



THE GREAT LEAP FROG

The E-commerce Revolution in China



2011 was the year e-commerce came of age in China. Everyone now knows that e-commerce is important and will be a big issue as well as a big opportunity for retailers and consumer goods companies alike. However we believe the implications of this are underestimated and that opportunities are left on the table.

The online channel is not just a channel to sell to consumers; it is fundamentally changing how consumer businesses interact with consumers. Formation of brand preferences, purchase decisions and transactions are all (and in many cases have) shifting dramatically into online environments. This new online

"e-cosystem" has fundamental implications for the business model required by retailers and consumer goods players to win in China.

In our view, getting this right will be one of the biggest determinants of who the next winners (and losers) are in China.

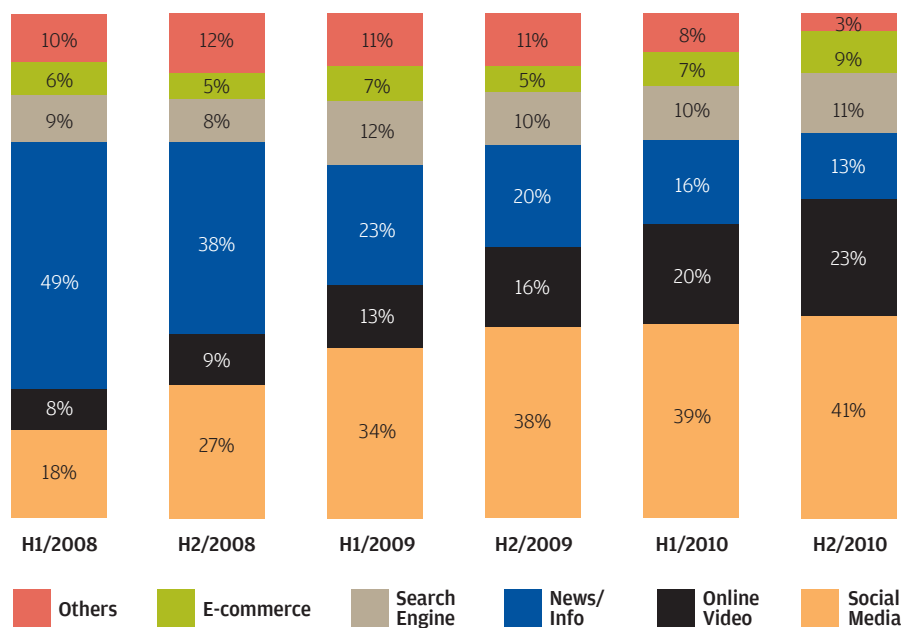
WHY WILL CHINA BE DIFFERENT?

With "online ready" consumers, lack of developed modern specialist retail and massive investment by e-commerce specialists, the development of e-commerce in China will be quicker, and more profound than in other markets.

Consumers' lives are already online

Consumers' lives are increasingly being conducted online - with the average internet user spending around 3 hours a day, or around half their leisure time online (one of the highest in the world). Social networking sites are now the most important communication tools between groups of friends and one of the most trusted sources of information.

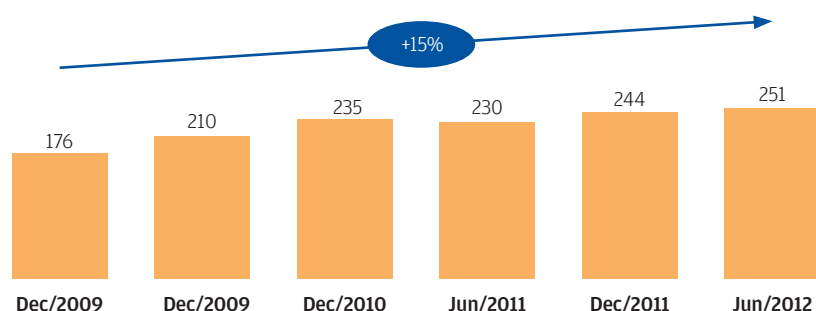
Exhibit 1: Percentage of time spent online by different type of sites, 2008 - 2010



