

QUICK TAKE

THE CHANGING
FACE OF GLOBAL
E-COM:
THE RISE OF
CHINA



GLOBAL RETAIL RESEARCH



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Fung Business Intelligence Centre

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Quick Take: The Changing Face of Global E-Commerce — The Rise of China

"Amazon and eBay are e-commerce companies, and Alibaba is not an e-commerce company. Alibaba helps others to do e-commerce. We do not sell things."

Alibaba co-founder – Jack Ma

Introduction

Starting September 19, Chinese e-commerce giant Alibaba is listed under the symbol BABA on the NYSE. A day before that, Alibaba priced its IPO at \$68 a share, the top end of the expected range, raising a record-breaking \$21.8 billion. The company closed the first day of trading at \$93.89 a share, up 38% from its IPO price. With a market cap of 231 billion (as of the close of September 19), Alibaba overtakes Amazon.com and Facebook and trails only Google, Apple, and Microsoft in size among technology companies listed in the U.S..

Alibaba is now a familiar name to the Americans, and the company will use the IPO proceeds to expand in the U.S., notably with the launch of local e-commerce platform 11 Main. It has also acquired stakes in companies including Uber, Lyft and search engine app Quixey. During the IPO roadshow, Alibaba's co-founder and Executive Chairman Jack Ma has reiterated the company's intent to internationalize aggressively after the listing.

Investors are no strangers to the best of the Chinese Internet companies, as many of them are listed in the U.S. or in Hong Kong, including Baidu, Tencent, Sohu.com and Sina. Within China, the three largest Internet companies – Tencent, Alibaba and Baidu – are leading innovations and changes in all aspects of everyday life, such as in retailing, banking, entertainment, education and healthcare. The Chinese refer to them simply as the "BAT."

Whereas Tencent, Alibaba and Baidu have their core businesses respectively in social media and gaming, merchandise e-commerce, and search engine, the three are increasingly intruding into each other's turf. They have spent more than \$7 billion since the start of 2013 to acquire or launch e-commerce, entertainment and other ventures. All of them are trying to become one-stop services for web surfers who increasingly go online using smartphones and are demanding omni-channel services.

The discussion surrounding the Alibaba IPO all points to one important message: China's tech companies have emerged as a force to be reckoned with, in terms of R&D capability, business model innovation, and execution prowess. This is the result of an overall focus on investment in infrastructure and human resources in the Chinese tech industry, the sheer size and potential of this market, as well as the quality of the current workforce and what we believe is a very strong new graduate pipeline.

With the latest international trend of cross-border e-commerce, the “BAT” may soon be bringing disruptions on a global scale. Both Tencent and Alibaba are being very aggressive in their internationalizations. WeChat, Tencent’s flagship mobile messaging product, launched a major promotional campaign in January to boost its presence in the U.S. market. Alibaba also introduced its U.S. e-commerce marketplace 11 Main in June.

This Quick Take looks at Alibaba and Tencent, the two among the “BAT” that have e-commerce elements (e-commerce refers to merchandise e-commerce instead of service e-commerce in this report, unless otherwise specified). It includes analysis of the two companies’ core strengths and business models, as well as their internationalization strategies.

What are Alibaba and Tencent?

Alibaba

Founded in 1999, Alibaba is China’s biggest e-commerce company, and one of the largest in the world. It is the most popular destination for online shopping in China, the world’s fastest growing e-commerce market. Transactions on its online sites totaled \$248 billion last year, more than those of eBay and Amazon.com combined. Its ecosystem is built upon the retail marketplaces below.

