. It was the fourth largest luxury goods market in 2016, taking up 7% of global luxury sales, just behind Europe, the U.S. and Japan (Exhibit 4).

Exhibit 3: Global personal luxury goods sales by consumer nationality, 2016



Source: Bain & Co; Fondazione Altagamma; compiled by Fung Business Intelligence
* Note: Estimated value

Exhibit 4: Global personal luxury goods sales by region, 2016



Source: Bain & Co; Fondazione Altagamma; compiled by Fung Business Intelligence
* Note: Estimated value

3. Luxury consumer price sees strongest growth in four years

Hurun's China luxury consumer price index (LCPI), which measures the price increase in selected luxury products in China, sharply moved up by 5.1% yoy in 2016, rebounding from a negative growth of 1.8% in 2015 (Exhibit 5). Furthermore, the LCPI was higher than the consumer price index (CPI) in 2016, indicating a strong demand for luxury goods in China.

Exhibit 5: YoY change on luxury consumer price index and consumer price index, 2012 - 2016

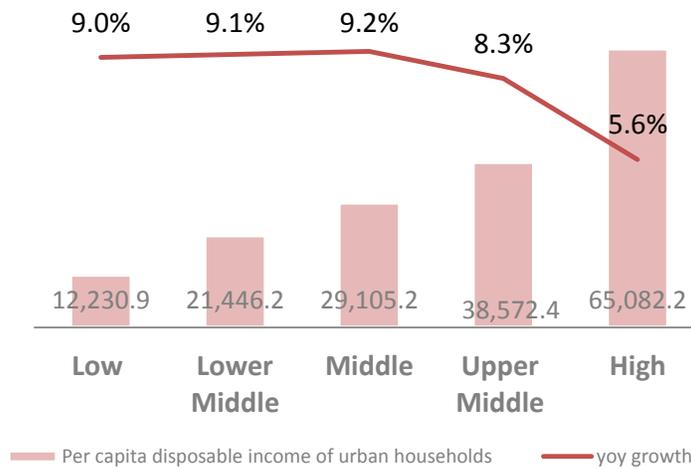
	yoy change	
	Consumer Price Index (CPI)	Luxury Consumer Price Index (LCPI)
2012	2.2%	4.9%
2013	2.7%	1.5%
2014	2.5%	4.0%
2015	1.4%	-1.8%
2016	1.9%	5.1%

Source: Hurun; compiled by Fung Business Intelligence

4. Rapid growth in household disposable income and number of wealthy individuals fuel the demand for luxury goods

Household disposable income in China has grown continually over the years. According to the National Bureau of Statistics of the PRC (NBS), middle income, upper middle income and highest income segments all registered strong growth at annual growth rates of 9.2% yoy, 8.3% yoy and 5.6% yoy respectively in 2015 (Exhibit 6). These groups of individuals often have a voracious appetite for luxury goods and are the biggest spenders on luxury products.

Exhibit 6: Per capita disposable income of urban households, by income group, 2016



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

* Note: Estimated value

Meanwhile, there has been a continual increase in the number of wealthy individuals in China over recent years. According to Hurun Wealth Report 2016, there were 1.34 million millionaires and 89,000 super-rich individuals in China as of May 2016, surging by 14.1% yoy and 10.7% yoy respectively, a second year of double-digit growth (Exhibit 7). Among all the regions, Guangdong had the highest number of millionaires in 2016, followed by Beijing, Shanghai, Zhejiang, and Jiangsu (Exhibit 8).

Exhibit 7: Number of millionaires and super-rich individuals in China, 2011 - 2016



Source: Hurun; China CITIC Bank; compiled by Fung Business Intelligence

* Note: Millionaires are defined as individuals with personal wealth of between 10 million and 100 million yuan; super-rich are defined as individuals with personal wealth of 100 million yuan or above

Exhibit 8: Number of millionaires and the super-rich individuals in China, by geographic region, 2016

	Geographic region	Number of millionaires		Number of super-rich individuals	
		In absolute terms	yoy change (%)	In absolute terms	yoy change (%)
1	Guangdong	240,000	17.6	14,000	17.6
2	Beijing	238,000	11.2	15,600	16.4
3	Shanghai	205,000	13.3	12,700	16.5
4	Zhejiang	160,000	9.6	10,300	17.2
5	Jiangsu	98,000	11.4	6,750	14.4
6	Fujian	48,000	9.1	3,300	13.8
7	Shandong	46,900	7.3	3,200	14.7
8	Sichuan	32,400	6.6	2,480	10.7
9	Liaoning	32,000	0.9	2,050	2.0
10	Tianjin	23,600	5.4	2,000	8.7
11	Henan	23,100	7.4	1,720	11.0
12	Hubei	18,000	9.1	1,500	13.6
13	Hunan	17,900	4.1	1,060	7.1
14	Hebei	17,500	2.3	1,390	3.0
15	Shaanxi	17,000	3.7	1,060	5.0
16	Shanxi	16,100	1.3	1,440	2.1
17	Chongqing	15,700	9.8	1,120	15.5
18	Inner Mongolia	13,300	2.3	850	3.7
19	Heilongjiang	12,500	0.8	830	1.2
20	Jiangxi	11,800	7.3	1,110	11.0
21	Anhui	11,500	6.5	1,190	10.2
22	Jilin	9,500	5.6	610	8.9
23	Yunnan	8,200	9.3	810	14.1
24	Guangxi	7,200	9.1	570	14.0
25	Hainan	5,200	9.3	230	9.5
26	Guizhou	4,410	13.1	450	18.4
27	Xinjiang	3,800	2.7	300	0.0
28	Ningxia	1,100	10.0	130	8.3
29	Gansu	890	-1.1	100	0.0
30	Qinghai	850	6.3	80	14.3
31	Tibet	550	10.0	70	16.7
	Total	1,340,000	--	89,000	--

Source: Hurun; China CITIC Bank; compiled by Fung Business Intelligence

5. Women and millennials are the leads in China's luxury market

The government's clampdown on extravagant personal spending and excessive gift-giving by officials have significantly impacted the luxury spending on men's apparel and watch items over recent years, paving the way for the financially independent female consumers to pick up the slack in luxury spending in China. Dominated by female luxury shoppers, a number of categories, including women's apparel, jewelry, cosmetics, perfume and personal care products contributed almost 50% of total luxury spending in China, and registered robust growth between 2013 and 2015 albeit the on-going anti-corruption drive (Exhibit 9).

Exhibit 9: Market share of China's luxury market and growth rates by category, 2015

	Market Share	CAGR		
		2012-2013	2013-2014	2014-2015*
Cosmetics, perfume and personal care products	30%	10%	7%	5%
Watches	20%	-11%	-13%	-10%
Leather goods	15%	5%	0%	-5%
Men's apparel	10%	-1%	-10%	-12%
Jewelry	8%	5%	2%	7%
Women's apparel	7%	10%	11%	10%
Shoes	5%	8%	8%	2%
Accessories	5%	8%	0%	-6%
Total	100%	2%	-1%	-2%

Source: "2015 China Luxury Market Study." 20 January, 2016. Bain & Co; compiled by Fung Business Intelligence

* Note: Estimated value

According to Germany's market research institute GfK, half of China's outbound travelers are 15-29 years old – the millennials – while over 37% are aged 30-44 years and 10% are 45-59 years old. Compared with their predecessors aged 50 and above, the young and wealthy consumers are more willing to spend money to indulge and pamper themselves; they are also less price sensitive and becoming the biggest purchasers of luxury goods in Asia Pacific.

6. Chinese luxury shoppers in pursuit of luxury “experiences”

With increasing exposure to luxury goods and services through different media channels, Chinese consumers have been drifting toward experiencing luxury and away from simply owning a luxury product. According to KPMG, Chinese consumers purchased large numbers of luxury services in 2015, including hotel reservations, restaurant bookings, domestic and overseas trips, beauty treatment, car rental services and investment services. Among the luxury services purchased online, hotels and restaurants bookings were the most sought-after service category, followed by domestic and overseas trips.

2. Major trends and strategies of luxury players in China

1. E-commerce becomes an influential sales channel, with mobile shopping on the rise

Chinese shoppers are more willing to purchase luxury items online nowadays. According to KPMG, 45% of luxury shoppers in China purchased over half of their luxury goods online, an increase of 28% versus 2014. Moreover, 75% to 95% of respondents showed a willingness to buy most of luxury categories online, including apparel, leather goods, cosmetics, jewelry, watch and wine.

Meanwhile, m-commerce has increasingly become a bright spot for growth; transaction value of mobile shopping is expected to advance by 45.7% yoy in 2017, representing 61% of all e-commerce sales, according to China’s Ministry of Industry and Information Technology. To capture a larger share in China’s online market, some luxury players have launched mobile apps to support online transaction, while others have started selling on social media platforms.

Exhibit 10: List of online stores of selected luxury brands in China

Brands	Format	URL
Armani	Self-operated online store	http://www.armani.cn/cn
Piaget	Self-operated online store	http://www.piaget.cn/
Cartier	Self-operated online store	http://www.cartier.cn/
Mont blanc	Self-operated online store	http://www.montblanc.cn/zh-cn/home.html
Tag Heuer	Announced in September 2015 to launch its first online store in China on JD.com	NA
Van Cleef & Arpels	Self-operated online store	http://cn.vancleefarpels.com/cn/zh.html#home
Burberry	Self-operated online store Online store on Tmall.com	https://cn.burberry.com/ https://burberry.world.tmall.com/
Coach	Online store on Tmall.com	https://coach.world.tmall.com/

Source: Respective companies' official websites; FDKG; compiled by the Fung Business Intelligence

2. Rising influence of digital media; social media increasingly becomes a new marketplace for e-commerce

In recent years, digital media has become a crucial marketing channel for luxury products in China. Increasing numbers of luxury retailers have launched China websites or used social networks such as Sina Weibo and WeChat to interact with Chinese consumers. Exhibit 11 summarizes the major digital media channels of selected luxury brands.

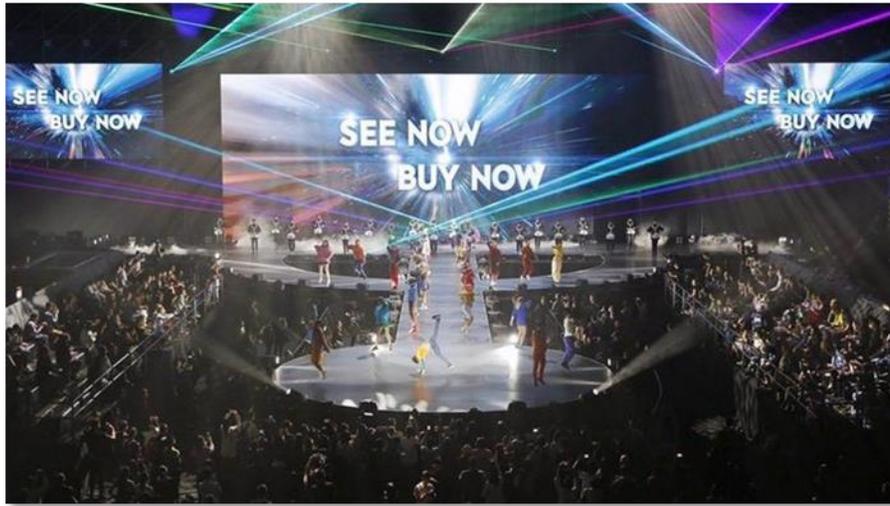
Exhibit 11: Digital media channels of selected luxury brands

Brands	WeChat	Sina Weibo	Official website in China
Armani	√	√	√ (Transactional)
Blancpain	√	√	√
Burberry	√	√	√ (Transactional)
Bvlgari	√	√	√
Cartier	√	√	√ (Transactional)
CHANEL	√	√	√
Chaumet	√	√	√
Dior	√	√	√
Fendi	√	√	√
Gucci	√	√	√
Louis Vuitton	√	√	√
Montblanc	√	√	√ (Transactional)
Piaget	√	√	√ (Transactional)
Salvatore Ferragamo	√	√	√
Tiffany & Co	√	√	√
Versace	√	√	√
Ermenegildo Zegna	√	√	√

Source: Respective companies' official websites; WeChat; Sina Weibo; compiled by the Fung Business Intelligence

Nowadays, the use of social media is not confined to posting comments or sharing feedback, but increasingly as a tool to carry out e-commerce transactions. An increasing number of luxury players now use social networks to market or sell their products. Take French luxury brand Givenchy as an example. In early February 2017, the French luxury brand partnered with a popular blogger in China (nicknamed Mr. Bags) to sell 80 limited-edition Valentine's day-special handbags on WeChat, with each handbag priced at 14,900 yuan. Following the posting of an article by Mr. Bags on his WeChat public account to announce the promotion, all the 80 bags were sold out in just 12 minutes, racking up a total of 1.2 million yuan.

Apart from WeChat, some luxury retailers also use live streaming platforms to promote and sell their products. For instance, a number of luxury brands, including Burberry, Ted Baker and Guerlain, took part in Alibaba's live fashion extravaganza "See Now, Buy Now" in October 2016, which was an eight-hour interactive live broadcasting fashion show held prior to Alibaba's 2016 11.11 Global Shopping Festival. Shoppers not only could view the latest collections of the brands, but also pre-order the items while watching the live streaming.



Alibaba broadcasted an eight-hour, interactive live fashion show during Alibaba's 2016 11.11 Global Shopping Festival. (Source: Alizila)

3. Heritage brands embracing price harmonization

Considering price harmonization as a strategy to address the grey market issue, many luxury brands, especially the higher-end ones, have adjusted their prices of products sold in China and overseas, as a move to encourage Chinese shoppers buying in their home market. According to marketing research firm L2, around 45% of luxury brands that display prices online have a price disparity of 15% or less between their prices in China and those in the U.S. All luxury brands with the smallest price gap fall into heritage luxury brands, such as CHANEL.

4. Luxury products for children become new growth point

With the full implementation of the “two-child policy” starting 1 January, 2016, couples in China are allowed to have two children. The repeal of the one-child policy is set to provide growth momentum for children’s luxury products in China. According to Credit Suisse, the new policy will bring about three to six million additional babies per year in China, a population boost of 17% to 33% from the current 16.5 million newborn babies per year. The new baby boom is estimated to bring an additional consumption of 120 million to 240 million yuan per year from 2017, representing around 4% to 9% of total retail sales in China, fuelling the demand for children-related products.

Tapping the childrenswear market enables luxury retailers to earn considerable profits as less material is used on children’s clothing but the prices are more or less the same. Therefore,

increasing numbers of luxury brands have launched childrenswear collections or enriched their childrenswear product offerings. For example, Italian luxury player Salvatore Ferragamo has recently launched a mini-selection of girls' shoes in two classic ladies' designs in Shanghai. To cash in on the new baby boom, Italian premium kidswear brand Gusella has announced plans to step up its expansion in Nanjing, aiming to boost its annual sales in China by 40% to some 15 million yuan in 2017.

5. Luxury retailers continues to launch China-themed products for Chinese consumers

Considering Chinese consumers making the majority of their sales, many global luxury retailers, not least in the U.S. and Europe, are exerting their efforts to woo the affluent Chinese shoppers with China-themed products such as zodiac-themed items. For example, during the 2017 Lunar New Year Holiday in February 2017, Italian luxury fashion house Gucci launched a collection of rooster-motif accessories, including scarfs, handbag, wallet and sneakers, targeting Chinese consumers. Another example is TOD'S, an Italian luxury footwear brand. The brand celebrated the Year of the Rooster with the launch of TOD'S iconic Gommino driving shoe. The Chinese New Year collection, tailored for stylish consumers who prefer not to look so cocky, covers up the Chinese New Year embellishment on the insole, with a dragon for men and a phoenix for women.

