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## Online retailing in China

### Market overview

- Online retailing witnessed explosive growth over the past few years, but still remains in its infancy. Online retailing sales value accounted for only 1.18% of the total retail sales of consumer goods in 2008.
- Young and tech-savvy generation embraces online shopping.
- Online retailing is most popular in first-tier cities such as Shanghai, Beijing and Guangzhou.
- C2C transactions dominate China's online retailing scene, accounting for over 90% of total transaction share in 2008.

### Competitive landscape

- C2C transactions dominate China's online retailing market. Market concentration of China's C2C online retailing market is high with Taobao capturing 82% of market share in 2008. Paipai (拍拍網) and EachNet (易趣網) were the distant second and third.
- China's B2C online retailing scene is more fragmented. The top ten players have achieved over 80% of the total market share. Prominent players include Taobao Mall, 360 Buy (京東商城) and Joyo Amazon (卓越亞馬遜). Although accounting for a small share in overall online retailing scene, the B2C market has received significant attention in the past years.

### Development trends

- The "click-and-mortar" model is increasingly popular in China.
- Brand players, manufacturers and suppliers use online platform to expand domestic sales.
- Vertical B2C portals, which are more specialized to target specific market segments, have emerged.
- The increasing popularity of the third party payment systems in recent years has greatly facilitated online transaction in China.
- Online retailers partnered with third-party logistics providers to enhance delivery efficiency.
- Investors are riding the Internet boom in China.
- Improving regulatory environment: the *Specification for E-Business Model* and *Service Specification for Online Shopping Transactions* will be effective in December 2009.
- Loss of tax revenue is a growing concern.

## Online retailing in China

Online retailing has been one of the major bright spots in China's commercial developments in recent years. Cost savings, shopping convenience and wide range of product offerings have attracted many regular offline shoppers in China to try shopping online, particularly among the young consumers.

Online retailing is bringing huge opportunities and challenges to commercial businesses in China. A growing number of commercial businesses in China now leverage on the Internet platform as a doorway to reach new customers, lower costs and diversify their marketing channels.

In this report, we will give you a general overview of online retailing<sup>1</sup> in China, the competitive landscape and the latest development trends.

### **I. China's online retailing market**

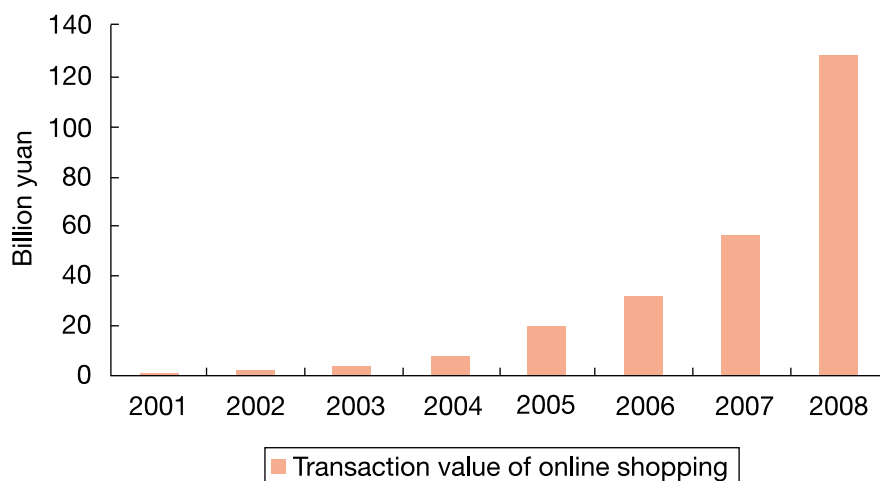
#### **1. Explosive growth over the past few years, but online retailing remains in its infancy**

According to the China Internet Network Information Center (CNNIC), China has the world's largest Internet population today. China's Internet population reached 298 million at the end of 2008, up by 41.9% year-on-year (yoy). Internet penetration in China was 22.6% at the end of 2008, slightly above the global average (21.9%); but the level is still lagging far behind many developed countries such as Japan (73.3%) and the United States (72.5%).