Exhibit 1: Alibaba’s major retail marketplaces

Alibaba Marketplace	Similar to	Customers	Sellers	Key metrics
		Chinese consumers	Chinese individuals and small businesses	<ul style="list-style-type: none"> Gross merchandise volume (GMV): RMB 1,833 billion (no. 1 in China) Annual active sellers: 8.5 million Annual active buyers: 279 million (For the twelve months ended June 30)
		Chinese consumers	Chinese brands and foreign brands (via Tmall Global)	
		Chinese consumers	The majority of sellers on Juhuasuan are Tmall sellers	

Source: Alibaba’s IPO Prospectus

Over the years, Alibaba has developed a mature ecosystem that is geared towards merchandise retail e-commerce. It relies on the lower-margins C2C marketplace (Taobao.com) to draw in a large number of visitor traffic, and redirects that flow to its higher-margins businesses (the B2C Tmall.com and other value-added services). Alipay, the escrow payment service, is indispensable for resolving the trust issues involved in e-commerce; and China Smart Logistics coordinates the different courier companies so that Alibaba can maintain a reasonable level of delivery service without substantive investment in logistics.

Exhibit 2: The Alibaba Ecosystem



Source: Global Retail Research – Fung Business Intelligence Centre

Tencent

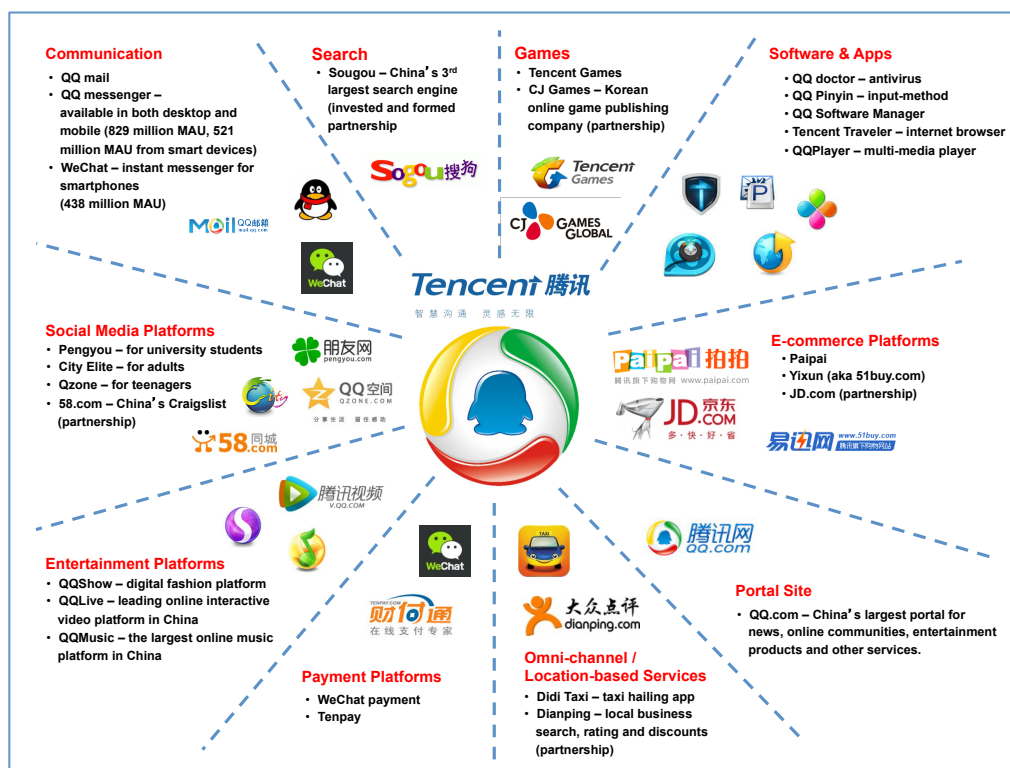
Founded in 1998 by Ma Huateng, Tencent has grown into one of China's most popular Internet service ecosystems. It provides value-added Internet, mobile and telecom services and online advertising under the strategic goal of providing users with a one-stop shop for online lifestyle services. Tencent's leading Internet platforms have created the largest Internet community in China that meets Chinese Internet users' needs in the areas of communication, information, entertainment and e-commerce.