Source: Data Center of China Internet

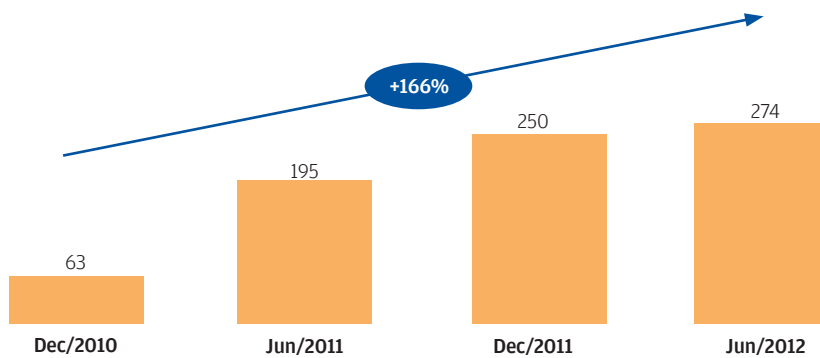
With increasing smartphone and tablet penetration, this online world is now being carried with them into shops, restaurants and bars. That is to say there is no longer a distinction in customers' minds between an offline and online world - they are truly multi-channel.

Exhibit 2: Number of Social Media users in China, Dec 2009 - Jun 2012 (mn)



Source: China Internet Network Information Center

Exhibit 3: Number of micro-blog users in China, Dec 2010 - Jun 2012 (mn)



Source: China Internet Network Information Center

By conducting their lives online, Chinese consumers are also shopping differently. Online information is now the prime source for researching products - with user generated content trusted more than official websites. Browsing online is a leisure activity with 60% of netizens (over 200m people) browsing online shops at least once a day, while on average purchasing an item every 1-2 weeks.

This shift in consumers' lives is now even creating "user generated" shops. Mogujie is an example of this type of social shopping site - with users posting products on the site (with click through to traditional e-commerce site) and ratings of products according to popularity. In this environment brand owners do not control their range or how products are displayed, while traditional "e-tailers" are downgraded to a mere transaction engine role.

Exhibit 4: Screenshots of Mogujie.com

Homepage

Display multiple channels
By category
By brand
By topic

Account tool bar connects to Weibo, QQ, Taobao and others

Allows use of smartphone

Shows price and links to the online store

Popularity rating and statistics

Creates online groups by interest for members to post photos and share ideas on fashion and beauty

Live comments

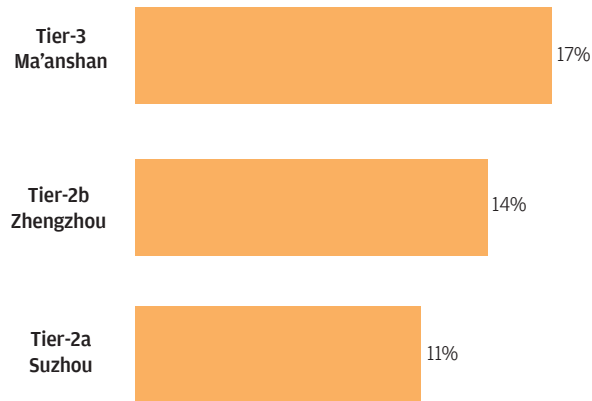
Source: desktop research

"Modern" specialist retail is not developed (and now may never develop) meaning e-commerce is becoming the default choice in many categories

Like many emerging markets, specialist retail is relatively under-developed in China. While top tier (Beijing, Shanghai, Shenzhen and Guangzhou) cities have about the same amount of retail space per head as global averages, outside these cities China only has about half of the global average. In particular, specialist retailers or category killers outside clothing and electrical are almost non-existent.

As a result, there is unsatisfied demand that only e-commerce is able to fulfill leading to e-commerce developing faster in lower tier cities in these categories. The important implication is that for many categories, online will develop as the default purchasing channel rather than traditional shops, and many forms of retail will simply not develop in China, with online remaining/becoming the dominant channel.