The Internet population has been growing at an astonishing pace in China by a CAGR of 38.12% between 2000 and 2008. Rapid growth of the Internet population is boosting the developments of online retailing in China. According to iResearch, there were 120 million registered online shoppers in China in 2008, showing a staggering growth of 185% yoy. 80 million users were active users who has purchased online at least once in 2008, up by 45.5% compared to 2007. According to iResearch, the transaction value of online shopping reached 128.1 billion yuan in 2008, up by 128.5% yoy (see Exhibit 1). Nevertheless, online retailing is still nascent in China. Online retailing sales value accounted for only 1.18% of the total retail sales of consumer goods in 2008.

<sup>1</sup> We will include transaction activities on Business-to-Customer (B2C) and Customer-to-Customer (C2C) portals; online air ticket purchase, hotel accommodation bookings, and bill payment services are excluded.

**Exhibit 1: Transaction value of online shopping, 2001 - 2008**



Source: iResearch Inc.

The recent economic slowdown has apparently not dampened the sales of online retailing. On the contrary, a growing number of belt-tightened consumers are now trying to seek for bargains online. The average annual online spending per person in 2008 was 1,600 yuan, up from 1,080 yuan in 2007. Wide range of product offerings in B2C and C2C marketplaces are also attractive to many e-shoppers, especially the white collars and youngsters. Apparel, books, cosmetics and consumer electronics were the most popular items purchased online in 2008.

## 2. Young and tech-savvy generation embracing online shopping

Among the online shoppers, youngsters aged between 18 and 30 are the major consumer group, accounting for above 60% of the total (see Exhibit 2). Youngsters tend to be more tech-savvy than their parents and more willing to embrace online shopping.

**Exhibit 2: Age distribution of China's online shoppers, June 2008**

City	Under 18	18-24	25-30	31-35	36-40	Above 40	Total
Beijing	3.4%	31.4%	34.0%	13.0%	9.6%	8.6%	100.0%
Shanghai	2.8%	35.0%	29.5%	13.7%	9.8%	9.1%	100.0%
Guangzhou	3.9%	35.7%	30.4%	17.1%	8.1%	4.7%	100.0%
Other cities	3.4%	41.4%	29.5%	12.9%	7.2%	5.5%	100.0%

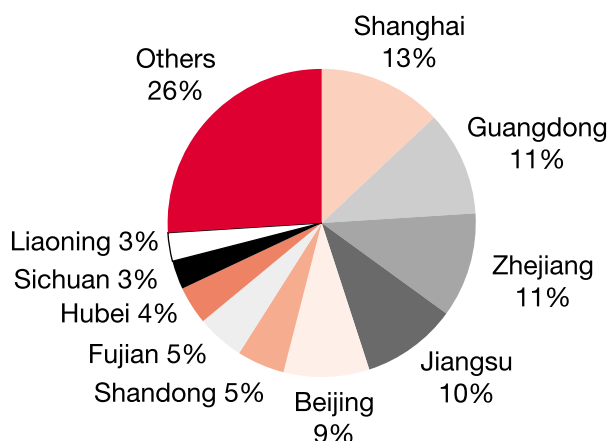
Source: China Internet Network Information Center (CNNIC)

### 3. Online retailing most popular in first-tier cities

Online retailing is most popular in cities such as Shanghai, Beijing and Guangzhou. Statistics from CNNIC as of June 2008 demonstrated that online shopping penetration in Shanghai reached 45.2%, followed by Beijing (38.9%) and Guangzhou (31.9%); the average of other key cities<sup>2</sup> is 21.6%.