Through an ecosystem of service-oriented (as opposed to merchandise e-commerce-oriented) online platforms, Tencent controls a large volume of Internet traffic flow and user information, and utilizes them to create value.

At a market cap of \$150 billion at the end of the trading session on September 18, Tencent is China's largest listed Internet company (before Alibaba's IPO) and one of the largest in the world. While Tencent may be no match for Alibaba in terms of merchandise e-commerce, it has the potential to win out in the omni-channel front building on its experience in the field of service e-commerce.

Tencent offers numerous Internet services. Its ecosystem involves gaming platforms, two immensely popular instant messengers (QQ and WeChat), e-commerce platforms, 3rd party payment platforms and other omni-channel services. As QQ and WeChat belong to two different business units and they compete with each other within the company, many services are duplicated (such as WeChat Payment and Tenpay).

Exhibit 3: The Tencent ecosystem



Source: Global Retail Research – Fung Business Intelligence Centre

How do the Chinese Internet giants compare with international peers?

Alibaba is set to be the biggest e-commerce player in the world, with valuation that makes companies like eBay and Amazon.com seem small by comparison. This is due to Alibaba's business model. Alibaba runs marketplaces and does not own the items sold on its platforms, so the amount of business that flows over its sites dwarfs that of other e-commerce companies. The flip side of the coin is that Alibaba gets a smaller share of the merchandise volume as revenue (mostly as marketing and transaction fees). The agency model enables Alibaba to be asset-light and maintain a higher profit margin than its peers. This asset-light model makes them incredibly efficient and scalable.

Tencent's market cap is slightly behind Amazon.com, but its income comes largely from online gaming and other value-added services rather than e-commerce. If its recent joint ventures with JD.com and commercial property company Wanda can create the synergies as planned and finally kickstart its growth in the e-commerce sector, there is a high chance that it can get much bigger.

Exhibit 4: Market cap of the major Internet companies
(As of September 19, in USD billions)

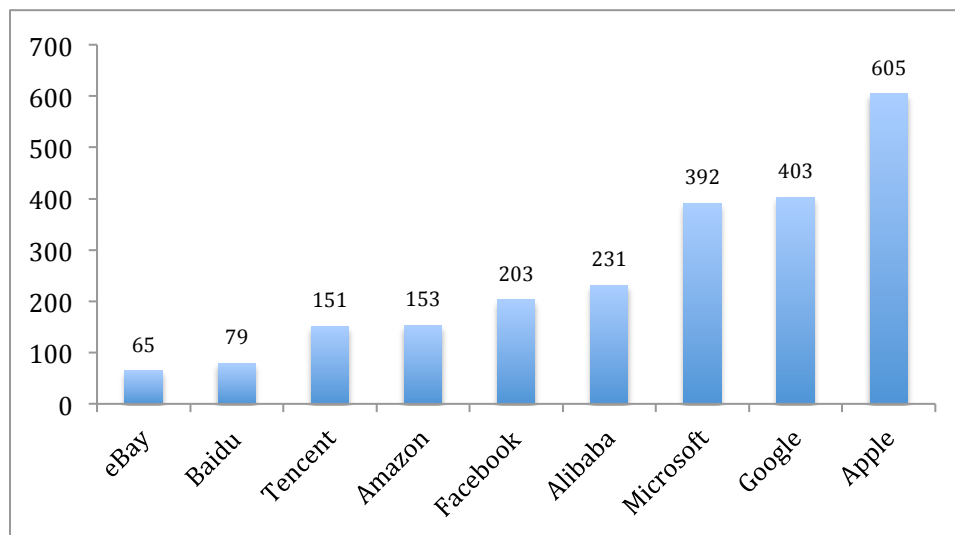


Exhibit 5: GMV of the largest e-commerce companies
(Q2 2014, in USD billions)