Other luxury retailers also introduced their Chinese New Year collections to court Chinese shoppers. Exhibit 12 shows the special edition products launched by selected luxury retailers during Lunar New Year 2017 to celebrate the Year of the Rooster.

Exhibit 12: The Year of the Rooster special-edition product collections launched by selected luxury retailers

Louis Vuitton



Launched a special-edition rooster-themed leather clutch

Dior



Launched Diorelita collection featuring a cartoonish rooster bracelet in gold-tone finish and red rope

Dolce & Gabbana



Launched a special-edition rooster jacket

MCM



Launched Year of 2017 collection featuring red rooster-embroidered leather bags, key holders and cases

Longchamp



Launched special handbag in red with rooster embroidery

Gucci



Launched a collection of rooster-motif accessories, including scarfs, handbag, wallet and sneakers

TOD'S

Launched the brand's iconic Gommino driving shoe, with symbols of Chinese New Year hidden on the insole – dragon for men and phoenix for women

Source: Respective company websites; Internet sources; compiled by Fung Business Intelligence

6. Increasing number luxury players expanding into F&B, real estate and beauty sectors

To expand their income streams, some luxury players have begun to expand beyond their core business into other industries such as food and beverages (F&B), beauty and real estate sectors in China. For instance, Gucci opened a restaurant named 1921 Gucci in Shanghai's iAPM shopping mall in July 2015. Vivienne Westwood also unveiled its cafés – Vivienne Westwood Café at K11 Art Mall in Shanghai in April 2015.

Other global fashion houses such as Hermès, Armani, and Dolce & Gabbana are expected to launch their restaurants and cafés in China as part of their new growth engines. Apart from the F&B sector, Armani has also paired with China's property developer Smart Hero Group to develop a luxury residential project in Beijing, scheduled for completion in 2017. Besides, Burberry has also expanded beyond fashion business and opened its first beauty salon – Burberry Beauty Box at Grand Gateway in Shanghai in August 2015.



Vivienne Westwood Café at Shanghai's K11 Art Mall. (Source: Fung Business Intelligence)

3. Concluding remarks

China's luxury market experienced the first sign of revitalization in 2016 following three years of negative sales growth at constant exchange rates. With the Chinese government's initiatives to boost local consumption and support domestic duty-free shopping, domestic luxury consumption is set to see huge development prospects over the coming years.

As Chinese consumers become more discerning and look for uniqueness and products that are of highest quality at the best prices, global luxury retailers should constantly reinvent themselves and reassess their strategies. For instance, they should widen their product offerings and re-adjust their pricing strategies in China so as to suit the tastes and preferences of Chinese customers. Moreover, in today's digital era, luxury retailers should put in place a comprehensive digital strategy and make good use of social media to sell and market their products; they should also embrace the Internet and advanced technologies to provide seamless shopping experience for customers.

The cover features a dark blue background with a bright blue spotlight effect on the left side. Several light blue squares of varying sizes are arranged in a cluster, some overlapping, creating a modern, digital aesthetic.

Spotlight on China Retail – Issue 6

E-commerce

Asia Distribution and Retail

 FUNG BUSINESS INTELLIGENCE

March 2017

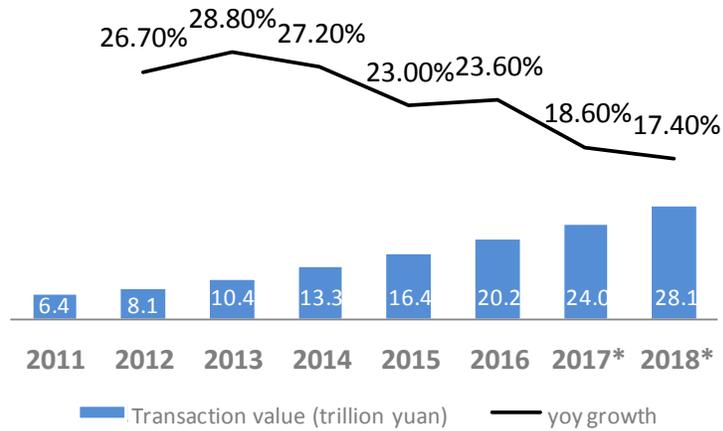
China's e-commerce sector has and will continue to attract the world's attention with its explosive growth and transformative effect on the retail landscape. Changes in consumers' preference and the emergence of innovative technologies and new business models have provided a strong impetus for the growth of the sector. E-commerce is now a major driver of growth under the "New Retail" regime.

1. Market overview

1. China's e-commerce market scales up

The e-commerce market in China has continued to grow rapidly and became a major growth driver of China's economy. According to iResearch, the total transaction value of China's e-commerce market reached 20.2 trillion yuan in 2016, up 23.6% year-on-year (yoy) (Exhibit 1).

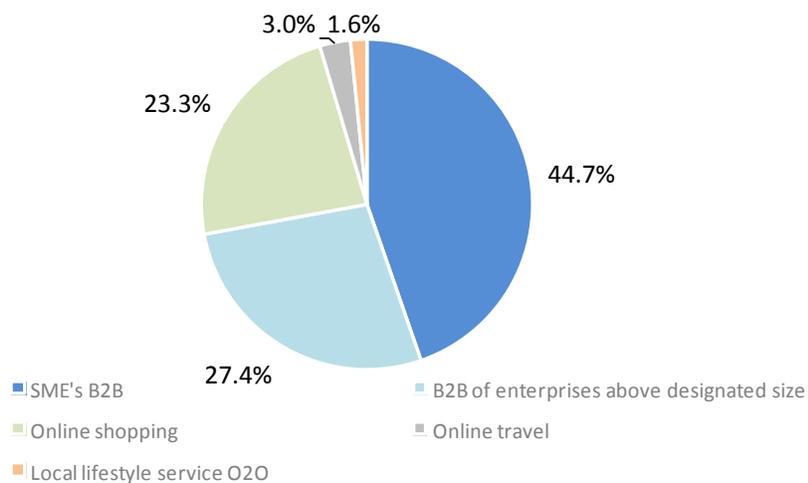
Exhibit 1: Transaction value of China's e-commerce market, 2012 - 2018



Source: iResearch; compiled by Fung Business Intelligence
 * Estimated figures

Among the major e-commerce market segments, small and medium-sized enterprises' (SMEs) B2B accounted for 44.7% of the total transaction value, and B2B of enterprises above the designated size commanded 27.4%. B2C and C2C together accounted for only 23.3% of the market share (Exhibit 2).

Exhibit 2: Share of China's e-commerce market segments, 2016



Source: iResearch; compiled by Fung Business Intelligence

2. SME's B2B represents the lion's share of total transaction value of China's e-commerce market; Alibaba remains the most popular SME's B2B platform

SME's B2B platform plays an important role in connecting manufactures and industrial buyers and sellers online. It offers a more convenient and time-saving way of conducting business for many SMEs. Among the SME's B2B platform players, the most popular ones include Alibaba, Global Sources, and JQW.com, accounting for 48%, 6%, and 5% of the total market share respectively in 2016 (Exhibit 3).

Exhibit 3: Market share of China's major SME's B2B operators by revenue, 2016

Rank	Major SME's B2B operators	Market share percentage
1	 Alibaba	48.0%
2	 Global Sources	6.0%
3	 JQW	5.0%
4	 DHgate	5.0%
5	 HC360	5.0%
6	 Made-in-China	3.0%
7	 Toocle	1.0%
8	 Mysteel	1.0%
9	 Global Market	1.0%
10	Others	27.0%

Source: iResearch; compiled by Fung Business Intelligence

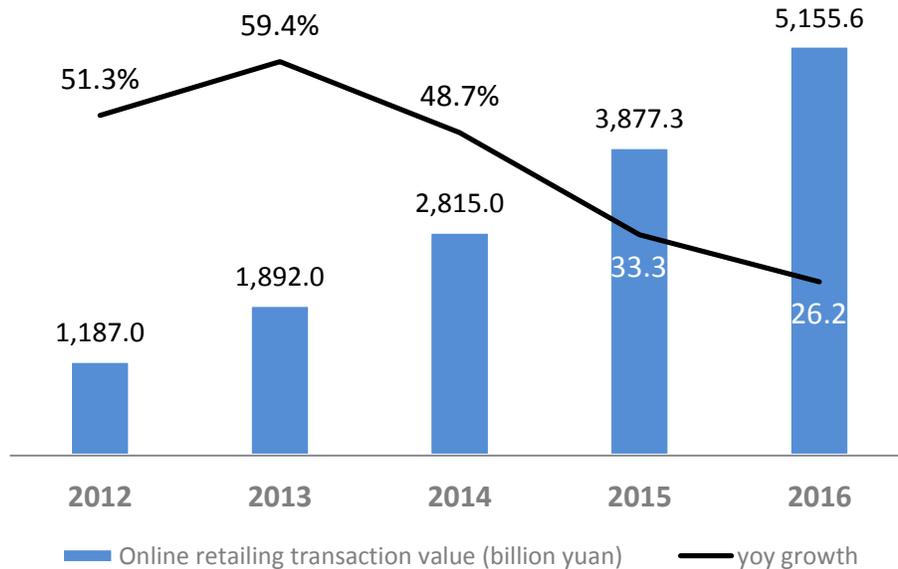
With the competition among SME's B2B platforms getting tougher, it is increasingly difficult to stand out from the competition by solely providing matching services for buyers and sellers. Hence, many SME's B2B platforms are actively moving from purely matching businesses to providing value-added services such as logistics, payment, and financial services. SMEs are also collaborating with searching engines, social media platforms, third-party payment providers, etc. to create a one-stop solution along the supply chain. Pursuing mobile strategies has been one of their focuses in recent years. For instance, DHgate and Alibaba's 1688.com have launched services via mobile app and WeChat.

3. B2C and C2C markets to continue growth momentum

Transaction value of online retail market enjoys resilient growth

China's online retail market, which comprises the B2C and C2C segments, is the largest in the world; it is nearly 80% bigger than the U.S. retail market and has shown resilient growth despite the slowing economy. According to the NBS, the transaction value of China's online retail market increased 26.2% yoy to reach 5.16 trillion yuan in 2016 (Exhibit 4)—much higher than the growth of the SME's B2B segment. Of this transaction value, the online retail sales of goods amounted to 4.19 trillion yuan, up by 25.6% yoy, accounting for 12.6 % of the total retail sales of consumer goods.

Exhibit 4: Transaction value of China's online retailing market, 2012 - 2016

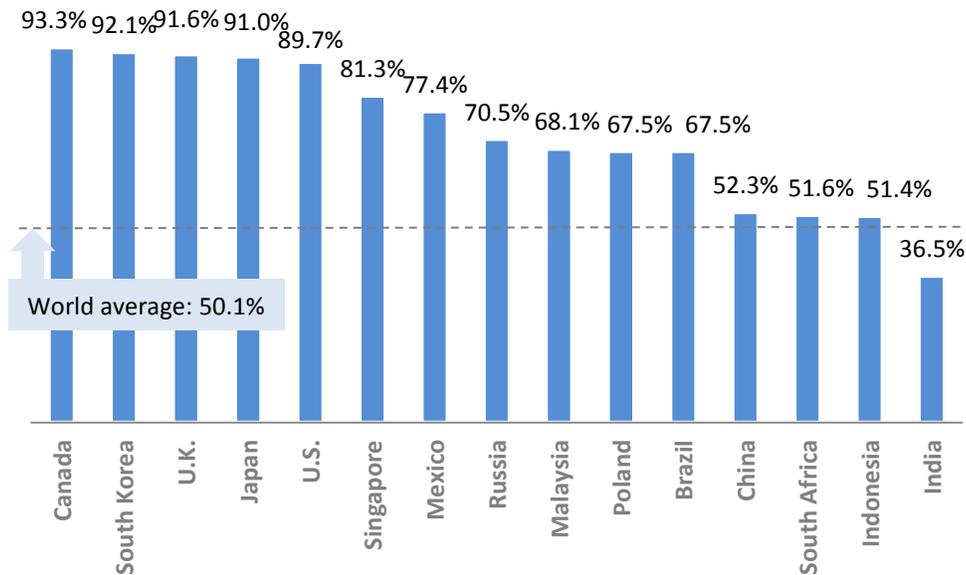


Source: iResearch (2012–2014), National Bureau of Statistics of the PRC (2015–2016); compiled by Fung Business Intelligence

China's huge Internet population drives online sales growth

The fast growth of the online retail market is mainly contributed to the large population of Internet users and the quick adaptation of consumers to online shopping. China has the world's largest number of Internet users and online shoppers, contributing significantly to the phenomenal growth of the sector. As of December 2016, there were 731 million Internet users in China, of which 467 million were online shoppers. Internet penetration rate in China was 52.3% as of June 2015, while Canada, South Korea, the U.K., and Japan have Internet penetration rates of over 90% (Exhibit 5). That said, China still lags behind many countries in terms of Internet penetration, reflecting the high growth potential of the market.

Exhibit 5: Internet penetration rates of selected countries, June 2016

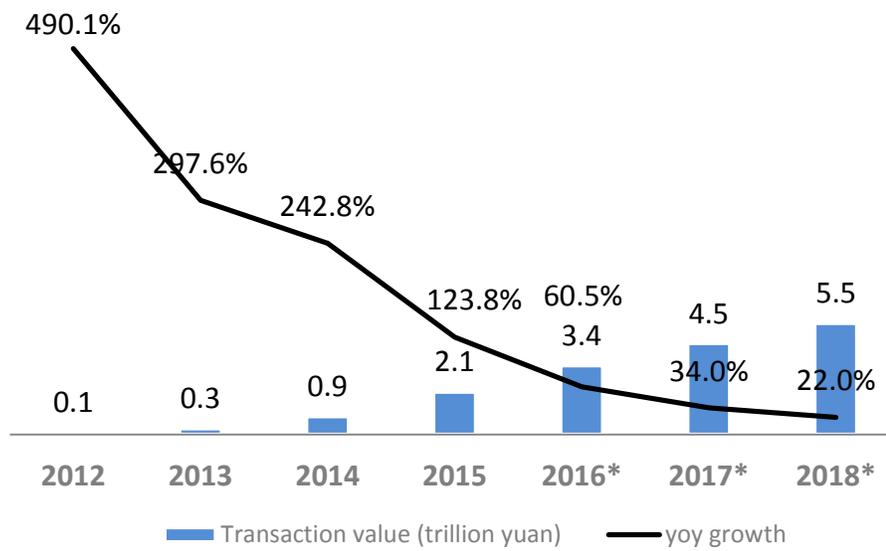


Source: *Internet World Stats; China Internet Network Information Center; compiled by Fung Business Intelligence*

M-commerce takes the lead

Chinese consumers have been overwhelmingly using mobile devices to access the Internet. According to the China Internet Network Information Center (CNNIC), 695 million people use mobile phones to access the Internet; of these, 441 million are mobile online shoppers. Penetration rate of mobile shopping increased from 54.8% in December 2015 to 63.4% in December 2016. Mobile commerce (m-commerce) has gained market share at the expense of PC-based transactions over recent years. The rise of budget smartphones, such as Huawei, Oppo, and Vivo, has brought mobile connectivity to most parts of China. With the aid of mobile devices, consumers can have real-time interactions with retailers, and enjoy convenient shopping experience anytime and anywhere. The mobile platform is now a highly significant sales and market channel. The total transaction value of mobile shopping is estimated to reach 3.4 trillion yuan in 2016, up 60.5% yoy (Exhibit 6). In 3Q16, 71.6% of the online shopping transactions were made on mobile devices, the figure is estimated to reach 73.5% by 2018.