Exhibit 5: Favourite shopping location for women's apparel across city tiers (% rank online as top 1)



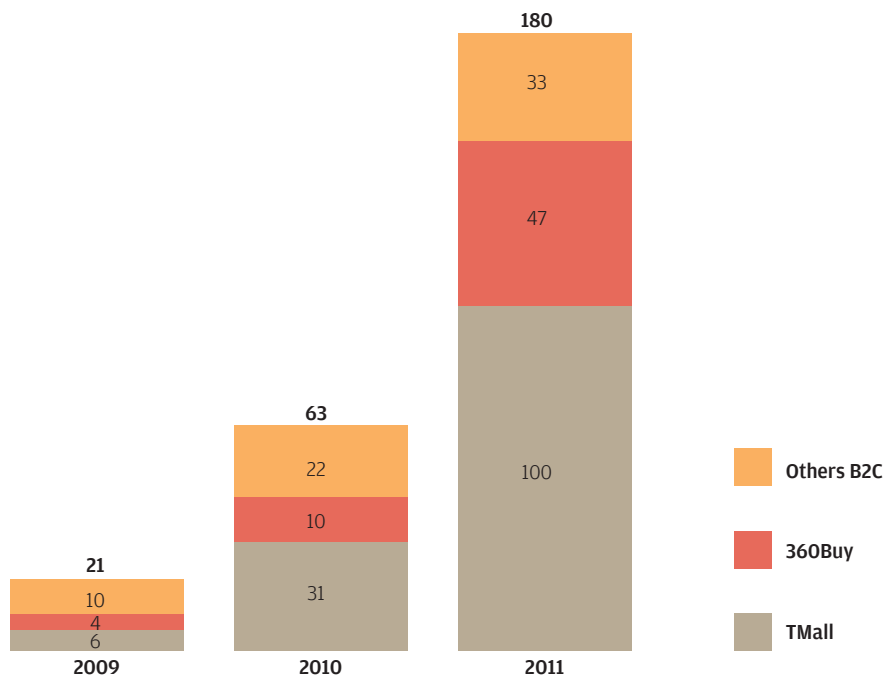
Source: OC&C consumer street intercept survey (Oct 2011)

Investment in online retail is huge

E-commerce in the developed markets has developed both with specialist players (led in particular by Amazon) and with multi-channel offerings. In China, the relatively under-development of retail means multi-channel offerings have typically been weaker.

By contrast, there is massive investment by online specialists trying to capture the enormous e-commerce prize. The market was first developed by TaoBao which remains the clear leader with its C2C offer, and the launch of T-Mall as a B2C e-commerce platform. However the huge new wave of growth is coming from the e-commerce specialists particularly 360Buy, Amazon, YiHaoDian, Vancl and DangDang.

Exhibit 6: B2C sales by leading providers (RMB bn)



Source: desktop research

SO WHAT DOES IT MEAN?

The rapid development of e-commerce that we have described above will create new and profound challenges for both retailers and consumer goods companies. For both e-commerce is a major opportunity to capture new spend and increase their reach. However to do this successfully they will need to fundamentally change their business models in China.