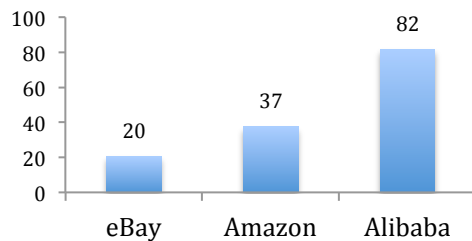


Exhibit 6: Revenue of the largest e-commerce companies
(Q2 2014, in USD billions)

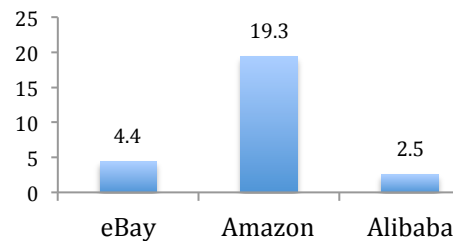


Exhibit 7: Net income of the largest e-commerce companies
(Q2 2014, in USD billions)

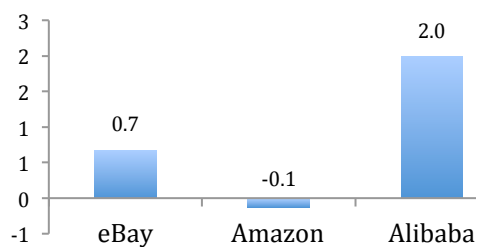
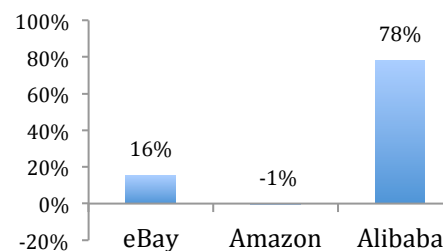


Exhibit 8: Net profit margins of the largest e-commerce companies
(Q2 2014)



(Note: Alibaba's net profit in the period was boosted by \$1.1B in interest/investment income)
Sources: financial results of the respective companies

China's booming e-commerce market

Alibaba has been dominant in China's merchandise e-commerce space, but the competition is heating up. In March, Tencent and JD.com formed a partnership with the intent of maximizing their respective strengths to become a legitimate competition to Alibaba's e-commerce business. By designating JD.com as Tencent's preferred partner for merchandise e-commerce, the strategic partnership enables JD.com to tap into Tencent's significant mobile and Internet user base, and allows Tencent to leverage JD.com's merchandise e-commerce services, streamlining an enhanced user experience.

In August, Tencent and Baidu partnered with Wanda Group, China's biggest property developer, to launch an e-commerce joint venture. The three companies plan to integrate online and offline channels to provide e-commerce services in Wanda's 107 shopping malls, as well as its hotels and resorts.

The rise of O2O (Online to Offline) in China

One trend to note is the growing O2O market in China. Omni-channel retailing, which has been growing rapidly in the U.S. and Europe, is blurring the division between online and offline purchasing channels. China's interpretation of this business model is "Online to Offline" (O2O), which is about searching online and purchasing offline or buying online and picking up in-store, and also much more.