Exhibit 6: Transaction value of mobile shopping, 2012 - 2018

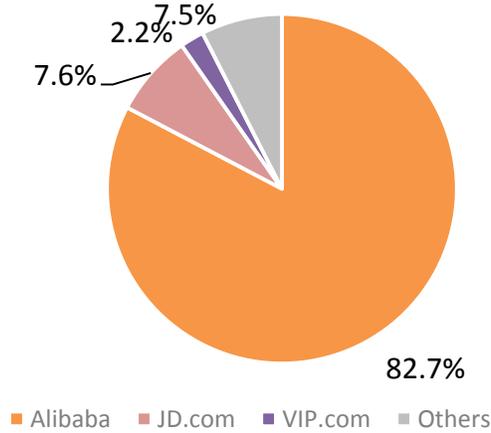


Source: iResearch; compiled by Fung Business Intelligence

* Estimated figures

As shown in Exhibit 7, Alibaba is currently the largest player in the m-commerce market. In 2015, Alibaba accounted for 82.7% of the market share, followed by JD.com and VIP.com with 7.6% and 2.2% market share, respectively.

Exhibit 7: Market share of China's major mobile retailing operators by revenue, 3Q16

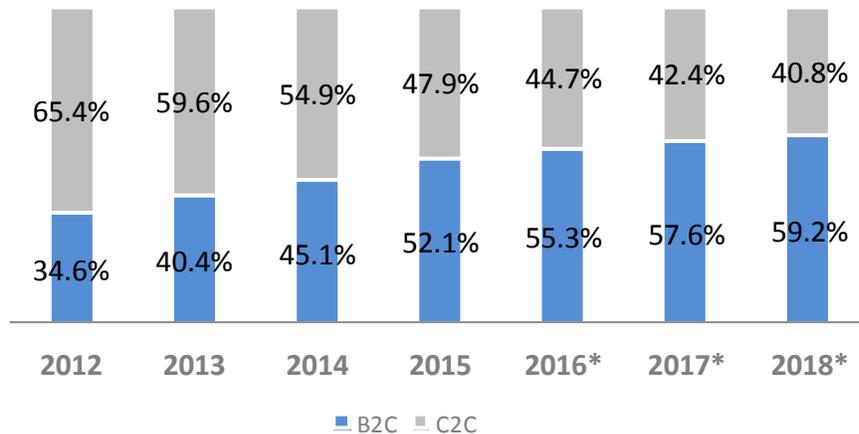


Source: iResearch; compiled by Fung Business Intelligence

B2C segment exceeds the C2C segment; Tmall continues to be the market leader

According to iResearch, the B2C segment has exceeded the C2C segment in terms of market share. In 2016, B2C and C2C segments accounted for 55.3% and 44.7%, respectively, of the total transaction value of online retailing in China (Exhibit 8).

Exhibit 8: Market structure of online retailing in China: C2C vs. B2C, 2012 - 2018

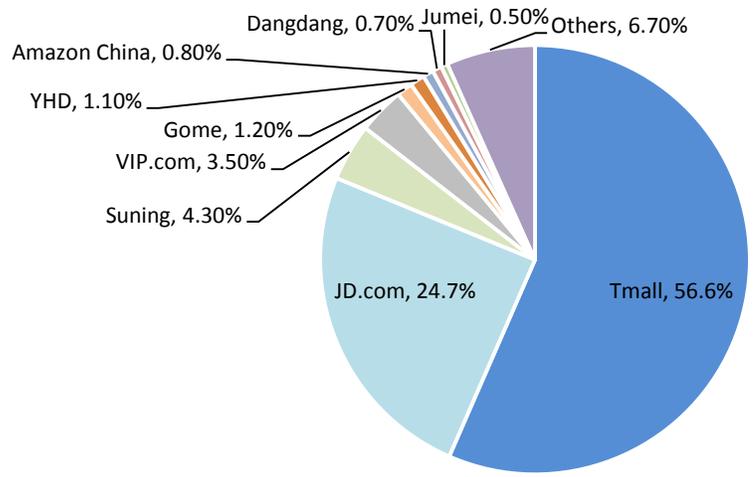


Source: iResearch; compiled by Fung Business Intelligence

* Estimated figures

Tmall is the leader in the B2C market, which accounted for 56.6% of the total market in 2016, followed by JD.com with 24.7% market share (Exhibit 9).

Exhibit 9: Market share of top B2C players, 2016

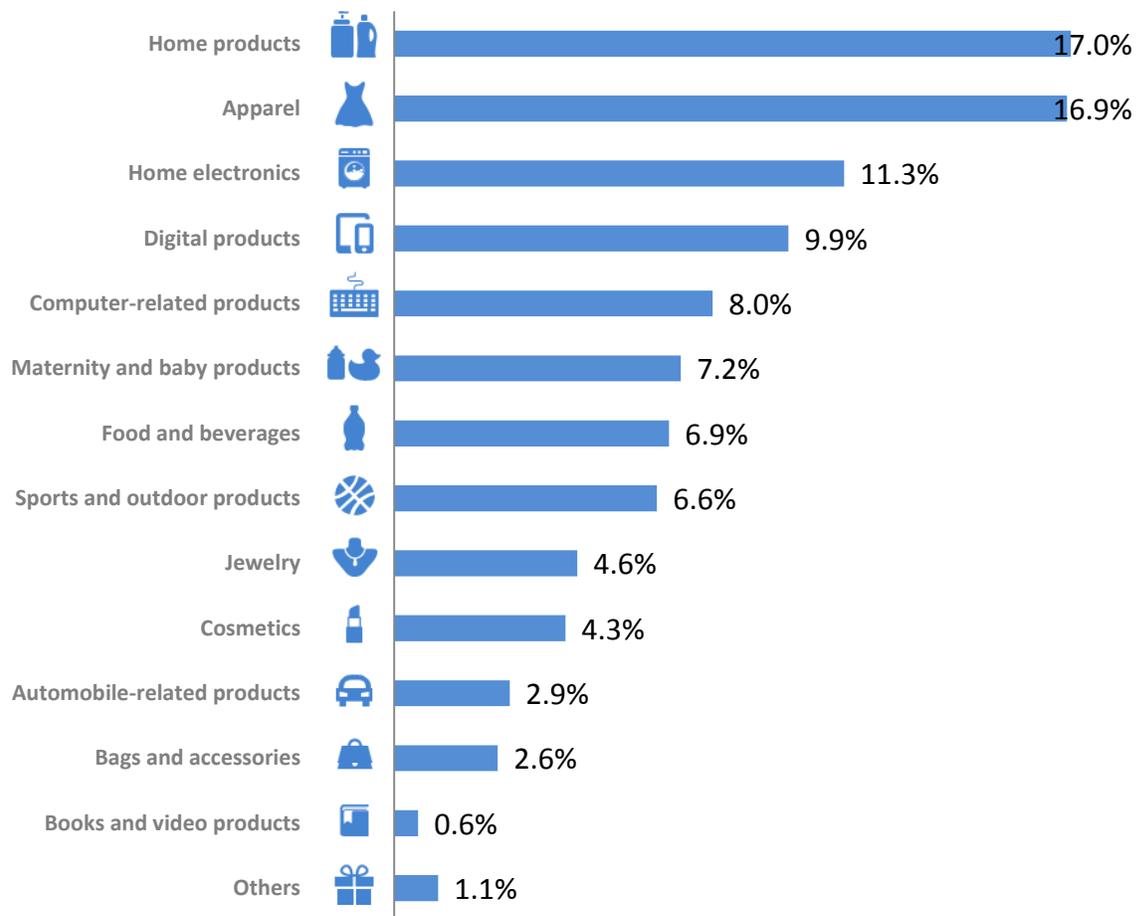


Source: iResearch; compiled by Fung Business Intelligence

Home products and apparel were the most popular categories sold online

According to O2O Consulting, home products and apparel were the two best-selling categories sold online in 2016, accounting for 17.0% and 16.9% of the market share respectively, followed by home electronics (11.3%) and digital products (9.9%) (Exhibit 10).

Exhibit 10: Market share by categories, 2016

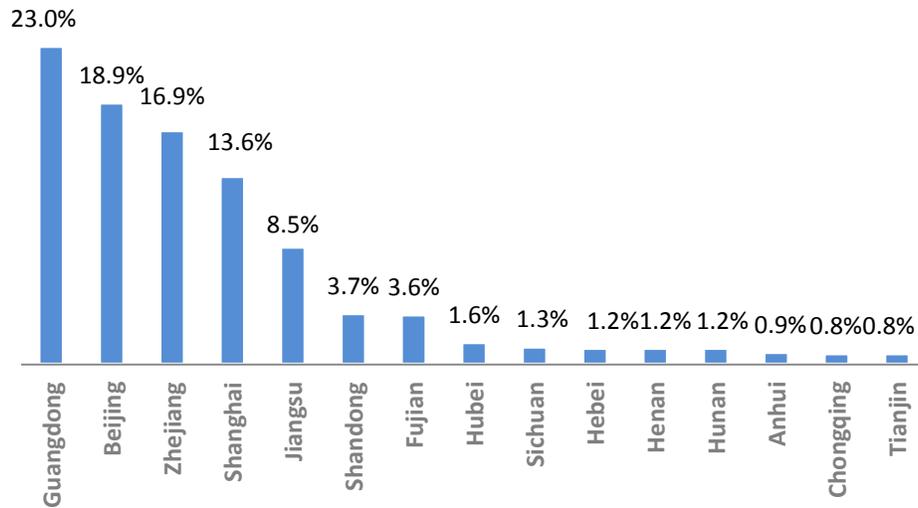


Source: O2O Consulting; compiled by Fung Business Intelligence

Guangdong tops the provinces in terms of online spending

According to O2O Consulting, Guangdong ranked the top among all provinces in terms of online spending. 23% of the online transactions are made in Guangdong, followed by Beijing (18.9%) and Zhejiang (16.9%) (Exhibit 11).

Exhibit 11: Market share by provinces, 2016

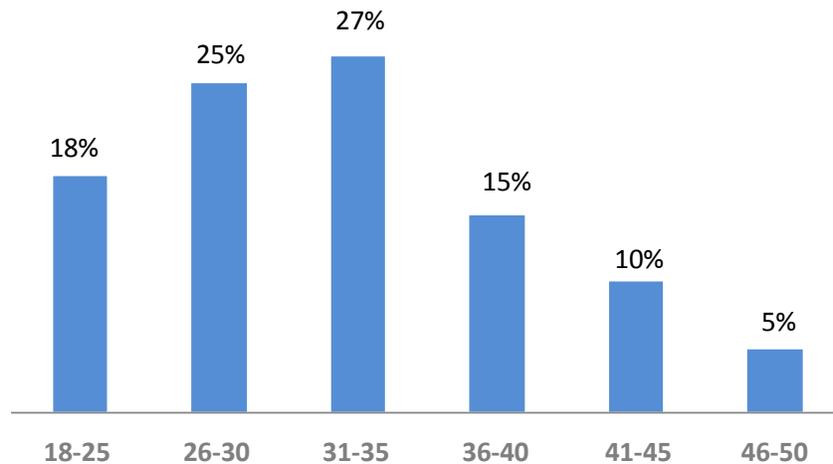


Source: O2O Consulting; compiled by Fung Business Intelligence

New consumers as a powerful driving force for the e-commerce market

Chinese millennials aged 26-35 are the largest group of online shoppers in China. This generation has grown up with the Internet during a period when China experienced phenomenal Internet growth. They embrace the Internet more wholeheartedly than the older generations, and generally have stronger spending power online (Exhibit 12).

Exhibit 12: Online spending per month by age group, 2015*



Source: iResearch; compiled by Fung Business Intelligence

* Note: Estimated value

4. Widespread use of third-party online payment and mobile payment drives the growth of e-commerce market

The widespread use of third-party online payment and mobile payment has driven the growth of China's e-commerce market. In 2016, third-party online payment services in China achieved a total transaction value of 19.2 trillion yuan, soaring 62.2% yoy from 2015 according to iResearch. The total transaction value of third party mobile payment was estimated to hit 38 trillion yuan in 2016, up 215.4% yoy from 2015. There are three major categories of third-party payment companies, including (1) Internet companies' online payment channel (e.g., Alipay, Tenpay); (2) companies from traditional financial institutions (e.g., UnionPay Online); and (3) pure third-party online payment companies (e.g., Yeepay). Currently, the third-party payment market in China is dominated by Alipay¹, followed by Tenpay² and UnionPay Online³ (Exhibit 13).

¹ Alipay is a third-party online payment platform launched by Ant Financial Services Group, an affiliate of Alibaba Group.

Exhibit 13: Market share of third-party online payment services, 2Q16

Rank	Online payment platforms	Market share percentage
1	 Alipay™ Alipay	42.8%
2	 财付通 腾讯旗下在线支付平台 Tenpay*	20.0%
3	 UnionPay 银联 UnionPay	10.9%
4	 快钱 99Bill.com 99Bill	7.0%
5	Others	19.3%

Source: iResearch; respective company websites; compiled by Fung Business Intelligence

* Note: include WeChat Pay and QQ Wallet

It is noteworthy that new government restrictions may affect operation of third-party payment. People's Bank of China announced that effective from December 1, 2016, each individual can only open one full-functioning payment account in each non-bank payment institution. The announcement also requested non-bank payment institutions to set limits to both the amount and frequency of payment transfer allowed daily for each account. This may affect consumer's incentive to use third-party mobile payment.

2. Market highlights

1. Rural e-commerce is the next big thing

The rural online retail market has become a new growth engine with the near saturation of the urban online market. Rural consumers prefer shopping online because of the less developed

² Tenpay is a one-stop online payment platform launched by Tencent. It offers payment services including WeChat Pay and QQ Wallet via WeChat panel and QQ panel, respectively.

³ China Union Pay is the only domestic bank card organization in China.

retail infrastructure in rural areas. The number of online shoppers in the rural area reached 92.5 million by the end of 2015. It is expected that the penetration rate of online shoppers in rural areas will exceed 60% by 2018. According to China International Electronic Commerce Center, the transaction value of rural online market is estimated to reach 647.5 billion yuan by the end of 2016.

Recognizing the ample growth potential of the rural e-commerce market, increasing numbers of leading retailers and e-commerce players have adopted various “going rural” strategies. For instance, 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.

The government has been very supportive towards the development of rural e-commerce. The State Council released the Central Government No.1 Document for 2017, entitled *Several Opinions on Deepening Supply-side Reform in Agriculture to Further Speed up the Formation of New Growth Momentum for Development in Rural Areas and the Related Industries*. The document highlighted the following tasks: further promoting the development of rural e-commerce, speeding up the process of establishing industry standards to guide the development of rural e-commerce, supporting the establishment of e-commerce platforms and physical service stations for rural products, promoting the interaction of traditional commerce, commercial services, express mail, and e-commerce, strengthening the logistics infrastructure connecting rural areas, and facilitating the development of express delivery services in rural areas.