With a share of 13%, Shanghai topped in transaction value in online shopping in 2008, followed by Guangdong (11%), Zhejiang (11%), Jiangsu (10%) and Beijing (9%), according to iResearch (see Exhibit 3). With the improvements of the logistics infrastructure and network connection, industry experts believes that strong growth of online retailing will extend to other regions in China.

**Exhibit 3: Transaction value of online shopping by province, 2008**



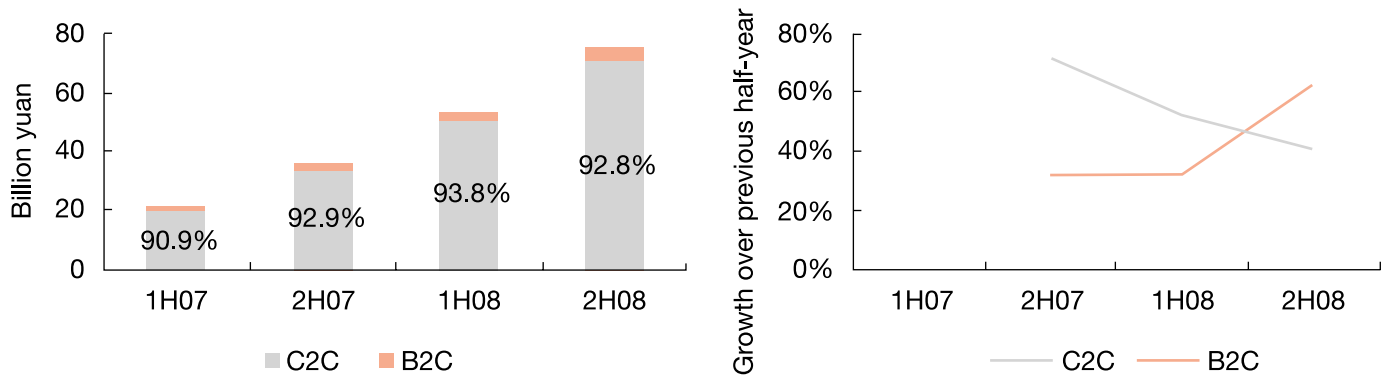
Source: iResearch Inc.

### 4. C2C transactions dominate China's online retailing scene

According to iResearch, C2C and B2C online retailing transaction value reached 131.2 billion yuan and 8.62 billion yuan in 2008 respectively. C2C transaction has accounted for over 90% of total transaction share (see Exhibit 4).

<sup>2</sup> Other key cities included Tianjin, Chongqing, Dalian, Changchun, Harbin, Shenyang, Hangzhou, Jinan, Nanjing, Ningbo, Qingdao, Xiamen, Wuhan, Shenzhen, Chengdu and Xian

**Exhibit 4: Transaction value and growth of B2C and C2C markets, 2007 - 2008**



Source: iResearch Inc.

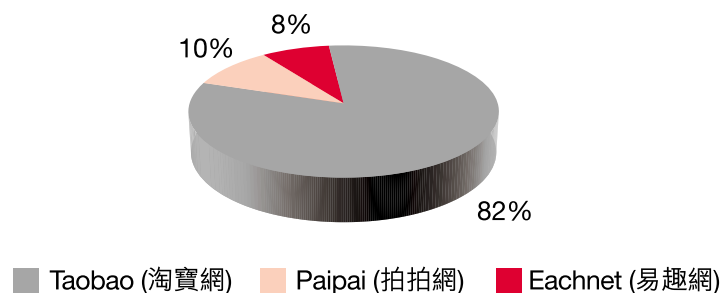
Although accounting for less than 10% of total transaction share, it is believed the B2C transaction will demonstrate better growth potential in the future as more and more players paying efforts to develop the B2C market. Besides, players in the B2C market tend to be more credible than individual sellers in the C2C market, giving B2C players a distinct edge.