FOR RETAILERS

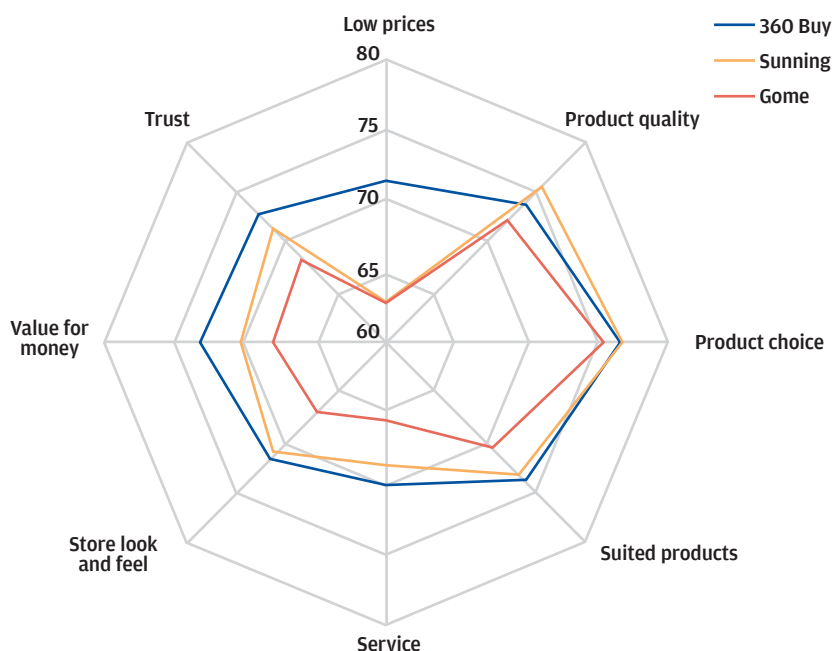
Re-think the role of the store

As e-commerce becomes a major, if not the main channel in many categories, retailers need to think about what role the store will play, and as a result how many stores (and of what size) they need.

Electrical retail provides a particularly interesting case, where a rapid shift to e-commerce is diminishing the need for shops at all. In this category consumers are showing a strong preference to

the e-commerce retailers, as a result traditional retail chains that do not adapt their proposition will simply not survive.

Exhibit 7: Overview of proposition scoring - Electricals retail (% of max possible score)



Source: OC&C proposition index survey 2011

Follow the customer

Most categories will be shopped in a multi-channel way. Even where transactions remain store based, decision making will often be online (and vice versa). As such retailers need to be able to interact with customers in the way that best suits the customer, allowing them to migrate (for example) from browsing the shop for inspiration, using a smartphone to check friends' opinions through social media, purchasing through T-mall and having product delivered to their place of work.

Simply being able to do transactions online is not an adequate response. Retailers need to develop a true multi-channel strategy interacting with customers much earlier in the decision making process, and then allowing customers to seamlessly switch between channels. This change in mindset needs to encompass marketing, commercial and operational teams to work closely together.

Delivery becomes a must

Delivery is more economical in China, as labour costs, while increasing, are still relatively low compared to the West. In our experience the cost of a delivery is about one fifth to one quarter that of a developed country, as a result we expect many retailers to embrace delivery as a core part of their proposition. As a result free delivery, or lower free delivery thresholds will be more common, as will "value added" delivery including services such as tailoring or installation.

To T-mall or not to T-mall

To many retailers, looking at the challenges of e-commerce T-Mall is an attractive and relatively simple answer. Certainly a presence on T-Mall is a good step in the multi-channel direction. However it is likely to be insufficient. T-Mall is like a very

large shopping mall with 1000s of brands, and just being present (like just opening a shop) does not guarantee customers will notice, let alone buy from you. T-Mall is a useful channel but on its own it's unlikely to be enough.

Exhibit 8: Fashion and beauty brand displays in the online department store - T-mall

1/F: Clothes, underwear, accessories

The sub-category of female clothes alone has more than 200 brands

3/F: Jewelry & watches

2/F: Shoes & bags

4/F: Beauty products

Categories shown are only 1/3 of all in the 12-storey "department store"

Source: T-mall website

Challenge the business model

In our view, winners in this new e-ecosystem are the ones that understand how they add value, and align the business system behind this. As an example in electrical retail, we believe the main purpose of stores will be to showcase products and provide service. However, most transactions are likely to be done online. Shops are still part of the decision making process, but will not capture the transaction. This is likely to lead to a model where suppliers will fund shops directly, effectively as part of their marketing, in order to influence customers' choices in

other channels.

In this scenario the winning retailers are the ones who recognize the changes quickly and align to serve the suppliers marketing needs.

At OC&C, we believe that radical responses are likely to be required, to match the radical shift that is occurring in consumer behavior - retailers that are not clear how they add value in the new e-ecosystem will not survive.

FOR CONSUMER GOODS COMPANIES

Drive the new route to market

At a simple level, consumer goods companies now have a new route to market - however this route to market has quite different characteristics compared to the standard retail channel.