2. Social media becomes the new marketplace for commerce

Social media is a remarkable phenomenon across the global, but it is more important in China than it is in other countries. There are many well-established social media platforms in China, each with millions of active users. Exhibit 14 shows the monthly active user (MAU) accounts of major social media platforms. QQ and WeChat are the leading social media platforms, each with over 800 million MAUs. The booming mobile generations and accelerated growth of social media usage 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 and 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, Mengdian, and Koudai Gouwu to sell and market their products.

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. It is also an effective channel to clear excess inventory.

Besides directly selling on social media, some players are exploring other ways to market and sell on social networks. For instance, Starbucks China and WeChat jointly launched a new social gifting feature - “Say it with Starbucks” on WeChat in February 2017. Users can send Starbucks beverage or digital gift card to family and friends alongside with customized messages in the form of text, photo or video. During the initial launch period, WeChat opened a convenient access for “Say it with Starbucks” users in its WeChat Pay function. The function will be permanently available on Starbucks’s public WeChat account. Starbucks is the first retail brand to offer an O2O social gifting experience in China.



WeChat and Starbucks China jointly launched a new social gifting feature, “Say it with Starbucks” on WeChat in February 2017. (Source: adage.com)

It is notable that the business model for social selling is similar to that for pyramid selling schemes, of which the latter is currently illegal 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.

Exhibit 14: Monthly active user accounts of major social media platforms, as of June 2016

Platforms	Number of accounts	yoy change (%)
QQ	899 million	+7%
Mobile QQ	667 million	+6%
WeChat	806 million	+34%
Weibo	282 million	+33%

Source: China Internet Network Information Center; respective company websites; compiled by Fung Business Intelligence

3. Cewebrity economy gains popularity; 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, are people who 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 cewebrities, especially fashion cewebrities 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 them. 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 have become 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 broadcasted an eight-hour, interactive live fashion show on Tmall, Youku, and

Mobile Taobao. Viewers could see the latest fashion brand collections and preorder apparel and accessories from those collections. 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.



Alibaba broadcasted an eight-hour, interactive live fashion show during the 2016 11.11 Global Shopping Festival. (Source: Alizila)

Meanwhile, the government has also implemented stricter measures to govern webcasting. The Cyberspace Administration of China imposed a new regulation to govern webcasting starting 1 December 2016. Webcasting platforms are requested to register their webcasters' personal identities. Webcasters who have violated broadcasting rules will be blacklisted and banned from re-registering. Also, webcasting platforms need to apply for relevant licenses prior to their operation. These platforms are also asked to monitor the interactions between webcasters and the audience to make sure the content of the webcasting is appropriate.

4. O2O being a crucial element under the “New Retail” regime

Under the “New Retail” regime, e-commerce is no longer online only. It involves the integration of online-to-offline (O2O) activities. In recent years, more retailers and e-commerce companies have ventured into O2O; they leverage mobile, social media and technologies to bridge the gap between offline, online and mobile channels. Some common O2O initiatives adopted by companies include: leveraging mobile technologies to provide personalized services, offering new pick up options such as “click & collect” services and smart-lockers, forming strategic alliances with Internet companies to drive synergies, and enhancing in-store payment services.



Box 1: Alibaba's New Retail Regime - online and offline cooperation deepens

Alibaba is one of the pioneers to advocate the concept of “New Retail”. Jack Ma, founder and executive chairman of Alibaba Group, propagated the concept of “New Retail” in October 2016. According to Jack Ma, there are five major development trends shaping the world in the coming three decades, namely “New Retail”, “New Manufacturing”, “New Finance”, “New Technology” and “New Energy”. The trends are expected to fundamentally change all industries. He remarked that the upcoming technology revolution will provide tremendous opportunities for small enterprises from around the world. Technology, data and innovation will be the keys. Jack Ma also pointed out that pure e-commerce players will soon face tremendous challenges and that “E-commerce” will be replaced by “New Retail” in 10-20 years.

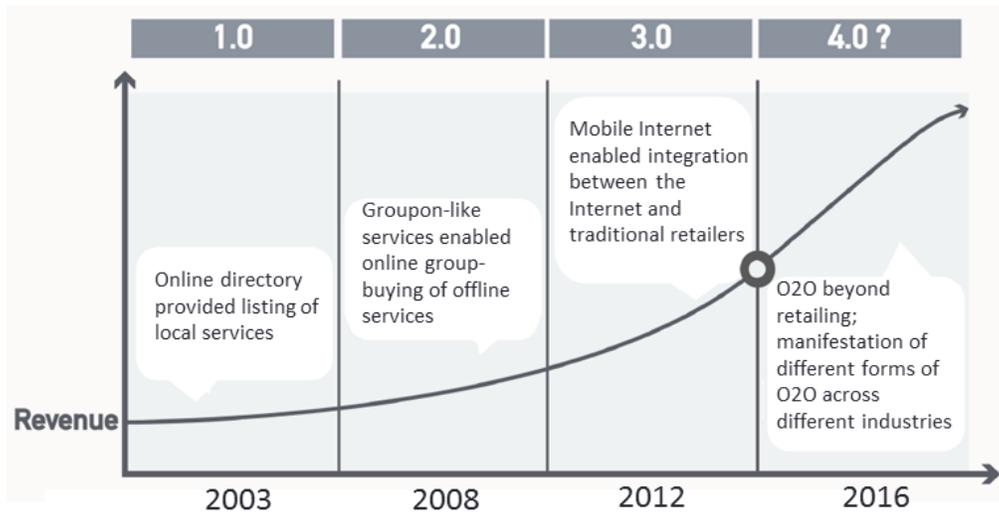
Jack Ma stated that “New Retail” entails the integration of online, offline, logistics and data across a single value chain. There are three characteristics of “New Retail”:

- Consumer-oriented: Use advanced technologies to collect consumer data and offer personalized products and services to customers.
- Integration of online and offline retail: Transform supply chains to minimize inefficiencies and unmatched supply and demand.
- Emergence of new retail formats and business models

Indeed, Alibaba has started to invest in several offline retail players a few years ago in a bid to extend its online dominance into physical retail. Noticeably, Alibaba has announced two strategic initiatives to support its “New Retail” concept in the beginning of 2017 – the privatization of Intime Retail Group in January 2017, and the retail strategic partnership with Bailian Group in February 2017.

Driven by the diverse needs of consumers, the O2O concept has extended from O2O for retail businesses to lifestyle services over recent years (Exhibit 15). The O2O 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. 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.

Exhibit 15: Evolution of China's O2O business practices



Source: Fung Business Intelligence



Box 2: O2O catering becomes increasingly popular

O2O catering platforms that provide group-buying catering and O2O food delivery services have witnessed explosive growth over the past year. Currently, Meituan Waimai, Elema, and Baidu Waimai are the top three players in the market. According to Meituan-Dianping's food delivery data, Meituan Waimai'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.

Despite the rapid popularization of O2O food delivery services, food safety and quality issues remain a major concern. According to a nationwide consumer survey conducted by the China Consumer Association in November 2016, there are seven major problems for O2O food delivery: 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.

5. The Opening of the C2B Era in China

China's e-commerce landscape is increasingly consumer-driven. Advanced Internet technologies allow seamless connections between consumers and business, making it easier for consumers to articulate their needs and opinions to business. More and more companies now adopt a Consumer-to-business (C2B) model, with an aim to provide customized products and services to meet the needs of discerning Chinese consumers. Internet giants such as Alibaba have placed increasing focus on this new game-changing business model.

In contrast with the B2C model, the C2B model allows businesses to extract value from consumers. Consumers come up with personalized needs or product requirements, and businesses produce the products or services based on the needs of consumers. The C2B model is a reversal of the B2C model; the whole process is driven by consumers. Under such model, businesses optimize their supply chains with flexible production lines. Products are produced in smaller batches and delivered to customers in a timely manner. Exhibit 16 demonstrates the role of consumer and business in the C2B e-commerce model.

Consumers enjoy personalization and tailored-made goods and services. They also receive faster response from businesses as the latter sell directly to them. Businesses that adopt C2B e-commerce model can build direct relationships with consumers. The supply chain can be optimized with more accurate production and better inventory management, thereby reducing production costs and risks.

Exhibit 16: What is C2B E-commerce?

Consumer	Business
<ul style="list-style-type: none"> • Co-create ideas, products/services concepts and solutions with business • Involve and participate in design of products/services • Decide how much they will pay for the products/services 	<ul style="list-style-type: none"> • Determine what to produce, how much to produce, when to produce based on consumers' requirement • Customization of products/services based on customers' requirements • Quick response to the market with flexible production line and fast delivery; better inventory control

Source: Fung Business Intelligence

6. Players jump on the VR and AR bandwagon

Virtual Reality (VR) has become a hot issue in recent times and is predicted to be one of the next big things in the world of commerce as this immersive technology eliminates the limitations of space and time and provides new ways for brands and retailers to run their businesses. It could

change or completely revolutionize the retail industry in the near future. VR has tremendous growth potential in China. The market is estimated to reach 5.66 billion yuan in 2016, and increase significantly to 55 billion by 2020, according to iiMedia Research.

Currently, they experience VR mainly in games, movies and travelling, but some leading Internet companies and e-commerce players have put more focus on VR as well as its sister technology Augmented Reality (AR) and come up with related initiatives or strategies. For instance, Alibaba held an official debut of its VR shopping product “Buy+” in July 2016 at its Taobao Maker Festival, an offline shopping event targeting millennial consumers. Shoppers, after putting on Alibaba’s VR headsets, are able to browse products such as clothes and fashion accessories on a model, with 360-degree view. Shoppers can also call for virtual guides to showcase items – before adding items to the shopping cart. In February 2017, Tmall launched its proprietary AR shopping technology “AR-GO” in its home products shopping festival. By using “AR-GO”, consumers can view the 3D model of the product recreated in AR mode in approximate proportion through users’ phone camera, thus improving shopping experience. Following its debut in the home products shopping festival, “AR-GO” will be adopted on Tmall and gradually applied in other product categories.

3. Concluding remarks

The ever-changing Internet landscape has brought revolutionary changes to people’s lives. Under the “New Retail” regime, broader range of service-based e-commerce and deepened O2O integration will continue to impose huge impact on the e-commerce sector in the coming year. At the same time, new business models driven by technologies will emerge and affect the ways companies operate their businesses. Internet giants and leading e-commerce players will continue to venture into new areas and expand their ecosystems, and will further foster the development of the sector.



Spotlight on China Retail – Issue 7

Cross-border E-commerce (Import)

Asia Distribution and Retail

 FUNG BUSINESS INTELLIGENCE

March 2017

Cross-border import e-commerce has been expanding rapidly over recent years. Many Chinese consumers are buying foreign products via approved Cross-border e-commerce (CBEC) platforms. The fast growth of CBEC is driven largely by the strong demand for imported goods. Ongoing concerns in China over unsafe and counterfeit products have undermined trust in many locally produced goods, pushing consumers toward foreign brands that are generally perceived to be of higher quality.

The government has been very supportive toward the development of CBEC. It has rolled out a number of favourable policies since 2012 to regularize CBEC. It has set up comprehensive e-commerce pilot zones that are designated exclusively for the development of CBEC industry. Since then, many foreign brands and retailers have entered the China market via the CBEC channel; meanwhile, increasing numbers of e-commerce operators and traditional retailers have started their CBEC businesses.

To facilitate further growth and development of the CBEC industry and balance the impacts of CBEC on traditional importers and existing sales channels, the government introduced new policies for CBEC in March 2016. The new policies set forth new tax rules for CBEC business, new operation procedures, a positive list of permitted imported goods, etc.

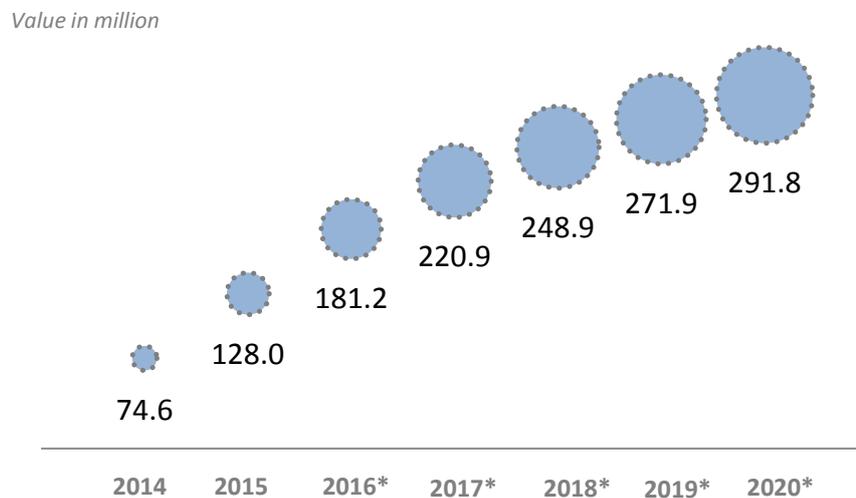
In this chapter, we first provide a brief overview of China's CBEC (import) market. We then review the stages of CBEC development and assess the new policies imposed by the government. We conclude with some major challenges facing CBEC import business. We also summarize in the Appendix the key policies relating to the development of the CBEC (import) market.

1. Market overview

1. CBEC sees rapid expansion amid favorable government policies, but recent policy changes add uncertainties to the market

CBEC has been expanding rapidly over recent years. Many Chinese consumers are buying foreign products via approved CBEC platforms. eMarketer estimated 181.2 million CBEC shoppers in 2016, and the number is estimated to reach 291.8 million in 2020 (Exhibit 1).

Exhibit 1: Number of CBEC shoppers in China, 2014 - 2020

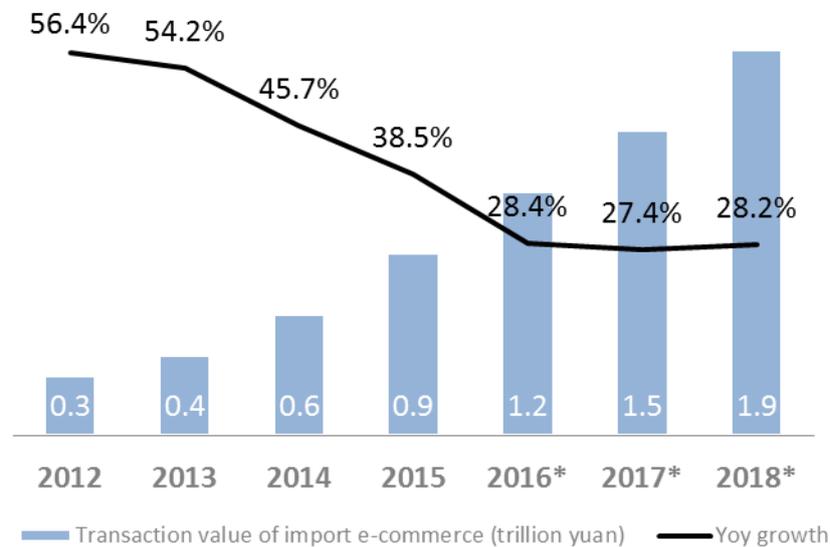


Source: eMarketer; compiled by Fung Business Intelligence

* Note: Estimated figures.