## II. Competitive landscape

### The C2C market

As mentioned, C2C transactions dominate China's online retailing market. Exhibit 5 demonstrates the market share of different C2C players. Market concentration of China's online retailing market is high with Taobao (淘寶網), the wholly-owned subsidiary of Alibaba Group, capturing 82% of market share in 2008. Paipai (10%) and EachNet (8%) were the distant second and third.

**Exhibit 5: C2C market in China, 2008 (merchandise transaction value: 131.2 billion yuan)**



Source: iResearch Inc.

## Exhibit 6: Brief information of major C2C players in China

C2C players	Website	Ownership	Payment system	Main source of revenue	Service charge to sellers and buyers
Taobao	www.taobao.com	Alibaba Group	AliPay ( 支付宝 )	Advertising	Nil
PaiPai	www.paipai.com	Tencent	Tenpay ( 财富通 )	Advertising	Nil
EachNet	www.eachnet.com	eBay and Tom online	Anfutong ( 安付通 )	Advertising	Nil

Source: Respective company websites, Li & Fung Research Centre

The tremendous success of Taobao can be attributable to its deep understanding of the Chinese market. Penetrating into China in 2002, eBay was once the market leader in C2C online retailing with market share over 80%. The company used to charge commission from sellers on its platform, using the same model as in the United States. However, by pursuing a free-services-charge strategy and promoting itself as homegrown Chinese brand, Taobao has quickly eaten the market share of eBay over the past 5 years. eBay later partnered with Tom Online to launch EachNet, and shut down its main China website(ebay.com.cn) in 2006.

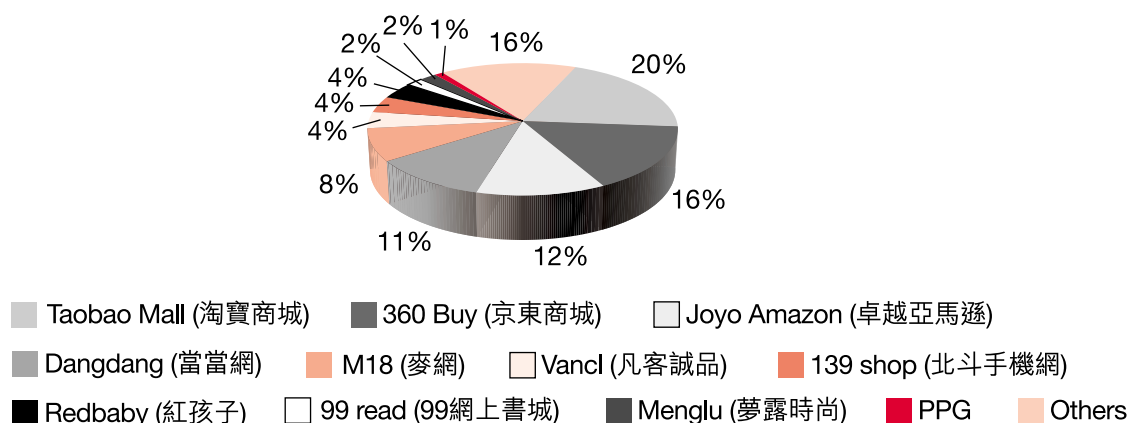
Capturing a lion's share of the C2C market, the leading position of Taobao is however not without its challenges. Paipai and EachNet are not to be ignored. Although Paipai accounts for only 10% of market share, it has been gathering strengths by leveraging on the instant messaging service QQ ( 騰訊 QQ ) which is under the same parent company Tencent. Learning from its early failures in China, eBay, joining hands with local partner Tom online, has also reviewed its strategy and exempted any service charges to attract users. On the other hand, eyeing huge market opportunities, some new rivals are joining the battlefield, for instance, China's largest search engine company Baidu has also rolled out a C2C platform Youa.com ( 百度有啊 ) in October 2008.

### The B2C market

Although accounting for a small share in overall online retailing scene, the B2C market has received significant attention in the past years.

