Distribution in China
The rise of O2O and its implications

November 2014
Introduction
On China’s Singles’ Day, a festival celebrating being singles in China which has later turned into the biggest shopping day in the world, a couple of weeks ago, Alibaba hit another sales record. A total of 57.1 billion yuan or US$ 9.3 billion of sales were realised, up by 57.7% year-on-year (yoy) from almost 280 million online orders. E-commerce is likely to be the next engine of consumption growth in China. In fact, the Chinese government has officially identified e-commerce as one of the six major areas to boost domestic consumption in a recent State Council meeting. Series of policies and measures supporting the development of e-commerce are expected to be launched in the coming future.

Realising the huge potential of e-commerce, increasing numbers of traditional bricks-and-mortar retailers in China have embarked their own mobile and social media strategies to lure more customers. However, most of them have yet to borne fruits. Meanwhile, capitalising on the success of the online market, pure-click companies are evolving from selling only online to building a physical presence.

Moreover, both bricks-and-mortar retailers and pure-click companies have started implementing “O2O” or “online and offline integration” (also known as omni-channel strategies), aiming at providing consumers with seamless experience across multiple marketing and sales channels.

To shed light on the latest developments of online operations and O2O initiatives, and the implications for distributors in China, the Fung Business Intelligence Centre, together with the China Chain Store and Franchise Association (CCFA), conducted a survey among traditional bricks-and-mortar retailers in China earlier this year. Apart from the survey, face-to-face interviews with retailers were conducted as well.

In this report, we first provide the background to the booming e-commerce and the rise of O2O in China, followed by a summary of the survey results. Then, we discuss how players along the supply chain react respectively. We also address the implications for distributors hoping to survive and thrive amid the O2O era.

Note: This English publication only summarises the key takeaways of the Chinese report. For more details of the Chinese report, please kindly visit http://www.ccfa.org.cn/portal/cn/view.jsp?lt=33&id=416944.
China's online retail market has registered stunning growth over recent years, and became the world's largest market in 2013. According to iResearch, the transaction value of China's online market increased by 59.4% yoy to reach 1.89 trillion yuan in 2013, accounting for 8.0% of the country's total retail sales. Total online sales are expected to reach 5.63 trillion yuan by 2017, accounting for 15.7% of the total retail sales (see Exhibit 1).

By contrast, proportion of sales of China's top 100 retail chain operators (the Top 100s) to total retail sales in China dropped from its all time high of 11.2% in 2007 to 8.6% in 2013. The significant slowing of Top 100 sales was due to the combined impact of changing consumer behaviour and intensified competition from...
What are the driving forces behind the e-commerce boom? An expanding Internet population is a major driving force for the robust growth of e-commerce. In fact, China has the world’s largest online population. The China Internet Network Information Center (CNNIC) reveals that China’s Internet population amounted to 632 million in 1H14, with a penetration rate of 46.9%, while the number of China’s online shoppers reached 332 million in 1H14 (see Exhibit 2).
E-commerce going mobile

The rising popularity of mobile devices across China over recent years has also driven the growth of e-commerce and it has dramatically altered the way people shop. As consumers are accustomed to buying online via their mobile devices, mobile commerce (m-commerce) is becoming a major part of the e-commerce purchase cycle. The CNNIC revealed that the number of m-commerce users amounted to 205 million in 1H14, up by 42% from 4Q13, accounting for 32% of China’s total Internet population (see Exhibit 3). The popularity of m-commerce is set to grow further – iResearch estimates the total transaction value of mobile shopping to exceed 3,207 billion yuan by 2017, up from 274 billion yuan in 2013.

As consumers are becoming accustomed to buying online via their mobile devices, retailers are putting more efforts into expanding their mobile services. Many have launched mobile apps to reach out to customers. At the same time, retailers have also leveraged the huge user databases of popular social media platforms such as Tencent’s WeChat and Weibo to promote their products and services.