According to iResearch, the transaction value of CBEC import market reached 900 billion yuan in 2015, up 38.5% yoy (Exhibit 2). The recent government initiatives to regulate the CBEC market—the launching of new CBEC tax policies and a positive list for permitted imported goods—have cast a cloud over the development of CBEC (see later sections for more details). It is expected that market growth will not be as rapid as in previous years in the short term.

Exhibit 2: Transaction value of CBEC (import) market, 2012 - 2018



Source: iResearch; compiled by Fung Business Intelligence

* Note: Estimated figures.

2. Large price gap between overseas and domestic markets, quality issue of locally produced goods drive the CBEC (import) market

There is a large price differential between goods selling in the domestic and overseas markets. International brands selling in China usually adopt a higher pricing strategy; taxes applied to imported products are also higher than those on domestic products. Consumers in China usually find the price of the same products to be higher in the China market. As buying direct from overseas becomes easier, Chinese consumers are increasingly drawn to buying imported products on overseas platforms.

Consumption upgrade of Chinese consumers is another reason for the high demand of imported products in recent years. Chinese consumers are increasingly looking for higher quality and unique products that are available overseas. Also, there are ongoing concerns over unsafe and counterfeit products for many locally produced goods in China. Many consumers have turned to overseas brands that are generally perceived to be of higher quality.

3. Females and consumers aged 23–35 and those living in southeastern coastal regions are core CBEC shoppers

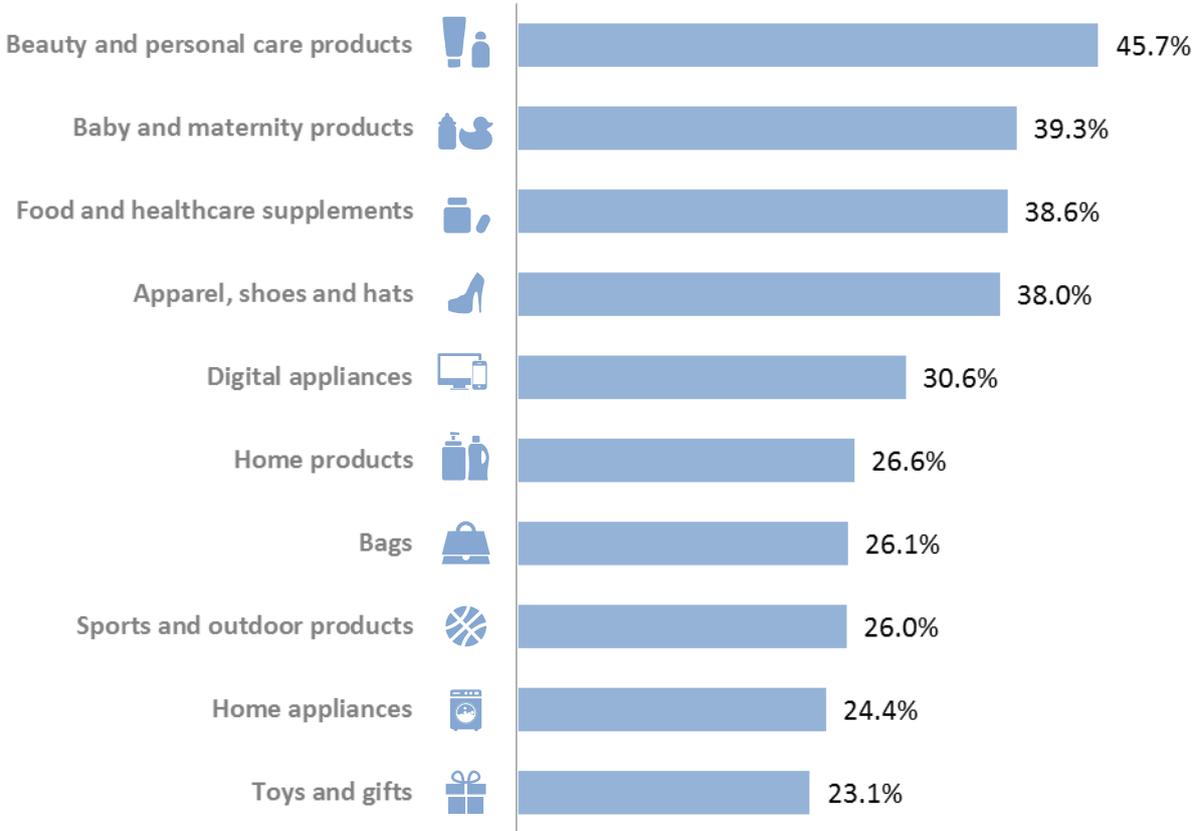
The preferences of male and female CBEC shoppers are quite different. Male shoppers usually care about product price the most, while female consumers care more about the authenticity of products. Male shoppers usually buy baby products and digital products on CBEC websites, while female shoppers tend to buy cosmetics and personal care products and baby and maternity products. According to Tmall Global, the CBEC platform launched by Alibaba, female consumers and consumers aged 23–35 were the major shoppers on Tmall Global in the fourth quarter of 2015.

According to iResearch, cross-border online shoppers are concentrated in the southeastern coastal regions. Guangdong and Shanghai accounted for 25% of the total number of cross-border online shoppers. The top five provinces or municipalities with the most CBEC shoppers in 2015 were Guangdong, Shanghai, Jiangsu, Beijing, and Shandong, respectively.

4. Beauty and personal care products, and baby and maternity products are the best-selling categories for CBEC (import) market

In China, the demand for overseas products, especially beauty and personal care products, baby and maternity products, and food and healthcare products are ever-increasing, due mainly to the quality issue of domestically produced goods. Exhibit 3 shows the categories of products CBEC shoppers have purchased on CBEC platforms in 2015. Recently, the share of sales of food and healthcare supplements, and home products are on the rise, while the share of sales of apparel, footwear, and bags are decreasing.

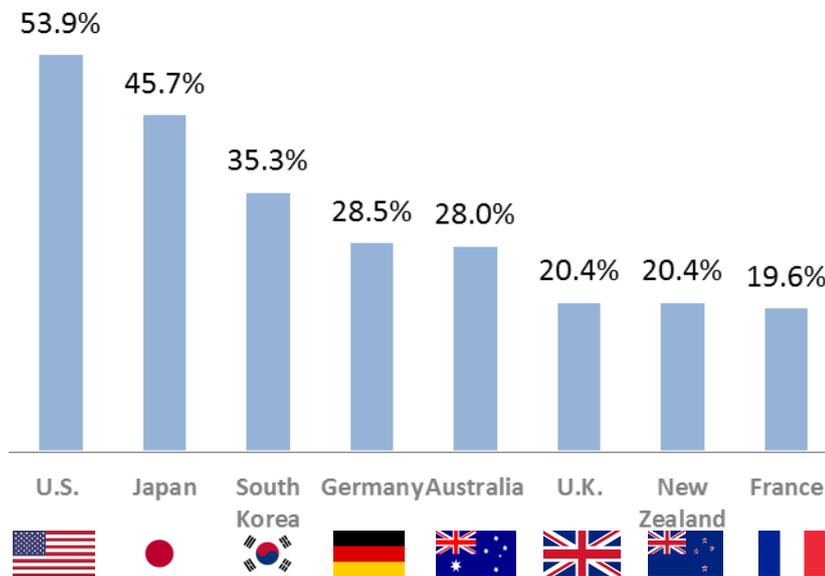
Exhibit 3: Categories of products purchased by CBEC shoppers on CBEC platforms in 2015



Source: *iResearch; compiled by Fung Business Intelligence*

As shown in Exhibit 4, in 2015, CBEC shoppers bought mostly from the U.S., Japan, South Korea, and Germany.

Exhibit 4: Top countries of cross-border online shopping, 2015



Source: iResearch; compiled by Fung Business Intelligence

2. Stages of development of CBEC (import) market in China

1. Stage 1: The flourishing of “daigou” activities through “haitao” channels (Before 2012)

Before the regularization of the CBEC (import) business, Chinese shoppers mainly purchased overseas products through buying agents (or so-called “daigou” agents) or directly from overseas online shopping platforms. This activity is commonly referred to as “haitao.” Exhibit 5 compares these two traditional ways of carrying out “haitao.” Both methods have their own advantages and disadvantages.

Exhibit 5: Comparison of traditional “haitao” methods

	Purchased through “daigou” agents	Purchased directly from overseas shopping websites
1) Operation	<ul style="list-style-type: none"> • “Daigou” agents purchase overseas products on behalf of consumers; they provide assistance to consumers especially on payment and delivery 	<ul style="list-style-type: none"> • Consumers place orders directly via overseas shopping websites. • Payments have to be settled in foreign currencies. • Products are reliable, authentic, and legal.
2) Import price of commodity	<ul style="list-style-type: none"> • Commodity price + taxes* + “daigou” agents’ commissions + logistics fees 	<ul style="list-style-type: none"> • Commodity price + taxes + logistics fees
3) Order placement and payment settlement	<ul style="list-style-type: none"> • “Daigou” agents help customers place orders. • Customers can pay in RMB and agencies can help settle the payment in foreign currencies 	<ul style="list-style-type: none"> • Paypal or a credit card is needed; payment is settled in a foreign currency.
4) Limitations	<ul style="list-style-type: none"> • “Daigou” agents are not reliable. • The purchasing process takes a long time to complete. • “Daigou” agents may import goods illegally (smuggling). • Unclear delivery liabilities. • Difficult for returns/ refunds. 	<ul style="list-style-type: none"> • Customs clearance is needed if parcels are shipped by international couriers. • Only some foreign websites offer delivery to China.

Source: Fung Business Intelligence; Deutsche Bank; Morgan Stanley; China Customs; compiled by Fung Business Intelligence

* Note: Some “daigou” agents are reportedly not correctly declaring at China Customs when importing goods into China.

According to a survey conducted by Tmall Global, many consumers were not fully satisfied with their traditional “haitao” experience. Dissatisfied shoppers cited long delivery lead times as their number one cause of annoyance when using the traditional “haitao” methods. Other major causes of dissatisfaction included hidden costs, language barrier, uncertainty in product quality, and difficulty in product returns.

2. Stage 2: The setting up of pilot zones for CBEC (2012~)

To fight against the gray import market and unauthorized “daigou” activities, the Chinese government announced several favorable policies to promote CBEC development. In 2012, the government rolled out a pilot program and established pilot zones for the CBEC import business. These pilot zones take the lead in setting new standards for CBEC transactions, payment, logistics, customs clearance, exchange settlement, inspection quarantine, etc., and facilitate the development of the CBEC import business.

As of March 2017, China has 10 pilot zones for CBEC businesses (Exhibit 6).

Exhibit 6: CBEC comprehensive pilot zones, as of March 2017



Source: The State Council; compiled by Fung Business Intelligence

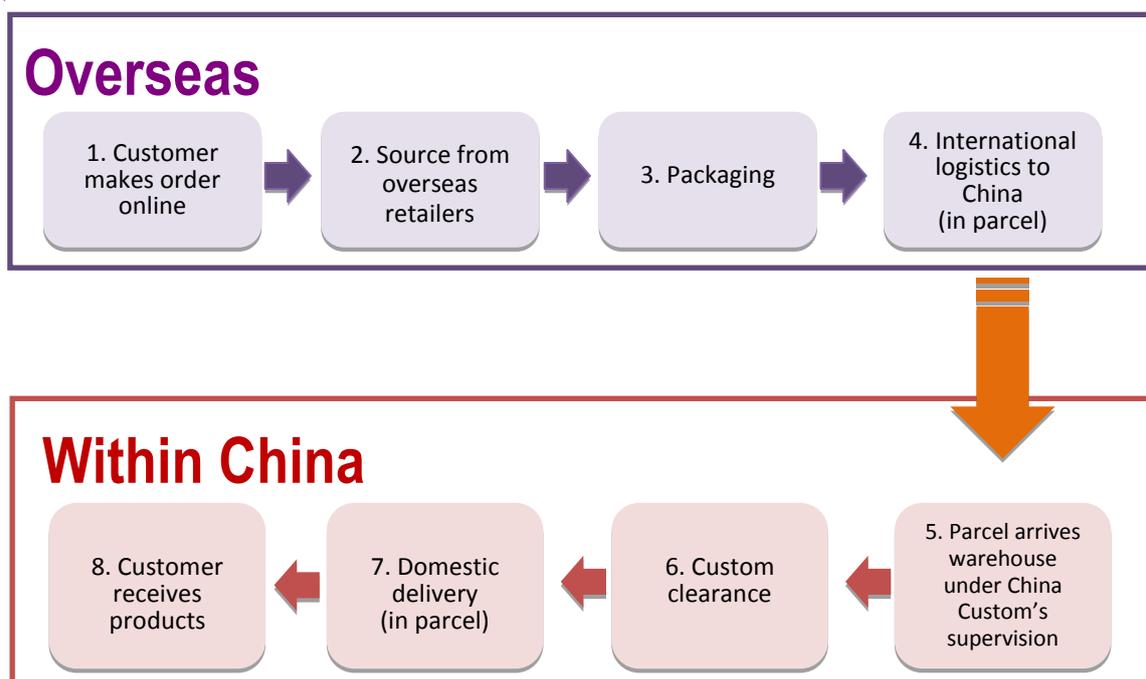
3. Stage 3: The emergence of new CBEC models and application of personal postal articles tax on CBEC imported products (2014~)

As a result of the government's efforts to promote the CBEC business, two new CBEC models emerged in 2014, namely, the "direct mail" model and the "bonded area import" model.

"Direct mail" model

After customers place orders on a registered CBEC platform, the platform will submit particulars of the orders electronically for Customs clearance. The products will then be shipped by direct mail to customers. Exhibit 7 shows the flow of purchasing CBEC imported products under the "direct mail" model.

Exhibit 7: Flow of purchasing CBEC imported products under the "direct mail" model



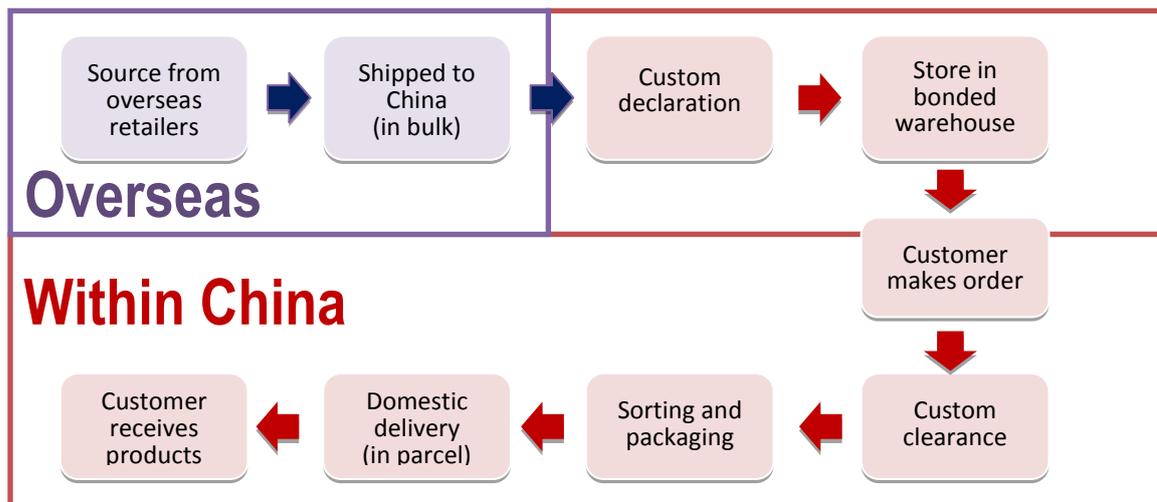
Source: Fung Business Intelligence

"Bonded area import" model

Products are shipped in bulk and stored in e-commerce platform's bonded warehouse in pilot cities before consumers place orders online. The CBEC platform makes a declaration in real-time Cross-border E-commerce (Import)

to Customs after customers have placed their orders. The products are shipped to customers from the bonded warehouse after completion of customs clearance, inspection, and quarantine procedures. Exhibit 8 shows the flow of purchasing CBEC imported products under “bonded area import” model.