E-commerce players, while now substantial, are still in their infancy and are unsophisticated retailers. As they double volumes every year, these players need to rely more on suppliers to understand how any particular category is being

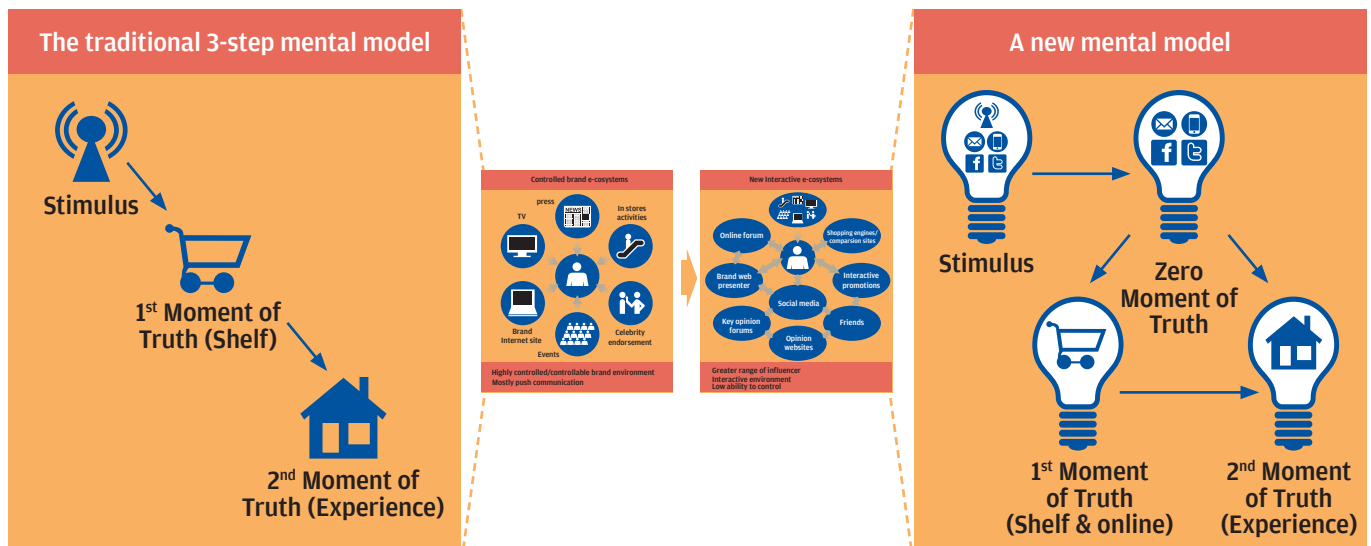
merchandised. This presents consumer goods players with a significant short term opportunity to shape their categories in partnership with major e-commerce players.

Embrace the new e-cosystem

FMCG companies have never had a better opportunity to talk to consumers directly, however it is a crowded space and with many competitors trying to shout loudly. The key is to understand where

your consumers are online and what is influencing them - where do they interact, what information do they trust, how are their preferences formed?

Exhibit 9: Comparison of traditional vs. new mental model



Source: OC&C analysis

Implementing this requires major organisational challenges - marketing is no longer the preserve of the marketing department but an activity that needs

to be undertaken by many departments and co-ordinated by marketing. The skills required are not those of the crusty old marketer working with an advertising

agency but those of the new tech savvy generation.