Increasing numbers of Internet companies have launched mobile payment services over recent years; this has made the m-commerce process easier. For instance, Tencent has rolled out Tenpay, a mobile payment service offered through WeChat; banks accounts can be bundled on a WeChat account, facilitating WeChat users to pay on the go. Alipay, the mobile payment arm of Alibaba has also introduced Alipay Wallet mobile app that not only facilitates online payments, but also supports offline transaction at points of sales using barcodes or QR codes.
O2O: a focus area for retailers

Consumers are now more discerning and highly connected, and they increasingly seek “shopping convenience” where they can shop anytime, anywhere and in any way, via a variety of channels. They also expect multiple methods of payment and various pickup and return options. There is growing demand for an integrated shopping experience across multiple channels.

In recent times, an increasingly number of retailers are exploring O2O. By embracing different types of new technologies and investing in multi-channel capabilities, retailers hope to deliver an impactful and seamless customer experience. Some of the most common ways retailers in China are experimenting their O2O initiatives include:

- Launching mobile apps and offering location-based marketing
- Offering mobile payment services in-store
- Using QR codes to bridge online and offline channels
- Creating a shared customer database and loyalty programme
- Supporting “click and collect”; customers can buy online and pick up the online orders in a physical store
- Integrating back-end operations and systems such as inventory, warehouses and logistics management systems
- Unifying online and offline pricing
The Fung Business Intelligence Centre, together with the China Chain Store and Franchise Association, conducted a survey among traditional bricks-and-mortar retailers in China earlier this year. A total of 56 valid samples were collected. About 61% of the surveyed traditional retailers have opened online shops as of end 2013. Major survey findings are summarized as follows:
Online product offerings are not rich enough

As shown in exhibit 4, among the surveyed enterprises who have started online retailing, 66% of them sold grocery products and 53% offered non-grocery products (excluding communication, consumer electronics and computer products). In terms of number of stock keeping units (SKUs), over 50% of the online shops offered less than 3,000 SKUs, presenting a relatively limited range of products (see exhibit 5).

**Exhibit 4**  Product category offered by the online store

- **Grocery products**: 66%
- **Non-grocery products**: 53%
- **Fresh food**: 41%
- **Communication, consumer electronics and computer products**: 34%
- **Other products**: 19%

**Exhibit 5**  Number of SKUs offered by the online store

- <1,000: 22%
- 1,000-3,000: 31%
- 3,000-5,000: 19%
- 5,000-10,000: 3%
- 10,000-50,000: 19%
- >50,000: 6%

Source: China Chain Store and Franchise Association (CCFA) & Fung Business Intelligence Centre (FBIC)
Sales volumes of the online stores are not impressive

**Exhibit 6**  Online sales volume in 2013

About 40% of the retailers recorded online sales of below 5 million yuan in 2013. Only about 12% of the retailers could sell over 100 million yuan in 2013. And almost 70% reported that the average number of orders per day is below 500. In terms of proportion of online retailing to total sales, over 80% of the surveyed enterprises said the figure was below 5%. Exhibits 6-8 show more details.

**Exhibit 7**  Average number of online orders per day

**Exhibit 8**  Online sales as a proportion to total retail sales

Source: China Chain Store and Franchise Association (CCFA) & Fung Business Intelligence Centre (FBIC)
Modest investment generates unimpressive return

Almost half of the retailers invested less than 5 million yuan in their online operation and over 60% of the retailers hired less than 30 staff to run their online operation. The relatively modest investment led to unimpressive sales performance – 63% of the retailers reviewed that the performance of online stores were just fair, with modest contribution to the total sales of the enterprises. Please see exhibits 9-11 for more details.

Source: China Chain Store and Franchise Association (CCFA) & Fung Business Intelligence Centre (FBIC)
Talents shortage is the major challenge for developing e-commerce

When asked about major challenges facing the traditional retailers for developing e-commerce, 78% stated lack of talents. Logistics facilities not supporting e-commerce (38%) and weakness in developing clear e-commerce strategies (38%) were also commonly cited (see exhibit 12).