Exhibit 8: Flow of purchasing CBEC imported products under “bonded area import” model



Source: Fung Business Intelligence



Box 1:

The emergence of the “near-border” model

A new “near-border” model has emerged recently. This is a hybrid of the “direct mail” and “bonded area import” models. Goods are shipped to a warehouse in Hong Kong for storage, and can be shipped to China within a short time. Retailers can have better inventory management. In case of excess inventories, goods can be sold to other places outside China or through other channels besides CBEC platforms. However, warehousing costs are relatively higher than both “direct mail” and “bonded area import” models. Shipping time is also slightly longer than that from mainland bonded warehouses.

Imported goods are regarded as personal consumption items under the “direct mail” and “bonded area import” models. Instead of import duties, consumption taxes, and value-added tax (VAT), personal postal articles taxes are also levied. It is noteworthy that from April 8,

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2016, a new tax for CBEC has replaced the tax for personal postal articles on CBEC imported products. Details on the new tax will be discussed in later sections. At the same time, the tax rates for personal postal articles were being revised in April 2016; the tax only applies to personal parcels, but no longer on CBEC imported products.

Exhibit 9 compares the CBEC imported model and the general import model for overseas products.

Exhibit 9: Comparison of different business models, as of April 2016

	CBEC model	General import model
Tax levied	<ul style="list-style-type: none"> Before April 8, 2016: Personal postal articles tax After April 8, 2016: Tax for CBEC* 	<ul style="list-style-type: none"> Import duties + VAT + consumption tax
Tax rates	<ul style="list-style-type: none"> Before April 8, 2016: Personal postal articles tax: 10%, 20%, 30%, 50% varies from products After April 8, 2016: Tax for CBEC: Import duties (0%) + 70% of VAT and consumption tax 	<ul style="list-style-type: none"> Import duties: varies from products VAT: 17% Consumption tax: varies from products (e.g., 30% for cosmetics)

Source: Various Internet sources; compiled by Fung Business Intelligence

* Note: From April 8, 2016, a new tax for CBEC has replaced the tax for personal postal articles tax.

4. Stage 4a: The introduction of new policies on CBEC (import) (April 2016~)

In response to the booming CBEC market in China, the Ministry of Finance, China Customs, and the State Administration of Taxation jointly announced new policies on CBEC. The new policies aim to better regulate the CBEC channels and reduce policy loopholes, ensure tax collection, and reduce the price gap between CBEC and general import, so as to provide a fair market environment for all players. The new policy is effective from April 8, 2016.

Key adjustments under the new regulation are as follows:

1. New transaction limit per order via the CBEC platform is increased from 1,000 yuan to 2,000 yuan. New upper limit per person each year (or the “annual cap”) will be set

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at 20,000 yuan.

2. For single orders with price tags larger than 2,000 yuan, or total transaction value over 2,000 yuan, taxes applicable for general import is levied.
3. For single orders with price tags under or equal to 2,000 yuan, or total transaction value under or equal to 2,000 yuan, a new tax will replace the tax for personal postal articles. The new tax includes import tariff + VAT + consumption tax, where the actual tax payable to the Custom is 70% of the calculated taxable amount. Current import tariff is temporarily set at 0%.
4. Before the tax adjustment, the personal postal articles tax was exempt by the Customs if the taxable value was 50 yuan or below. Under the new regulation, the exemption for CBEC is cancelled.
5. Duty-paid value (the actual transaction price) includes retail price of goods, shipping costs, and insurance costs. End-consumers are liable to pay the taxes, but CBEC platforms can pay the taxes on behalf of customers.
6. Customers can apply for tax refund for goods returned within 30 days of purchase from CBEC channels.
7. A positive list has replaced the previous negative list for CBEC (import) goods.
8. The new regulation is effective from April 8, 2016.

Exhibit 10 compares the CBEC regulations before and after April 8, 2016.

Exhibit 10: Comparison of the regulations

	Regulation BEFORE April 8, 2016	New regulation AFTER April 8, 2016
Value cap per transaction	<ul style="list-style-type: none"> • ≤ 1,000 yuan 	<ul style="list-style-type: none"> • ≤ 2,000 yuan
Annual cap	No nationwide requirement	<ul style="list-style-type: none"> • 20,000 yuan
Tax applied	<ul style="list-style-type: none"> • Personal postal articles tax 	<ul style="list-style-type: none"> • Import tariff + VAT + consumption tax
Personal postal articles tax	<ul style="list-style-type: none"> • 10%, 20%, 30%, 50% varies from products • Personal postal articles tax ≤ 50 	--
Import tariff	--	<ul style="list-style-type: none"> • Transaction of single orders <u>≤ 2,000 yuan</u>: 0% • Transaction of single orders > 2,000 yuan: import tariff for general import applied
VAT / consumption tax	--	<ul style="list-style-type: none"> • Transaction of single orders <u>≤ 2,000 yuan</u>: 70% of VAT and consumption tax
Products can be imported via CBEC channel	<ul style="list-style-type: none"> • Negative list is published 	<ul style="list-style-type: none"> • Positive list applicable to CBEC is released

Source: Ministry of Finance; compiled by Fung Business Intelligence

Meanwhile, for personal parcels, i.e., items for personal consumption, gifts, and items not for reselling purpose, the personal postal articles tax still applies but is being adjusted. The four rates (10%, 20%, 30%, and 50%) have been replaced by the new rates, which are categorized into 15%, 30%, and 60% levels. Exhibit 11 compares the current and new personal postal articles tax rates.

Exhibit 11: Comparison of the current and new personal postal articles tax

	Personal postal articles tax BEFORE April 8, 2016	Personal postal articles tax AFTER April 8, 2016
10%	<ul style="list-style-type: none"> Food & beverage, leather clothes & accessories, bags & shoes, furniture, toys 	--
15%	--	<ul style="list-style-type: none"> Food & beverage, furniture, toys Products with a zero most-favored-nation (MFN) tariff rate
20%	<ul style="list-style-type: none"> Apparel & textile, general watches 	--
30%	<ul style="list-style-type: none"> Luxury watches (>10,000 yuan) 	<ul style="list-style-type: none"> Leather clothes & accessories, bags & shoes, apparel & textile, general watches
50%	<ul style="list-style-type: none"> Cosmetics, skin care products 	--
60%	--	<ul style="list-style-type: none"> Luxury watches, cosmetics Luxury products applicable to consumption tax

Source: China Customs; compiled by Fung Business Intelligence

5. Stage 4b: A positive list is released to replace the previous negative list (April 2016~)

On April 7, 2016, 11 government authorities, including the Ministry of Finance, National Development and Reform Commission, Ministry of Industry and Information Technology, Ministry of Commerce, General Administration of Customs and State Administration of Taxation, jointly released a positive list for CBEC imported goods. Effective from April 8, 2016, the positive list will replace the previous negative list for CBEC imported goods; only goods that are on the list are eligible to be sold via CBEC channels. The positive list covers 1,142 types of product categories with an eight-digit H.S code. These products are mostly daily consumer goods with solid demand in China. According to the China Customs, these products can satisfy supervision requirements of authorities concerned, and can enter China via express delivery or direct mail. Product categories on the list include food and beverages, apparel and footwear, home appliances, cosmetics, paper diapers, and children's toys. Products on the list are exempt from submitting related import license to China Customs but

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should go through inspection and quarantine procedures in accordance with the laws and regulations of the PRC. The submission of China Inspection and Quarantine (CIQ) Clearance Notice is required when imported products enter bonded zones. Direct mailed products are exempt from CIQ Clearance Notice.

On April 15, 2016, 13 government authorities, including the Ministry of Finance, National Development and Reform Commission, Ministry of Industry and Information Technology, Ministry of Commerce, General Administration of Customs, and State Administration of Taxation, jointly announced the second batch of products allowed on the positive list for CBEC imported goods. The list covers an additional 151 types of product categories with an eight-digit H.S code. Newly added categories include fresh food (including meat and fruits), seafood, liquid milk, grains, cooking oil, certain nutritional and health products (including vitamin supplements), and registered medical instruments. Product categories on the positive list are set to be reviewed on a regular basis.

On May 24, 2016, General Office of China Customs issued a notice regarding the transition period for the implementation of new supervision regulations on CBEC imports. The document stated that the transition period will last for one year until May 11, 2017, during which importers will not be required to provide CIQ Clearance Notice before importing CBEC goods into bonded warehouses of pilot cities. Also, pre-market approvals for first-time imported goods such as cosmetics, infant formula, etc. via the bonded area import or direct mail models will be put on hold during the period.

On November 15, 2016, Ministry of Commerce further extended the one-year transition period for the implementation of new supervision regulations on CBEC imports to the end of 2017.

3. Development trends

1. Emergence of large numbers of CBEC platforms

Over the years, the government has been very supportive towards the development of the CBEC and has rolled out various policies to facilitate the development of the CBEC. This has led to the emergence of large numbers of CBEC platforms. These CBEC platforms are operated in various formats, including integrated CBEC platforms (marketplace, self-operated, and hybrid) and vertical CBEC platforms (marketplace and self-operated). The former sells a

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large variety of categories of products, while the latter focuses on a few specialized categories. Exhibit 12 shows the examples of these two major types of CBEC platforms.

Exhibit 12: Selected major CBEC platforms – Integrated platforms and vertical platforms

	Integrated CBEC platforms	Vertical CBEC platforms
1) Marketplace	<ul style="list-style-type: none"> Tmall Global, KJT.com, Ymatou.com 	--
2) Self-operated	<ul style="list-style-type: none"> Red (xiaohongshu.com), Xiji.com, Kaola.com 	<ul style="list-style-type: none"> Jumei Global (specialized in cosmetics)
3) Hybrid (marketplace and self-operated)	<ul style="list-style-type: none"> JD Worldwide, Amazon.cn, Yhd.com 	<ul style="list-style-type: none"> Mia.com (specialized in baby products)

Source: Various Internet sources; compiled by Fung Business Intelligence

2. Increasing numbers of overseas brands tap the China market via CBEC channels

The huge potential of CBEC has captured considerable attention globally. The CBEC channels provide a relatively cheaper and faster way for foreign brands and retailers to test the China market. Under the CBEC regulations, overseas retailers without Chinese business licenses can sell in China through authorized CBEC platforms. Many have set up stores on the two largest CBEC platforms—Tmall Global and JD Worldwide. Tmall Global reported that as of December 2016, around 14,500 international brands from 63 countries have entered its platform.

Increasing number of foreign department store operators have entered Tmall Global recently, including House of Fraser (U.K.) in July 2015, Macy's (U.S.) in November 2015, Aeon (Japan) in February 2016, AK Plaza (South Korea) in June 2016, Saks Fifth Avenue (U.S.) in October 2016, and Isetan Mitsukoshi (Japan) in November 2016. Some leading hypermarket and supermarket chains have also entered Tmall Global actively, including Costco (U.S.) in October 2014, emart (South Korea) in February 2015, Sainsbury's (U.K.) in September 2015, Woolworths (Australia) in December 2015, and Target (U.S.) in September 2016.

3. More and more traditional retailers engage in CBEC business

CBEC is increasingly becoming a popular way for retailers to transform their businesses. An increasing number of retailers, which have suffered from slowing sales growth over recent years, are actively tapping into CBEC business. Currently, most retailers run their CBEC business via two channels: either by establishing their own online cross-border shopping websites or by launching physical experiential stores that sell both duty-paid and bonded imported products. Duty-paid goods are goods imported to China under general trade procedures with value-added tax, consumption tax and import duties being paid. Customers can buy duty paid goods directly from the experiential stores and take them back home right away. Bonded imported goods, on the other hand, are goods that stocked in bonded warehouses in Free Trade Zones. The experiential stores display samples or photos of the imported products on shelves or walls, and customers can take the product card (usually with assigned barcode number) to the cashier to settle payment or they can scan the QR code to access the respective online platforms of the experiential stores to place order.

4. Major challenges

The biggest challenge facing enterprises engaging in CBEC business is the changing government policies. As mentioned earlier, the government announced several new policies in late March and early April 2016, with an aim to ensure sustainable tax collection and foster fair competition. The new policies have set forth new tax rules for different CBEC models, new operation procedures, new tax rates for personal postal article tax, a positive list of permitted imported goods, etc. These may create new challenges for companies engaging in CBEC business, such as a higher tax burden, product entry, more complicated custom clearance procedures, and quality compliance issues.

That said, we believe the new policies are not intended to stop CBEC imports, but to provide a level playing field for CBEC operators, traditional importers, and retailers. The extension of transition period is indeed a compromise from the government to accommodate interests of different parties. It hopes to encourage customers buying from overseas, while striking a balance between general trade and CBEC.

To stay relevant in the market, enterprises need to assess the potential tax implications, product entry, custom clearance, inspection and quarantine, logistics requirement, etc. and adjust their strategies accordingly.

On the other hand, it is noteworthy that the CBEC pilot zones play a critical role in facilitating CBEC import business. Each individual city has great autonomy in forming its own detailed CBEC plan; there may be variations among these pilot zones regarding CBEC operation.

5. Concluding remarks

The rapid growth of the CBEC business over recent years, to a certain extent, has led to irrational development. Competition in the market is getting more intense; products selling on CBEC platforms are highly similar. Many players reportedly compete mainly on price. It is expected that less competitive players who cannot survive the competition will eventually leave the market.

The new CBEC policies are set to change the way many enterprises run their business; yet, the impacts are largely manageable. The new tax may lead to a tax hike for the majority of products sold on CBEC platforms, which may suppress demand for some price-sensitive customers. But, for most regular CBEC customers, we expect the tax increase should be acceptable as long as prices offered by CBEC platforms are cheaper than those from traditional retail channels. With less tax advantage than in the past, CBEC operators are advised to put more focus on streamlining cross-border supply chains, and improving their sourcing capability. They should increase the variety and quality of products they offer.

New CBEC models are expected to emerge in the coming years. Meanwhile, we expect the government to continue to roll out new policies to tighten control over the CBEC market—not to stop CBEC activities, but to better regulate the market and build synergies among different players.