China's B2C online retailing scene is more fragmented. The top ten players have achieved over 80% of the total market share. Prominent players include Taobao Mall, 360 Buy and Joyo. Taobao Mall was launched in early 2008.

**Exhibit 7: B2C market in China, 2008 (merchandise transaction value: 8.62 billion yuan)**



Source: iResearch Inc.

**Exhibit 8: Brief information of major B2C players in China**

B2C players	Website	Major product categories
Taobao Mall	<a href="http://mall.taobao.com/">http://mall.taobao.com/</a>	Diversified product offerings including apparel, health and beauty products, etc
360 Buy	<a href="http://www.360buy.com/">http://www.360buy.com/</a>	Mainly on electronics, home appliances, computers and accessories
Joyo Amazon	<a href="http://www.amazon.cn/">http://www.amazon.cn/</a>	Books, electronics, health and beauty products, daily consumption products
Dangdang	<a href="http://www.dangdang.com/">http://www.dangdang.com/</a>	Books, electronics, health and beauty products, apparel, baby items, grocery
M18	<a href="http://www.m18.com/">http://www.m18.com/</a>	Apparel, health and beauty, accessories, baby items, home furnishings
Vancl	<a href="http://www.vancl.com/">http://www.vancl.com/</a>	Apparel
139 shop	<a href="http://www.139shop.com/">http://www.139shop.com/</a>	Mobile phones and accessories
Redbaby	<a href="http://www.redbaby.com.cn/">http://www.redbaby.com.cn/</a>	Baby items, health and beauty, home furnishings, electronics
99read	<a href="http://www.99read.com/">http://www.99read.com/</a>	Books
Menglu	<a href="http://www.menglu.com/">http://www.menglu.com/</a>	Lingerie
PPG	<a href="http://www-ppg.com/">http://www-ppg.com/</a>	Menswear and accessories

Source: Respective company websites, Li & Fung Research Centre

Major B2C players either act as a transaction facilitator or operate in a direct-to-customer retailing model (see Exhibit 9). Leading player Taobao Mall is a typical transaction facilitator. Acting as matchmaker between individual buyers and sellers, Taobao Mall generates most of its income from commission, online storefront listings and advertising. It does not engage in the logistics and warehousing of the goods; it also bears no inventory risks. Many other B2C players, such as

Dangdang and 360Buy, operate in a direct-to-customer model. Apart from commission and advertising, these players also generate revenue from merchandise mark-up. However, they have to manage warehousing and logistics of goods and bear inventory risks as well.

Since the logistics infrastructure is yet well-developed in China, saving a great deal of warehouse and logistics costs allows Taobao to focus on its core business. This asset-light business model has proven to be successful in China; Taobao has successfully captured 20% of market share in B2C market within months.

Taobao's success can also be attributed to the offering of free-of-charge services. At the expense of a short-term revenue stream, it is hoped that the free platform could generate a huge database of online users and gather valuable market information for long-term development.

## Exhibit 9: Business models of B2C players

	Major players	Sources of revenue	Strengths & disadvantages
Transaction facilitator	Taobao Mall	Commission, online storefront listing, advertising	<ul style="list-style-type: none"> <li>✓ Saving warehouse and logistic cost; Asset-light</li> <li>✓ Do not need to bear inventory risk</li> <li>✗ Relying on commission and advertising</li> <li>✗ Risk of fake goods</li> </ul>
Direct-to-customer retailing model	Dangdang, 360Buy, Joyo, 99read, M18, Redbaby, Menglu, Vancl, PPG	Commission, merchandise mark-up, advertising, online storefront listing	<ul style="list-style-type: none"> <li>✓ Taking advantage of low-cost online marketplace compared to brick-and-mortar retailers</li> <li>✓ Better control the quality of merchandises</li> <li>✗ Higher cost on managing inventories and logistics</li> </ul>

Source: Respective company websites, Li & Fung Research Centre

## Taobao Today

Taobao is China's most prominent online retailing pure-play. Leveraging on its huge user base and company reputation, Taobao has launched its B2C platform Taobao Mall in 2008. Within months, Taobao Mall has quickly grabbed around 20% of the total market share.