Exhibit 12  Challenges for developing e-commerce

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of talents</td>
<td>78%</td>
</tr>
<tr>
<td>Logistics facilities does not support e-commerce business</td>
<td>38%</td>
</tr>
<tr>
<td>Weakness in developing clear e-commerce strategies</td>
<td>38%</td>
</tr>
<tr>
<td>Huge capital outlay is required</td>
<td>36%</td>
</tr>
<tr>
<td>Existing supply chain does not support e-commerce business</td>
<td>33%</td>
</tr>
<tr>
<td>Online and offline pricing strategies</td>
<td>29%</td>
</tr>
<tr>
<td>Lack of mechanism to support development of e-commerce</td>
<td>25%</td>
</tr>
<tr>
<td>MISC Others</td>
<td>4%</td>
</tr>
</tbody>
</table>

A growing number of traditional retailers are engaging in O2O initiatives

43% of the surveyed traditional retailers have launched different types of O2O initiatives. The remainder stated that they are willing to give it a try in future. 65% of these retailers launched O2O initiatives on their own. Other enterprises sought help from outside parties – 17% of them partnered with Tencent while 13% worked with Alibaba (see exhibit 13).

Exhibit 13  Partnership with outside parties

<table>
<thead>
<tr>
<th>Partnership</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Team up with Tencent</td>
<td>17%</td>
</tr>
<tr>
<td>Team up with Alibaba</td>
<td>13%</td>
</tr>
<tr>
<td>Team up with JD.com</td>
<td>8%</td>
</tr>
<tr>
<td>Team up with Yihaodian</td>
<td>8%</td>
</tr>
<tr>
<td>Others</td>
<td>8%</td>
</tr>
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</table>

65% Launched O2O initiatives on their own

Source: China Chain Store and Franchise Association (CCFA) & Fung Business Intelligence Centre (FBIC)
How do players along supply chains respond to the rise of O2O?

Manufacturers extend to distribution and retail businesses

The stunning growth of e-commerce in China offers manufacturers an additional distribution channel. In the past, they used to sell only to distributors or retailers. But now, they can sell their products directly to consumers via either B2B platforms like 1688.com or B2C platforms like Tmall, or build their own online store. Manufacturers now adopt a new model – branching out from manufacturing into distribution and retailing.

Traditional retailers develop new business models

- embracing O2O initiatives as well as developing merchandise direct sales

It is inevitable that e-commerce will pose a threat to bricks-and-mortar retailers. Indeed, some traditional retailers, especially the department stores and some specialist retailers such as the consumer electronics specialist retailers, have seen significant slowdown in sales growth over recent years as a result of the combined impact of intensified competition from online retailers and changing consumer behaviour. Realising the increasing importance of online retailing, many traditional retailers have already launched their O2O initiatives. Setting up online stores, launching mobile apps, engaging in social media and launching mobile payment choices are the mostly observed.

Meanwhile, some department store operators have recognised the drawbacks of the prevailing concessionary model – low profit margins, poor differentiation of brands and products and low customer loyalty, and tried to develop a more sustainable one by engaging in merchandise direct sales. They source products directly from suppliers and generate profits from merchandise mark ups rather than commissions.
Product distribution in China

In general, goods have to pass through multiple tiers of distributors before reaching the hands of consumers in China. There are different parties involved in these supply chains, being agents, distributors, wholesalers and sub-distributors. Given the complexity of the China market, companies distribute via several different models depending on their needs. The majority adopt a combination of distribution models. More information on distribution sector in China can be found at http://www.funggroup.com/eng/knowledge/research/china_dis_issue112.pdf.

Logistics service providers also tap into distribution and retail businesses

Logistics service providers have also started venturing into the retail sector. For instance, SF Express, one of the largest courier service providers in China, launched its online store, SF Best, in 2012. The online store sells mainly fresh farm produce and other edible products. SF Express has also engaged in O2O initiatives recently. Orders placed on SF Best can be delivered to consumers’ preferred address, or collected at SF Express service centers as well as SF Express community service stores, Heike. Besides picking up online orders from SF Best, customers can also place online orders with the smart devices available in the Heike stores. Moreover, customers can also enjoy a wide range of services, such as ATM service, mobile phone credit top up service and bill payment service, at Heike stores.