Appendix 1: Key policies relating to cross-border e-commerce (import), August 2012 – November 2016

Announced date	Policy	Details
August 2012	Approval of Five Pilot Cities for CBEC business	<ul style="list-style-type: none"> • Issued by the NDRC • It approves Shanghai, Chongqing, Hangzhou, Ningbo, Zhengzhou to be the pilot cities for CBEC business.
February 2014	GAC Announcement No. 12, 2014 (The Addition of a Customs Supervisory Method Codec)	<ul style="list-style-type: none"> • Issued by the GAC • It specifies that “9610” customs supervision code is applicable to individual customers or e-commerce companies who would like to realize transactions through CBEC platforms. It is also the first customs supervision, particularly for CBEC.
March 2014	Notice on Issues Related to CBEC Service Pilot Online Bonded Imports	<ul style="list-style-type: none"> • Issued by the Department of Processing Trade and Bonded Affairs Control and Supervision of the GAC • It re-emphasizes the restrictions on individual customers’ overseas shopping value and volume, tax levies and other details, which are mentioned in GAC Announcement No. 43, 2010.
July 2014	GAC Announcement No. 56, 2014 (Announcement on Matters relating to the Regulation of Imported and Exported Goods and Articles via CBEC)	<ul style="list-style-type: none"> • Issued by the GAC • It states that customs supervision is applicable to both companies and personal cross-border transactions through an e-commerce transaction platform. E-commerce enterprises should process an e-commerce business filing with Customs for imported goods. Further, enterprises or individuals engaging in CBEC business should submit orders, payments, and logistics information to Customs before declaring goods to enter or exit China.
August 2014	GAC Announcement No. 57, 2014 (The Addition of a Customs Supervisory Method Codec)	<ul style="list-style-type: none"> • Issued by the GAC • It specifies that “1210” customs supervision code is applicable to bonded CBEC business.
March 2015	Official Reply of the State Council on Approving the Establishment of the China (Hangzhou) CBEC Comprehensive Pilot Zone	<ul style="list-style-type: none"> • Issued by the State Council • It approves Hangzhou to be the first CBEC comprehensive pilot zone.
September 2015	Letter on Strengthening Bonded Supervision over CBEC Online Imports	<ul style="list-style-type: none"> • Issued by the Department of Processing Trade and Bonded Affairs Control and Supervision of the GAC • It clarifies that only pilot cities that have special zones with bonded logistics centers and supervised by customs officials are allowed to engage in CBEC import business. Other cities and zones, including bonded warehouses, are not allowed to conduct CBEC business.

January 2016	Official Reply of the State Council on Approving the Establishment of CBEC Comprehensive Pilot Areas in 12 Cities	<ul style="list-style-type: none"> • Issued by the State Council • It approves the establishment of new CBEC comprehensive pilot zones in 12 cities including Tianjin, Shanghai, Chongqing, Hefei, Zhengzhou, Guangzhou, Chengdu, Dalian, Ningbo, Qingdao, Shenzhen, and Suzhou.
March 2016	Circular on Tax Policy for CBEC Retail Imports	<ul style="list-style-type: none"> • Issued by the MOF, the GAC and the SAT • It states that effective from April 8, 2016, CBEC imported goods are no longer subject to personal postal articles tax. New tax on CBEC is applicable which includes import tariff, VAT, and consumption tax, where the actual tax payable is 70% of the calculated taxable amount. Transaction limit per order and new upper limit per person each year are also amended.
March 2016	Notice on Adjustment of Personal Postal Article Tax	<ul style="list-style-type: none"> • Issued by the MOF, the GAC, and the SAT • It states that effective from April 8, 2016, personal postal articles tax is adjusted. New rates are categorized into 15%, 30%, and 60% levels.
April 2016	GAC Announcement No. 25, 2016 (Announcement on the Classification and Nomenclature Table of Imported Articles of the PRC and the Duty-paid Price Table of Imported Articles of the PRC)	<ul style="list-style-type: none"> • Issued by the GAC • It makes adjustment on the GAC Announcement No. 15, 2012 with details on the classification as well as the duty-paid price of imported goods.
April 2016	GAC Announcement No. 26, 2016 (Announcement on Matters relating to the Regulation of CBEC Retail Imports and Exports)	<ul style="list-style-type: none"> • Issued by the GAC • It provides guidelines for the submission of documents of CBEC business to the Customs, clarifies the customs clearance management, tax collection management, logistics control, and return management. The policy is effective from April 8, 2016. • It also abolishes the GAC Announcement No. 56, 2014 on CBEC trade supervision.
April 2016	Announcement on Issuing the List of CBEC Retail Imports	<ul style="list-style-type: none"> • Issued by 11 government authorities, including MOF, NDRC, GAC, and MOFCOM. • It announces a positive list for CBEC imported goods. The list covers 1,142 types of product categories. Effective from April 8, 2016, the new positive list will replace the previous negative list for CBEC imported goods.
April 2016	Announcement on Issuing the List of CBEC Imports (Second Batch)	<ul style="list-style-type: none"> • Issued by 13 government authorities, including MOF, NDRC, GAC, and MOFCOM. • It announces the second batch of positive list with an additional 151 types of product categories. The list is effective from April 16, 2016.

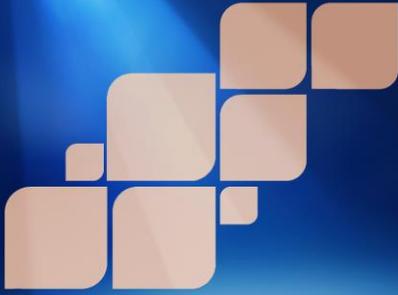
May 2016	Notice on the Implementation of New Supervision Regulations on CBEC Imports	<ul style="list-style-type: none"> • Issued by the GAC • It announces the transition period for the implementation of the new supervision regulations on CBEC imports to last for one year until May 11, 2017, during which importers will not be required to provide CIQ Clearance Notice before importing CBEC goods into bonded warehouses of pilot cities. Also, pre-market approvals for first-time imported goods such as cosmetics, infant formula, etc. via the bonded area import or direct mail models will be put on hold during the period.
November 2016	Transition period for the implementation of new supervision regulations on CBEC imports to extend to end-2017	<ul style="list-style-type: none"> • Issued by the MOFCOM • It announces the one-year transition period for the implementation of new supervision regulations on CBEC imports which starts from May 11, 2016 to extended further to the end of 2017.

Source: Various government websites; compiled by Fung Business Intelligence

* Note: NDRC: National Development and Reform Commission; GAC: Gener

Ministry of Finance; SAT: State Administration of Taxation; MOFCOM: Ministry of Commerce

Spotlight on China Retail – Issue 8



Retail and E-commerce Logistics

Asia Distribution and Retail

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With the advent of technology and new consumer buying behaviour, the retail logistics market in China has seen significant growth in terms of market size and new services offered. As China's retail market becomes increasingly sophisticated and consumers expect fast delivery, the efficient movement of goods along the supply chain is a key success factor for retailers. The explosive growth of China's e-commerce market, especially rural e-commerce and cross-border e-commerce (CBEC), over recent years has fuelled the demand for retail logistics services, particularly express delivery.

To cope with the changing needs of the market, many logistics companies and e-commerce players have expanded their logistics capabilities and service offerings. Some have leveraged technologies to optimize their logistics processes and provide new logistics solutions for retailers.

1. Market overview

1. Strong growth of online retail sales fuels demand for logistics services; rural online market is a new source of growth

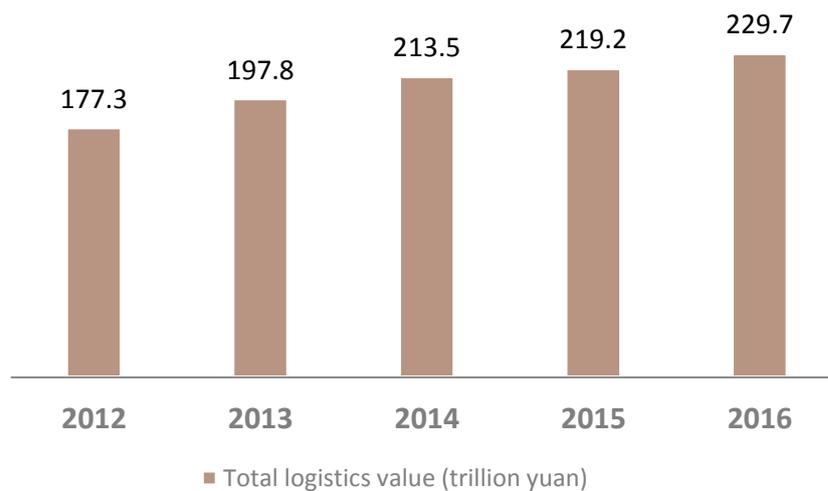
Despite the slowing of the economy, China's retail sector has maintained steady growth over the past years. Among the retail segment, online retailing, in particular, has seen exponential growth. Total online retail sales increased by 26.2% year-on-year (yoy) to reach 5.16 trillion yuan in 2016, while online sales of physical goods amounted to 4.19 trillion yuan, up by 25.6% and accounted for 12.6% of total retail sales.

The rural online market contributed significantly to the growth of total online retail sales. According to the China International Electronic Commerce Centre, rural online retail transactions reached 312 billion yuan in 1H16, accounting for 14.14% of total online retail sales. The market size of rural e-commerce was estimated to reach 647.5 billion yuan by the

end of 2016.

The rapid growth of online retailing in China has boosted the demand for logistics services, especially express delivery. Total logistics value reached a record high of 229.7 trillion yuan in 2016 (Exhibit 1), up by 6.1% yoy in real terms.

Exhibit 1: China's total logistics value, 2012–2016

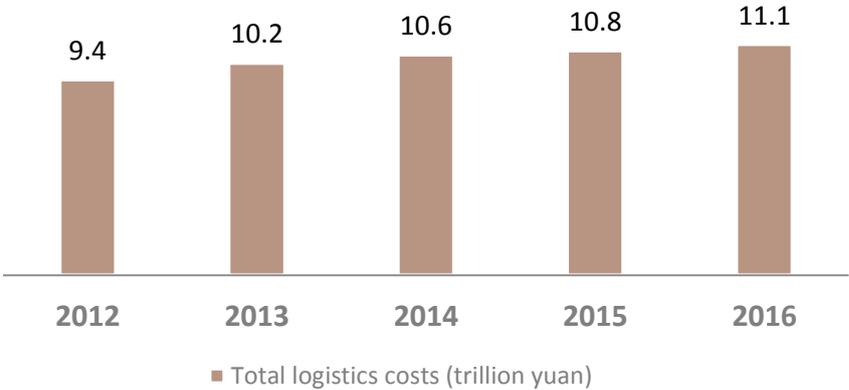


Source: China Federation of Logistics and Purchasing; compiled by Fung Business Intelligence

2. Logistics costs remain high; transportation costs account for the lion's share of total costs

Total logistics costs remain high in China. According to the China Federation of Logistics and Purchasing, China's total logistics costs amounted to 11.1 trillion yuan in 2016 (Exhibit 2), up by 2.9% yoy. The ratio of total logistics costs to GDP was 14.9% in 2016, down from 17.4% in 2010 and 16.0% in 2015. However, the ratio is still much higher than the global average at around 11%, and way above the 8% level in developed economies such as the U.S., Japan and Germany.

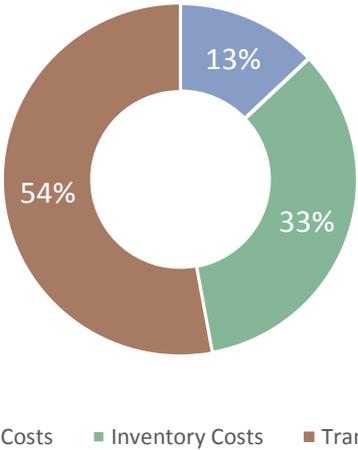
Exhibit 2: China's total logistics costs, 2012-2016



Source: China Federation of Logistics and Purchasing; compiled by Fung Business Intelligence

As shown in Exhibit 3, transportation costs accounted for the largest share of total logistics costs and comprised almost 54% of the total costs in 2016, while inventory and management costs accounted for 33% and 13% of the total logistics costs respectively.

Exhibit 3: Cost structure of logistics industry in China, 2016

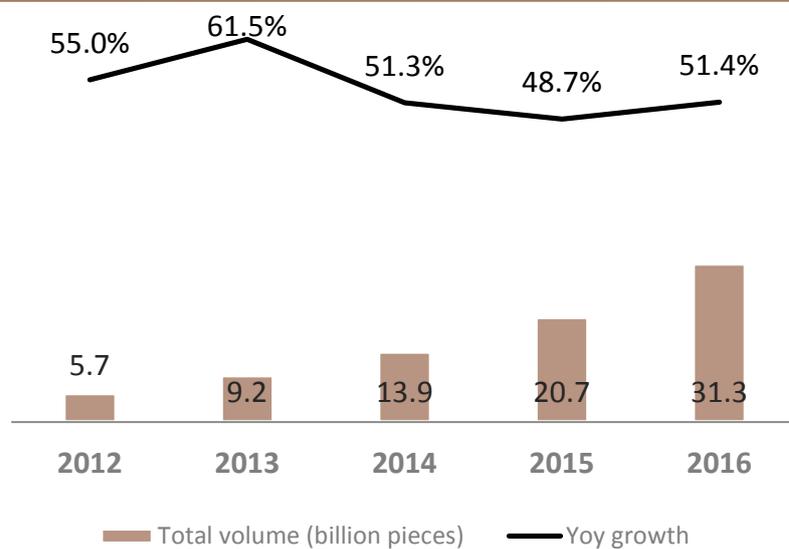


Source: China Federation of Logistics and Purchasing; compiled by Fung Business Intelligence

3. Express delivery market scales up; growing demand for intra-city courier services (same-city delivery)

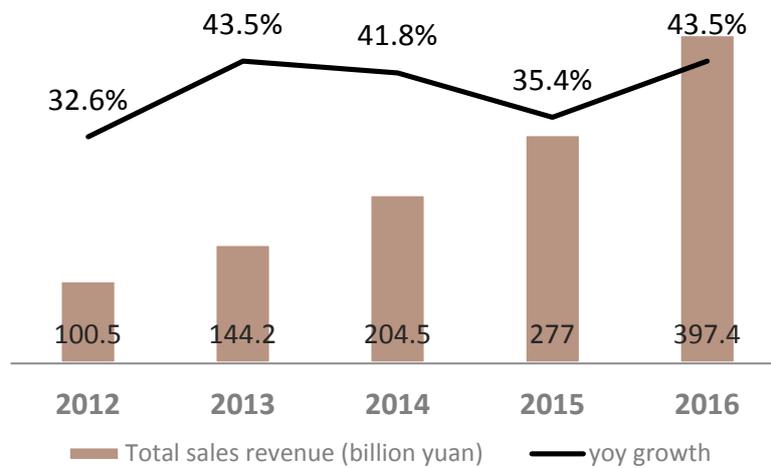
Being a critical part of e-commerce logistics, the express delivery sector has grown rapidly over the years. As shown in Exhibit 4, the total volume of completed delivery amounted to 31.3 billion pieces in 2016, up 51.4% yoy, making China's express delivery market the largest in the world in terms of delivery volume. Total sales revenue of the sector amounted to 397.4 billion yuan, increased by 43.5% yoy (Exhibit 5).