Serving as a matchmaker between buyers and sellers, Taobao does not bear any inventory risks. To attract users, the company has partnered with prestigious brands such as Uniqlo, Li Ning (李寧), Lenovo (聯想), Dell, Midea (美的), Philips and Abbott. This asset-light business model helps save warehouse and logistic costs.

In order to fend off the rivals and attract potential users, Taobao services have been free-of-charge since its launch in 2003. This strategy has borne fruit for the company. With 98 million registered users, the total merchandise transaction volume surged to 99.96 billion yuan in 2008, up 131% yoy.

Despite the astonishing figures and rapid development of Taobao, its profit-making ability has been questioned. According to company management, it was until August 2008 that Taobao achieved break-even, thanks to growing advertising revenue. However, no further financial details have been disclosed. The number of active registered is also unknown.

Membership registrations of sellers and shoppers are free of charge. Today, Taobao mainly derives its revenue from advertising and commission (ranges from 0.2% to 5% of each B2C transaction).

## The "Big Taobao Strategy"

Under the umbrella of Alibaba Group, Taobao has leveraged on the strengths of its sister companies including payment platform Alipay, portal services operator Yahoo! China (中國雅虎), online advertising marketplace Alimama and information sharing platform Koubei (口碑網).

In 2007, the Alibaba Group listed its business-to-business (B2B) platform in Hong Kong Stock Exchange. The public listing does not only successfully help the group raise over 10 billion Hong Kong dollars for future developments but also enhances its company reputation. There are positive spillovers to other subsidiaries of Alibaba Group including Taobao as well. Taobao's influences in virtual marketplaces have also been reinforced after merging with Alimama in 2008. Such collaboration is regarded by the management as the "Big Taobao Strategy".

Furthermore, financial support is also given by the parent company. Alibaba Group has promised in 2008 to inject 5 billion yuan into Taobao in 5 years.

## III. Development trends

### 1. Format diversification: the “click-and-mortar” model is increasingly popular in China

Format diversification has been a key growth strategy for many retailers to reach potential customers. Online platform offers a low-cost alternative for many brick-and-mortar retailers. Attracted by the huge traffic flow, some traditional retail operators have already explored the opportunity online by either opening a online storefronts in B2C portals such as the Taobao Mall and Joyo Amazon or developing their own shopping websites such as Sasa (莎莎) and BONO (報喜鳥).

On the other hand, some online retailers have also diversified “offline” to reach people who seldom access the Internet. For example, leading player Taobao has opened more than 30 offline stores in more than 20 large-and medium-sized cities at the end of 2008 in a low-profile manner. The combination of offline and online channels is considered by Taobao as a quick way to extend the customer reach.

### 2. Brand players, manufacturers and suppliers using the online platform to expand domestic sales

Brand players, manufacturers and suppliers are growingly interested in utilizing the online platform to improve sales performance. For instance, one of the largest instant noodles companies in China, Sichuan Baijia Food Company (四川白家食品), has announced plans to embark on online direct sales in March. The company will set up an online flagship store and seek cooperation with major platforms such as Taobao.com, Eachnet.com, Youa. baidu.com, and Dangdang.com to launch Baijia's online direct sales system. On the other hand, against the backdrop of weakening export trade, many export-oriented Chinese companies have shifted their attention to the home market. B2C platforms such as Taobao are viewed as important channel for exporters who are inexperienced in domestic sales to test the market feedback at a relatively low cost.

Meanwhile, an increasing number of brands which do not participate in online retailing are also launching e-marketing campaigns to approach consumers to promote their brands. For example, Ford has partnered with China's leading video streaming website Tudou (土豆) to launch a series of integrated marketing campaign from February 2008, including a drama series featuring Ford cars and other interactive activities etc. Partnering with instant messaging service Tencent's QQ, Coca Cola rolled out the Virtual Olympic Torch Relay online across China with more than 57 million participants as of July, 2008. McDonald's China has also partnered with Taobao to open a virtual store to promote its brand.