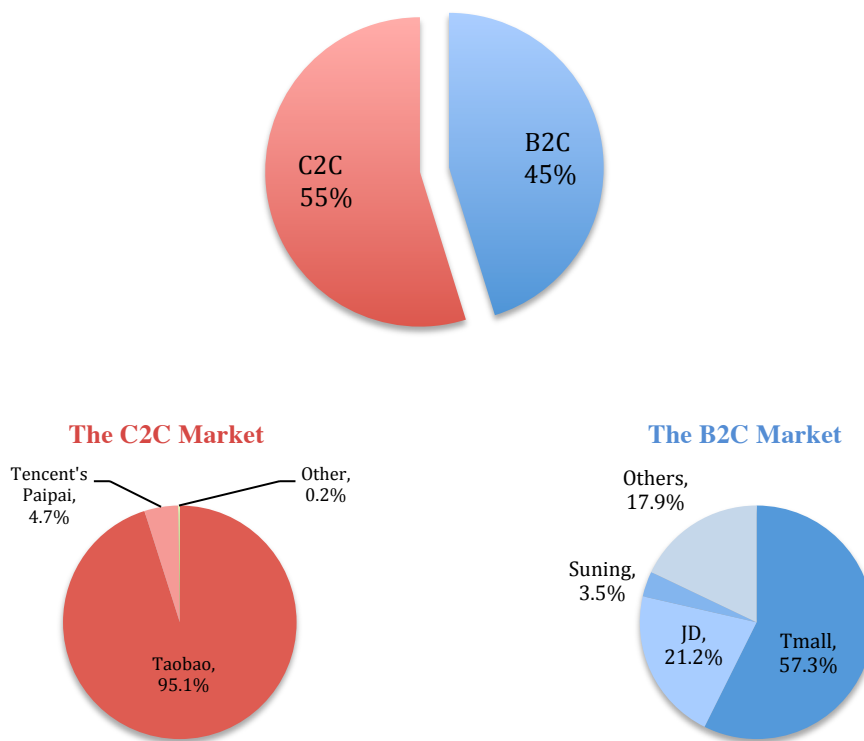
In 2012, Alibaba's Tmall opened a 25,000-square-meter furniture store in Beijing to allow customers to physically try out the furniture before buying online. Before the 2013 Singles' Day (on November 11) in China, many stores ran showroom previews in their physical locations, encouraging shoppers to try on their products and add them to their e-commerce site's wish-list. Potential customers would then be persuaded to complete the purchase on November 11 with automatic discount notifications.

Along the same line, major players such as JD.com and SF Express (a leading delivery services company in China) are also connecting with the physical stores. In March, JD.com announced its plan to partner with 11,000 physical convenience stores nation-wide.

As e-commerce is becoming increasingly mobile and is integrating with offline commerce in previously unimaginable ways, Alibaba is vulnerable to challenges from Tencent, which operates WeChat, China's most successful mobile instant messaging apps with e-commerce and payment (WeChat Payment, or WePay) capabilities.

Exhibit 9: Breaking down China's e-commerce market

The size of the e-commerce market is \$456 billion in Q2 2014

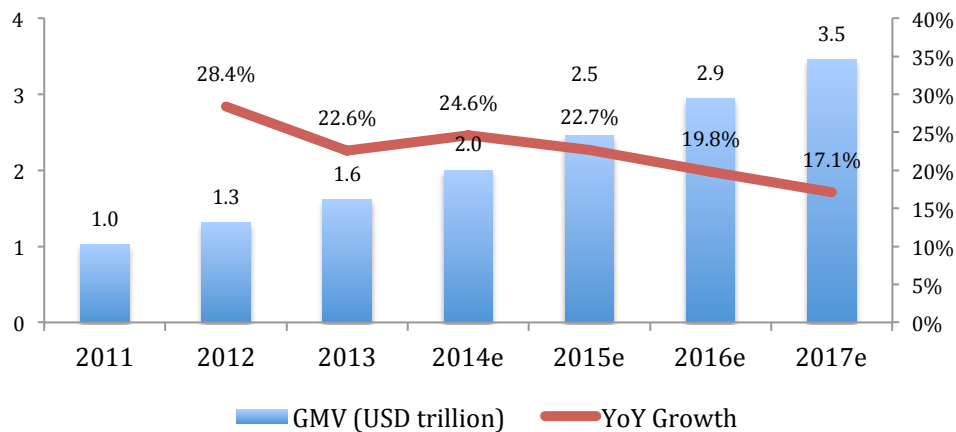


Source: iResearch, CECRC

Note: Data are for the period of Q2 2014, except for C2C market breakdown, which is for the period up to June 2013.