Exhibit 4: Total volume of China's express delivery sector, 2012 - 2016



Source: State Post Bureau; compiled by Fung Business Intelligence

Exhibit 5: Total sales revenue of China's express delivery sector, 2012 - 2016



Source: State Post Bureau; compiled by Fung Business Intelligence

China's express delivery sector has three major market segments, namely, intra-city courier, inter-city courier, and cross-border delivery. As shown in Exhibit 6, inter-city courier accounted for the largest share of the sector, contributing over 74% of the total market volume and over 52% of the total revenue. Intra-city business accounted for only 23.7% and 14.2% of the total market volume and total revenue in 2016 respectively. That said, the intra-city business has been the fastest growing segment in recent years. In 2016, sales revenue of intra-city courier increased by 40.8% yoy to 56.31 billion yuan; by contrast, sales revenue of inter-city courier rose by 38.8% to 209.93 billion yuan and sales revenue of international courier increased by only 16.1% yoy to 42.9 billion yuan.

The surge in demand for intra-city courier is due in part to the emergence of new retail practices such as online-to-offline (O2O) e-commerce and an increasingly large number of online channels selling fresh produce.

Exhibit 6: Market share of the three segments of the express delivery sector, 2013 - 2016

	Intra-city courier		Inter-city courier		International courier	
	% of Volume	% of Sales Revenue	% of Volume	% of Sales Revenue	% of Volume	% of Sales Revenue
2013	24.9	11.5	72.2	57.5	2.9	18.8
2014	25.4	13.0	72.3	55.3	2.3	15.4
2015	26.1	14.5	71.8	54.6	2.1	13.3
2016	23.7	14.2	74.3	52.8	2.0	10.8

Source: State Post Bureau; compiled by Fung Business Intelligence

2. Development trends

1. E-commerce and logistics players actively invest in technologies; “smart logistics” see great potential

In today’s rapidly evolving market, the application of advanced technologies such as data analytics, Radio Frequency Identification (RFID), and Global Positioning System (GPS) in the logistics process has driven innovation and improved efficiency of the retail logistics sector. Many e-commerce and logistics players have invested heavily in technologies, hoping to enhance fulfilment capability and operation efficiency. “Smart logistics” and data-driven logistics operation have gained increasing attention in recent years.

In December 2016, Suning Commerce Group partnered with a number of Chinese tertiary institutions and R&D enterprises to form the Suning Institute of Logistics Research, which is dedicated to conducting researches related to the formation of smart logistics ecosystems. The institute focuses on three major research areas: predictive analytics in logistics, intelligence sharing within the supply chain, and innovative application of smart technologies. Suning also established a S-Lab within the institute, which will spearhead cutting-edge research projects such as warehouse cloud automation, artificial intelligence, warehouse robotics, as well as self-driving car in express delivery.

Cainiao, the logistics affiliate of Alibaba, has invested substantially in technologies over the years. Cainiao has built an information system connecting all its partnering logistics service providers (LSPs) and allowed information sharing and standardization among all stakeholders. The company has introduced “Cainiao World,” a data sharing platform that covers

information on courier package delivery and uses an algorithm to help with the distribution process. The adoption of advanced technologies allows Cainiao to provide more high value-added services and improve operational efficiency.

JD.com is another significant example of an e-commerce platform deploying innovative strategies to provide value-added logistics services. JD.com has set up a JD Logistics Lab to further enhance operational efficiency and improve customer experience. The lab has started a series of experiments with drone delivery, and started to use drones to deliver parcels to remote areas. It has also showcased other technologies such as warehouse robot assistants, and auto-pilot delivery vehicles. Moreover, JD.com has built seven “Asia No. 1” smart logistics centers in China, each equipped with a high degree of automation and used big data applications to streamline operation processes.

2. Internet and e-commerce players set up nationwide logistics network

The fast growing e-commerce market has led to an increasing demand for efficient logistics and quick fulfilment services. To cope with the needs of e-commerce, especially rural e-commerce as well as CBEC, some leading Internet and e-commerce players have set up a nationwide logistics network and actively deployed big data analytics to enhance fulfilment capability and distribution efficiency.

A typical example is JD.com. It has made huge investments to build a nationwide logistics network in recent years. As of the end of 2016, the company has 256 warehouses across China, with a total operating area of approximately 5.6 million sqm. It has over 5,300 local delivery stations and self-pickup stations in more than 1,500 counties and 420,000 villages across the country.

Alibaba has also invested heavily in expanding its logistics network via Cainiao. As of March 2016, Cainiao worked with over 40 domestic Cainiao partners to provide domestic end-to-end logistics solutions. Total gross floor area of Cainiao’s self-owned and leased warehouses as well as Cainiao partners’ warehouses totalled over 1.7 million sqm. Its vast network covered over 2,800 counties and 14,000 villages in China. In terms of CBEC logistics services, as of May 2016, Cainiao has 13 domestic bonded warehouses and 16 overseas warehouses providing CBEC logistics services for 224 countries and regions.

3. Large-scale retailers develop in-house logistics capabilities

In the past, most retailers tended to outsource their logistics activities to third-party LSPs. However, the emergence of new business models, O2O initiatives, and new delivery options such as “click & collect,” and increasing demand for fast delivery have prompted some large-scale retailers to develop in-house logistics capabilities.

To enhance operation efficiency, some retailers have also adopted sophisticated IT systems to facilitate warehouse automation. For instance, to enhance regional services and improve speed to market, Carrefour China opened its sixth logistics center in Shenyang to provide logistics services for Northeast China. Located in the Economic Area of Shenyang International Logistic Park in Yuhong District, the logistics center occupies a floor area of around 32,000 sqm and has an annual average capacity of up to around 80,000 tonnes. The center provides all-round, automated logistics services such as warehousing and delivery for over 30 stores in Liaoning and Heilongjiang provinces.

Another example is Suning Commerce Group. To meet the increasing demand for logistics services both online and offline, the company set up an independent logistics company in 2014. It also established a large-scale automated warehouse in Nanjing. With an operating area of 200,000 sqm, the automated warehouse can handle 1.5 million SKUs, over 20 million pieces of goods and complete 1.81 million pieces of shipments per day. Warehouse automation reduced the logistics cost per piece of good by 32% yoy in 2015; and greatly enhanced overall efficiency for the distribution of products, especially small commodities.

4. Strengthening last-mile delivery

Increasing numbers of retailers and logistics players have introduced various means to enhance last-mile delivery capabilities. Some retailers such as Wal-mart (China) and Uniqlo have introduced “click & collect” services, while others have invested in logistics infrastructure such as smart lockers, or partnered with convenience stores or community stores to provide pick-up services. Recently, some retailers and e-commerce players have also started to use crowd-sourced delivery — a new type of web or mobile-based courier service that leverages large groups of geographically dispersed individuals to take up the delivery job. Originating from the concept of the “sharing economy”, the new delivery model not only helps enterprises reduce their logistics costs, but also solves part of the last-mile delivery problems resulting from e-commerce promotion spike periods. Crowd-sourced delivery is particularly valuable for categories in which fast delivery is needed, such as fresh produce.



Last-mile delivery by SF Express. (Source: Fung Business Intelligence)

Exhibit 7: Last-mile delivery initiatives of selected companies

Retailers introduce “click & collect” services

In January 2017, Uniqlo rolled out “click & collect” service in China, enabling Chinese online customers to pick up their purchases at its physical stores. Customers could collect their online purchases at any of the 400+ Uniqlo stores in China; they could also choose to have their order delivered home.

* * * * *

Wal-Mart (China) provides self-pickup service at its Shenzhen branches. Customers can collect their online purchases at the physical stores. Customers can enjoy the convenience of online shopping as well as the quality sales service at the physical store when they pick up their merchandise.

Logistics players invest in smart lockers and pick-up stations

In 2015, several logistics companies including SF Express, STO Express, ZTO Express, Yunda, and Global Logistics Properties jointly established Shenzhen Hive Box Technology Co. Ltd., a company that provides self-pickup services at smart lockers located at different locations. The company planned to deploy over 10,000 service points in 33 cities by the end of 2015.

* * * * *

Cainiao has established a community-based pick-up network in collaboration with community stores, chain stores and colleges, etc. As of August 2016, it has over 40,000 pick-up stations across the country, including 2,000 campus pick-up stations across 1,500 colleges.

Retailers partner with convenience stores or community stores to provide pick-up services

Rainbow Department Store, a leading Shenzhen-based department store chain, opened its own convenience stores “O2O Store” in Shenzhen in 2014 to act as “last-mile” delivery points for its online consumers. Customers can also return their online purchases in the O2O Store.

Crowd-sourced delivery

In May 2015, JD.com rolled out its JD Crowdsourcing service in Shenzhen. JD.com’s O2O service platform, JD Daojia, is the first service that uses the JD Crowdsourcing service. JD Daojia users can buy products from partnering local supermarkets or ordering meals from partnering restaurants, and experience fast delivery services provided by JD.com’s part-time couriers.

Source: Various Internet sources; compiled by Fung Business Intelligence

5. Retailers and e-commerce players to “go rural”

To tap into the fast growing rural e-commerce market, a number of leading retailers and e-commerce players such as Suning, Alibaba, and JD.com have actively adopted “going rural” strategies (Exhibit 8).

Exhibit 8: Selected “Going rural” strategies of selected retailers and e-commerce players

Company	“Going rural” strategies
	<ul style="list-style-type: none"> • Suning Commerce Group opened 1,500 service centers and 10,000 franchise depots in lower-tier cities in 2015. The company planned to open another 1,500 service centers in 2016 and employ tens of thousands of staff in villages.
	<ul style="list-style-type: none"> • In October 2014, Alibaba announced a plan to invest 10 billion yuan to build 1,000 county-level service centers and 100,000 village-level service centers in China over the next three to five years. • The company has recruited and trained local partners to serve as Alibaba’s representatives and run its service centers in rural towns. These local partners will assist rural shoppers to place online orders, especially those without Internet access, provide product information, and promote popular products that are available on Taobao marketplace to rural residents. • As of September 2015, Alibaba had 128 county-level service centers and 5,600 village-level service centers across 23 provinces.
	<ul style="list-style-type: none"> • In August 2015, JD.com rolled out an online shopping mall for farm produce, offering agricultural produce and farming tools to millions of farmers across rural towns. • Apart from working with 3PL, JD.com operates its own network of regional warehouses and thousands of smaller local delivery stations across the country. In remote areas, JD.com has hired about 100,000 “brand promoters,” who work as a part-time courier at JD.com’s rural service centers to deliver goods to rural customers. • JD.com also tested out drone delivery as a possible means to reach out to outlying rural areas. According to JD.com, drones will be able to deliver to over 400,000 villages in the future. • It has set up rural e-commerce centers and service centers to provide e-commerce, logistics services and finance in over 1,500 counties and 420,000 villages across the country.

Source: Respective companies’ websites, Internet sources; compiled by Fung Business Intelligence

Meanwhile, some logistics players have stepped up efforts to build their rural infrastructure networks. For instance, Cainiao has created an information system that can share data and facilitate the flow of cold-chain products from rural producers to warehouses and pick-up locations in cities. It has created a logistics network that connects more than 2,800 counties and 14,000 villages across the country, allowing rural products to reach cities more easily.

6. Booming demand for cold chain logistics

Chinese consumers are more quality-driven and health-conscious nowadays, leading to an increasing demand for fresh produce and healthcare products. Temperature control is necessary in the handling of these products to retain their efficacy. This offers great development prospects for cold chain logistics. According to the China Federation of Logistics and Purchasing, the market size of cold chain logistics services in China is estimated to reach 470 billion yuan by 2017, up from the 150.9 billion yuan in 2015.

The growing demand for fresh produce and healthcare products has also provided ample development opportunities for LSPs. Increasing numbers of enterprises have set up healthcare and medical logistics infrastructure to provide temperature-controlled delivery services for the pharmaceutical industry. For instance, in March 2015, JD.com announced the launch of its new cold chain warehousing and distribution services with next-day delivery. JD.com's cold chain logistics provides entire cold chain services from warehousing, sorting, transport to distribution. It can maintain various temperature ranges, including room temperature for vegetable, 0 to 8 degrees Celsius chilling for fruit, and -12 to -18 degrees Celsius freezing for fish and meat. At present, cities in Central China, Southern China, Eastern China and Northern China can enjoy next-day delivery service.

7. Retail and E-commerce logistics witness robust investments and strategic collaborations; a burst of IPO listings among express delivery companies

China's retail and e-commerce logistics sector has witnessed robust capital investments in recent years. In particular, a number of privately owned logistics companies have received substantial capital investments from investors in 2015. For example, in May 2015, YTO Express won strategic investment from Alibaba and Yunfeng Capital, while SF Express received capital investment from CITIC Capital Holdings Ltd., Oriza Holdings, China Merchants, and Jade Capital Management Co. Ltd. In June 2015, global private equity firm Warburg Pincus, Hillhouse Capital Group, and Standard Chartered invested in ZTO Express.

At the same time, increasing numbers of retail and e-commerce and logistics players have formed strategic partnerships with others to enhance their offerings and strengthen their competitive edge. For instance, STO Express announced a strategic partnership with TTK Express in September 2015 to collaborate in areas such as last-mile delivery, information services, product development, with the aim to improve service standards.

Meanwhile, the government has been eager to encourage capital investment in the logistics sector. In October 2015, the State Council issued the *Opinions on Promoting the Development of Express Delivery Industry*. The Opinions specify the importance of encouraging capital investment in the express delivery sector through means such as mergers and acquisitions and public listing.

Recently, a number of key domestic express delivery players went public in China or overseas as a means of business expansion. Significant examples include IPO listings of YTO Express on the Shanghai Stock Exchange and ZTO Express on the New York Stock Exchange in October 2016. SF Express also listed on the Shenzhen Stock Exchange in February 2017.

8. Government policy in support of the development of the retail logistics industry

In recent years, various government departments have issued specific policies and regulations that support the development of the retail and e-commerce logistics industry. For example, in March 2016, six ministries including the Ministry of Commerce, the National Development and Reform Commission, the Ministry of Transport, the General Administration of Customs, the State Post Bureau, and the Standardization Administration jointly issued the *Special National Plan for the Development of E-commerce Logistics (2016–20)*. The plan laid out important development tasks that will support the development of e-commerce logistics.

In February 2017, the Ministry of Commerce and four other departments jointly issued the *13th Five-Year Plan for the Development of Trade Logistics*. The Plan ascertained nine major tasks for the development of the logistics sector, including constructing a multiple-layer logistics network, promoting the standardization of logistics, strengthening the information technology infrastructure of logistics, facilitating the transformation of logistics to become more sustainable, and establishing a credit system for the logistics industry. These government policies are set to provide a more regulated and transparent environment for the development of retail logistics.

3. Concluding remarks

The fast growing retail and e-commerce market has created huge development opportunities for the logistics sector. At the same time, the constantly evolving retail sector and rising demand for convenience by consumers are posing a lot of challenges for logistics players. E-commerce and O2O, in particular, require a whole new level of logistics support. For example, demand for fast delivery and pick-up convenience have resulted in new forms of value-added logistics service requirements. The increasing needs for reverse logistics in handling returned goods also pose challenges for the logistics industry. While companies strive to meet the demand of consumers, profitability and feasibility of the new service models remain to be tested.

To succeed in the increasingly sophisticated and rapidly changing retail and e-commerce sector, logistics players are advised to constantly enhance their logistics capabilities and expand their logistics infrastructure and facilities. They should speed up the construction of automated warehousing and logistics facilities, enhance logistics informatization, and fully utilize advanced technologies such as big data analytics and the Internet of Things (IoT). They should also build a nationwide logistics infrastructure network in order to meet the rising logistics demand from rural e-commerce and CBEC.

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