### 3. Vertical B2C portals emerging

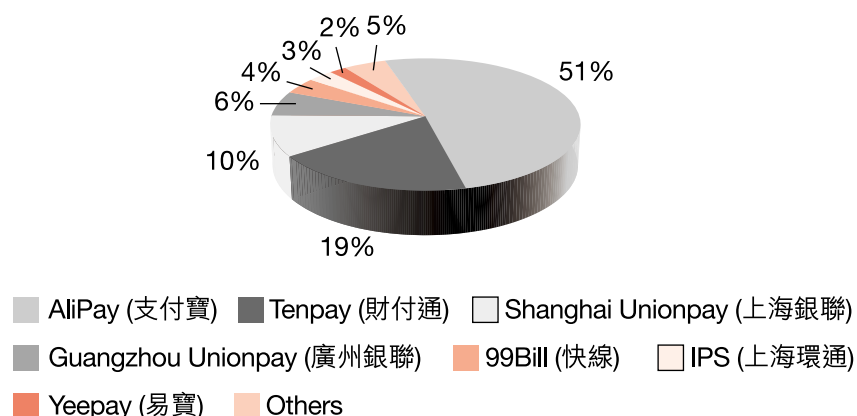
Leading B2C portals in China such as Taobao Mall and Joyo Amazon are integrated sites, which aim to provide one-stop shopping experience to online shoppers. Today, a number of vertical B2C portals, which are more specialized to target specific market segments have emerged. For example, 360buy positions itself as electronics gadgets specialists; RedBaby (紅孩子) targets maternity and baby products market etc. These vertical B2C portals are posing increasing challenges to their integrated counterparts.

## 4. More mature online payment system

The increasing popularity of the third party payment systems in recent years has greatly facilitated online transaction in China. According to CNNIC, 71.3% of the online transaction was settled by electronic payment methods in June 2008, up from 61.5% in December 2005, online shoppers are increasingly confident towards electronic payment and the improvement of online infrastructure.

The Alibaba Group established a third party payment platform Alipay, which is similar to the PayPal owned by eBay, in 2004 to settle payments online. According to iResearch, AliPay handled 51% of online transaction, which was the most popular third-party payment platform of China in 2008 (see Exhibit 10).

**Exhibit 10: Market share of third party payment platform, 2008 (valued at 274.3 billion yuan)**



Source: iResearch Inc.

AliPay serves as a middleman between buyers and sellers. With deposits of the buyers in AliPay accounts, sellers could only receive the payment after the buyers received their purchases. To facilitate online payments, AliPay has also partnered with the leading banks in China, including Bank of China, China Construction Bank, Agricultural Bank of China, the Industrial and Commercial Bank of China as well as Visa and other financial institutions.

AliPay is now extending its leadership outside the Alibaba and Taobao marketplaces. Having attracted more than 460,000 external merchants, AliPay had more than 110 million users and a daily transaction volume exceeding 550 million in October 2008.

However, the operation of the third party payment system has recently drawn attention from the Chinese government. In order to better regulate the online payment and settlement businesses as well as to protect the legal rights and interests of the public, all non-financial institutions including Internet platform AliPay now have to register under the new guidelines and report to the People's Bank of China.

## 5. Online retailers partnered with third-party logistics providers to enhance delivery efficiency

Robust growth in online retailing is generating huge demand for efficient logistics services. Online retailers are striving hard to minimize delays in delivery, which hurts consumer experience and brand reputation. To enhance delivery efficiency, some online retailers have partnered with third-party logistics providers (3PLs). For instance, Taobao has partnered with third party couriers for delivery services; logistics companies including EMS (中國郵政), Yuantong Express (圓通), ZJS Express (宅急送), STO (申通) and Yunda Express (韻達) are on the recommendation list of Taobao. Information on scope of delivery service, service charge, and reimbursement on fail dispatches are also readily available on respective company's websites.