China's e-commerce market will continue to grow rapidly

Exhibit 10: The size of the e-commerce market in China, 2011-2017e



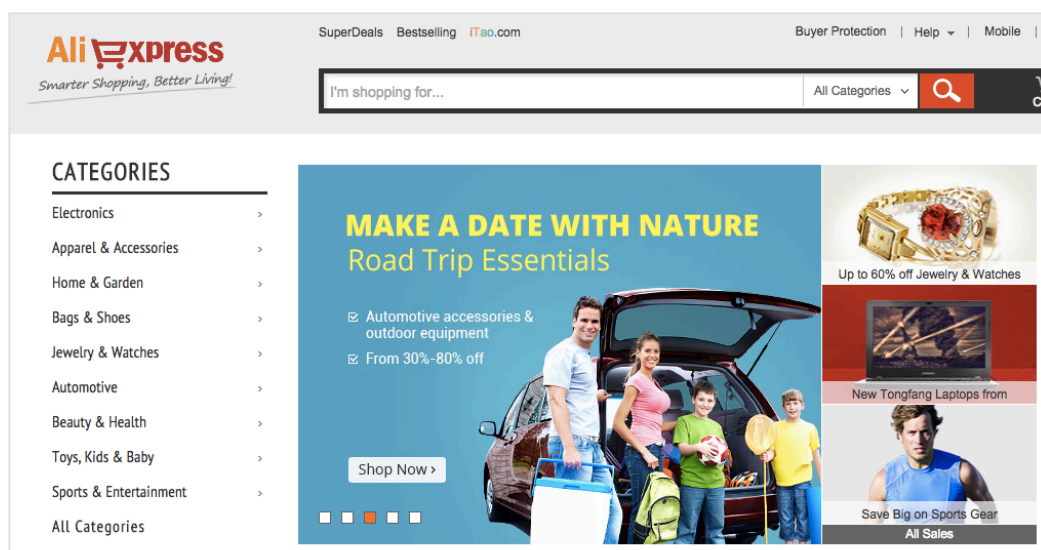
Source: iResearch

China's e-commerce companies going global

Alibaba currently relies on the China market for the bulk of its revenue. In 2014 (year ended March 31), its e-commerce revenue from outside China was only \$782 million, or 9.2% of its total revenue of \$8.46 billion. However, it has been expanding rapidly in the international market in recent years.

Alibaba's current international strategy has three components: 1) launching directly into the U.S. market with 11 Main to facilitate transactions between U.S. retailers and consumers, 2) matching consumers around the world with Chinese suppliers through AliExpress, and 3) matching brands from outside China directly with Chinese consumers with Tmall Global.

Alibaba launched AliExpress in 2010. The global retail marketplace enables consumers from around the world to buy directly from wholesalers and manufacturers in China. In the twelve months ended June 30, AliExpress generated \$4.5 billion in GMV.

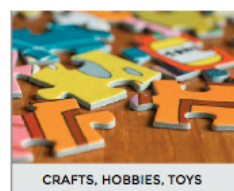
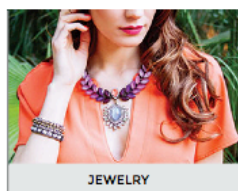
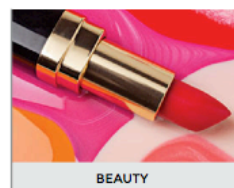
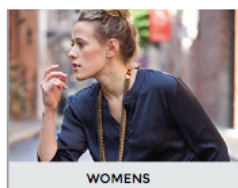


Revenue from Alibaba's international retail e-commerce business increased by 100.0% YoY to reach \$58 million in the three months ended June 30. The main reason behind the impressive growth was an increase in GMV transacted on AliExpress, primarily from the increasing number of buyers in Russia, Brazil and the U.S.

In June this year, Alibaba launched 11 Main, an online retail site for unique goods and crafts highlighting American businesses and giving Alibaba a window into the U.S. retail e-commerce market. Complete with offerings like fixed-gear bicycles and women's jewelry, this marketplace features select vendors and boutiques that are meant to provide as close to an online representation as possible of Main Street, U.S.