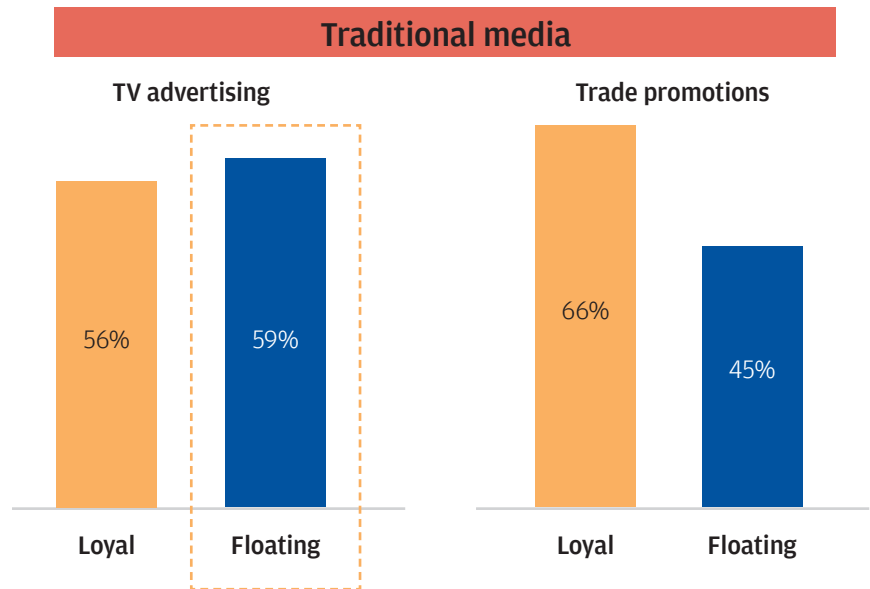
Hire different types of people

China is a crowded marketplace for all consumer products. Standing out in the growing online channel is very difficult in this marketplace. Just getting online distribution is not adequate - even more so marketing and sales need to work closely in the new e-cosystem.

This has significant organisational implications for FMCG companies - with social media and e-commerce so closely inter-twinned, so marketing and sales online need to be regarded as part of the same activity. This presents a major organisational and people challenge to most consumer goods companies. Sales and marketing can't be discreet silos.

Exhibit 10: Percentage of favourable* responses - traditional media

*Favourable defined as those who selected top two boxes "like very much" and "like a bit" options in survey



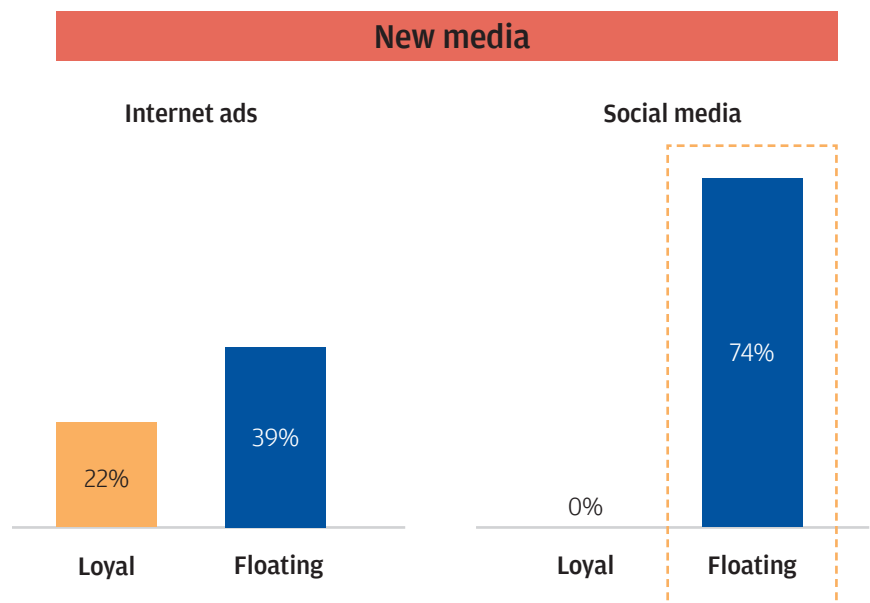
Source: OC&C beer online survey 2011

Develop China specific capabilities

China is different. As we argued above Chinese consumers live their lives online, and they do so on Chinese platforms. While there are many similarities between Twitter and WeiBo consumer goods companies can't cut and paste their US Twitter operations into China. In our experience, companies that have adjusted well to the shift to online are the ones that have done this in a China specific way, rather than trying to apply a global framework to a market that is different.

Exhibit 11: Percentage of favourable* responses - new media

*Favourable defined as those who selected top two boxes "like very much" and "like a bit" options in survey



Source: OC&C beer online survey 2011

CONCLUSIONS

The rise of the online channel in China is dramatically changing the retail landscape, and will ensure that retail will take a different path from the one it has in developed countries where specialist retailers have large legacy store portfolios. In many ways we see Chinese consumer space as becoming more multi-channel and in many ways more advanced than in developed markets - as such to be a winner in China you cannot simply copy what is developing elsewhere.

Retailers need to revolutionise their business models and re-think how to serve customers who are now shopping very differently to only a few years ago. Consumer goods companies not only face a new route to market but also the opportunity for a new and much closer relationship with the end consumer. The winners in the consumer space in China will be those who grasp this change wholeheartedly.

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