China's logistics industry has improved significantly today; nonetheless, there is still huge improvement room for service quality, reliability and punctuality of delivery, and underdeveloped package tracking system. It is expected that the logistics infrastructure will become more mature and 3PLs companies will expand more extensively in China. This shall facilitate further growth of online retailing.

## 6. Investors riding the Internet boom in China

Lured by the online retailing boom, investors have shown an increasing appetite for investments related to China's online retailing market. Dangdang has received capital injections by local publisher Kewen, Tiger Fund, IDG, Luxembourg Cambridge and Softbank China Venture Capital since 2000. 360Buy.com gained the supports by Capital Today, Bull Capital and private company under the name of Francis Leung Pak To. Francis Leung has been called "the Father of the Red Chips" for his active role in bringing Mainland's state-owned enterprises to list in Hong Kong in 1990s.

Exhibit 11 demonstrates some recent examples. It is also believed that the launch of Nasdaq-like growth board in China will provide a more convenient exit channel for the investors.

**Exhibit 11: Recent infusion of venture capital and investment funds, April 2008 - March 2009**

Online retailers	Website	Investors	Capital invested	Date
360Buy (京東商城)	www.360buy.com	Bull Capital Partners, Capital Today	21 million USD	2008/12/19
Udooo (悠都網)	www.udooo.com	SIG, Legend Capital	3 million USD	2008/11/12
Vancl (凡客誠品)	www.vancl.com	Qiming Venture Partners, IDGVC, SAIF Partners, Ceyuan Ventures	20 million USD	2008/8/1
Leyou (樂友網)	www.leyou.com	AsiaVest Partners, Deutsche Bank	n.a.	2008/6/2

Source: ChinaVenture.com

## 7. Improving regulatory environment

In view of the growing popularity of online shopping in the country, the Ministry of Commerce has launched the *Specification for E-Business Model* (電子商務模式規範) and *Service Specification for Online Shopping Transactions* (網路交易服務規範) in April 2009, aiming to set standards for e-commerce businesses to better safeguard consumers' interests. The two new rules will be effective on December 1 2009. In addition, the Beijing Administration for Industry and Commerce promulgated the *Suggestion on E-commerce Supervision and Management* (關於貫徹落實〈北京市信息化促進條例〉加強電子商務監督管理的意見) on August 1, 2008 to safeguard online transactions. Profit-oriented online businesses based in Beijing must obtain a business license before starting operation. Nonetheless, some industry experts have questioned the effectiveness of these rules and regulations. Officials not having enough resources and training would affect the effective enforcement of the rules.

## 8. The loss of tax revenue is a growing concern

Taxation policy on e-commerce is weak in China, as compared to the United States and European Union. Currently, taxes are imposed on C2C transactions (for those monthly transactions exceeding RMB 5,000) and B2B transactions. However, as observed by industry analysts, most of the transactions, especially for C2C transactions, are not taxed in China due to the difficulties in enforcement. As a result, a large number of smaller B2C players have pretended to be individual consumers and sold discounted products on C2C platforms to evade revenue taxation. As online retailing becomes more popular, the loss of tax revenue is drawing attention. There is growing discussion on improving the taxation policy on online retailing in China.

## IV. Concluding remarks

Despite minimal share in overall retail sales, online retailing is quickly transforming the commercial landscape in China, bringing huge opportunities as well as challenges for different commercial players. While businesses can today extend its consumer reach easily, they also face increasing competitive pressures from quicker supply chains and higher information transparency.

Looking ahead, online retailing will continue its rapid growth in China. We believe more and more will embrace the "click-and-mortar" model. Commercial players should prepare well to compete in this information era.

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