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Alibaba may soon be disrupting the U.S. retail market on another front, by facilitating direct purchases from U.S. e-commerce platforms for Chinese consumers (the practice is popularly known as *haitao* within China). This may also significantly impact U.S. e-commerce sales. The possibilities seem endless with the potential of all Chinese consumers having easy access to products offered in various U.S. e-commerce sites and marketplaces. We believe this presents an excellent opportunity for U.S. retailers to offer private label goods to Chinese consumers on their e-commerce sites.

Alibaba has also launched Tmall Global (www.tmall.hk, instead of tmall.com) to capture the growing cross-border e-commerce demand in China. Tmall Global is a solution that enables companies that are based outside China to directly advertise and sell to millions of Chinese consumers. International companies without China business licenses can apply to open a store in Tmall Global. They do not need to have a legal or physical presence in China, as orders can be fulfilled and shipped from outside, and customer payments are settled in the preferred native currency. Companies are only required to provide a China-based product return arrangement and Chinese-language customer service support. This business model provides an interesting option for companies that want to enter China but do not want to commit with heavy investments in the initial stage.

The company's cross-border e-commerce strategy is quite apparent. Alipay has partnered with Japan's Rakuten and Korea's Lotte, offering payment options to Chinese customers. As of now, most Chinese do not even have an international credit card such as Visa or Mastercard, and that is the main reason why they cannot purchase from foreign e-commerce sites.

Alipay is also working with the U.S. company Stripe (a service similar to PayPal) to facilitate payment for Chinese consumers at U.S. e-commerce sites serviced by Stripe. Stripe makes software that helps businesses accept various types of payments on websites and mobile devices, and is known among software developers for its ease of setup. It is one of the largest companies of its kind, with businesses in 14 countries using it as part of their infrastructure for receiving payment online. The partnership will allow Stripe's international business clients to offer Alipay as a payment option for the Chinese shoppers.

In May, ShopRunner, an online shopping service platform that offers members shopping deals from over 100 retailers in the U.S., announced a partnership with Alibaba to allow Alipay's Chinese users the ability to order goods directly from ShopRunner's partners, including Neiman Marcus and Toys "R" Us.

On the other hand, Alibaba is also forming partnerships with companies such as the Australia Post and the Singapore Post to enhance the group's international logistics network. With the help of Alibaba's logistics capabilities, it is believed that ShopRunner's products can be delivered to China within 10 days.

Tencent has also been aggressive in its international expansion, with notable success in the Asia Pacific region. According to the GlobalWebIndex (GWI), WeChat's active user base in Asia Pacific (excluding the Chinese Mainland) has grown by over 60% in the twelve months ending Q2 2014. Within the region, Hong Kong (222%), Taiwan (166%) and The Philippines (100%) have experienced the most impressive growth rates.

Conclusion: a SWOT analysis for Chinese e-commerce companies going global

As Tencent is stronger in social media and gaming, and Alibaba has its core strength in merchandise e-commerce, they can both be big winners as they go global. As a conclusion to this Quick Take, below is a general SWOT (Strengths-Weaknesses-Opportunities-Threats) analysis for Chinese e-commerce companies going global.

Strengths

- The ability to innovate rapidly
- Favorable government policies
- Availability of technology and e-business talents
- Intimate knowledge of users (and by extension the consumers in general) enabled by big data
- Experience and know-how acquired throughout the years of operating in China's competitive online market

Weaknesses

- Inability to fully comply with international business practices
- Unfamiliar with local consumer preferences outside China
- Weak copyright protection

Opportunities

- Strong growth of China's e-commerce market
- The ability to leverage on the size of China's market to experiment and innovate
- The opportunity to expand internationally by tapping into their experiences in operating platforms and online/mobile payment in China

Threats

- Vulnerable to margin erosion, especially as some business models have low barriers to entry
- Regulatory risks
- Disruption from the next wave of technologies and innovations