Distributors also develop new business models

- supplying to online channels and engaging in retail business

The box above shows how products are distributed from manufacturers to the hands of consumers in China. Amid the O2O era, upstream, manufacturers sell via online platforms. Downstream, retailers operate online stores and develop merchandise direct sales. Distributors need to adapt to the changing environment and provide new service offerings. For instance, some distributors supply products to online stores now. Some even start opening online stores for their clients (i.e. brand owners) as well.
The rise of the Internet is an irreversible trend and it brings about revolutionary changes to the distribution and retail sector. Everything is now just “a few taps away”. Manufacturers, retailers, logistics service providers are all moving with the times and adopting new business models. Distributors are no exception and should keep the followings in mind.
Maximising client satisfaction by adopting more diversified distribution models

Consumer buying habits and preferences are changing across all channels. To respond, retailers have started providing new facilities and service offerings as well as launching O2O initiatives. For example, some retailers have set up pick up points in the retail shops in affiliated convenience stores for online order pick up; such new service offerings require adjustments for the back end operation such as warehouse management and logistics arrangements. Even manufacturers have begun to sell to retailers or consumers directly. Distributors should adapt to the dynamic market and review their service offerings to their clients. For instance, supplying products to online stores efficiently is obviously a new type of service distributors should provide.

Achieving competitive edge by capitalising on advanced technologies

Technology is such a powerful enabler that it in fact changes the way people shop. Advanced technologies allow enterprises to open online stores, engage in social media and launch mobile apps. Besides, IT technologies also act as a powerful tool for data analytics to track consumer behaviour and preferences. With the big data, distributors can enhance customer service, improve product design and innovation, target customer segments more effectively as well as better engage with customers. For instance, distributors can recommend products to the customers precisely when they go online. This not only brings in more sales, but also strengthens customer loyalty. Distributors should recognise the critical role of big data and equip themselves with the appropriate hardware, including a bespoke IT system, and a competent IT team to meet the new service requirements.

Monitoring consumer behaviour and preferences by embracing smart devices and mobile platforms

Thanks again to the technological advancement, smart devices are becoming mainstream. The mobile platform is now a highly popular sales and marketing channel. Many consumers shop and settle payment via smart devices such as smartphones. Moreover, as Chinese consumers engage actively in social media, it now plays a larger role in supporting consumer purchase decisions. Indeed, many Chinese shoppers like to visit online blogs, forums, review websites and social networks for reviews and comments before making purchases. In light of this, distributors should, together with brand owners, develop mobile strategies, such as developing mobile apps, for marketing and sales purposes.

Boosting further growth by establishing self-operated online platforms

Instead of merely adapting to changes and new requirements by existing clients, distributors should consider building their own online distribution platform. With their own online distribution platform, distributors will be able to open online stores for their existing clients. Meanwhile, distributors could lure new clients to open online stores at the same platform as well. Yet, setting up a self-operated online platform is no easy task as it requires huge capital outlay and professional knowledge. Distributors should consider forming alliances with players along supply chains, including manufacturers, retailers, logistics service providers, online payment solution providers and IT consultants, to build an online distribution platform.
About the Organizations

The China Chain Store and Franchise Association

Founded in 1997, the China Chain Store & Franchise Association (CCFA) is an official representative of the retailing and franchise industry in China. Currently, there are 1,000 enterprise members with 200,000 outlets, including domestic and overseas retailers, franchisers, suppliers, and relevant organizations. The total sales of China’s “Top 100 retail chain operators”, which are part of the members of the CCFA, amounted to about 2.03 trillion yuan in 2013.

CCFA participates in policy making and coordination, safeguards the interests of industry and members, provides a series of professional training and industry information and data for its members and establishes platforms for exchange and cooperation.

The Fung Group

The Fung Group is a privately held multinational group of companies headquartered in Hong Kong whose core businesses are trading, logistics, distribution and retailing. The Fung Group employs over 45,000 people across 40 economies worldwide, generating total revenue of more than US$22.6 billion in 2013. Fung Holdings (1937) Limited, a privately held business entity headquartered in Hong Kong, is the major shareholder of the Fung group of companies.

The Fung Business Intelligence Centre

The Fung Business Intelligence Centre, through its unique relationships, collects and analyses market data on China’s economy, with special reference to sourcing, supply chains, distribution and retail. It also produces reports on sourcing and trading in other Asian countries and has recently expanded its research services on the global retail industry, where unprecedented change is being driven by technological innovation, the advent of multi-sales channels and greater supply chain efficiency.

Serving as a knowledge bank for the Fung Group, the Centre also makes its market data and analysis available to businesses, scholars and governments around the world. It is an impartial thought leader on issues shaping the future of manufacturing, distribution, logistics and retailing in China, and retailing globally. It regularly provides advice and consultancy services to internal and external clients.

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