SHOPPING WITHOUT BOUNDARIES

CHINA CROSS-BORDER E-COMMERCE: AN OPPORTUNITY NOT TO BE MISSED

AUTHORS

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AN OPPORTUNITY NOT TO BE MISSED

In the quest to meet the needs of increasingly sophisticated and demanding Chinese consumers, the e-commerce industry in China has never been short of creative solutions. We have already seen the rise of online-to-offline commerce (O2O), social commerce, and mobile commerce. Now cross-border e-commerce has become the latest hot topic for Chinese e-commerce players, and is capturing the attention of the world’s leading brands and retailers.

Today’s cross-border e-commerce has grown out of the so-called “Daigou” model, which involved small businesses, staffed by one or a few people living abroad, who brought or sent products back to China. The 2008 infant milk formula crisis contributed significantly to the growth of Daigou. Many successful Daigou are no longer small businesses, but have become major traders or key category players.

With the rapid expansion of cross-border e-commerce through the “Daigou” model, the Chinese government established experimental zones of cross-border e-commerce in 2013 for better regulation. Shanghai was the first city selected for such an experiment, followed by a further 11 cities by June 2016.

A series of other regulations have helped the government to gain control over the quality, safety and manufacturing standards of imported products, and helped to ensure that taxes on these imports are properly traced and collected.

International brand owners and retailers are taking advantage of this new channel, and an increasing number have started an official cross-border business. They either open their own official stores on major platforms such as Tmall International, or sell directly to major B2C players such as JD Worldwide.

Since the official launch in 2013, cross-border retail e-commerce has grown to more than 3% of total e-commerce transactions in China (B2C and C2C), reaching RMB 120 billion in 2015. It is expected to grow at a compound annual growth rate (CAGR) of more than 60%, reaching 7% of total Chinese e-commerce value by 2018. Last year, one out of every five online Chinese shoppers purchased on cross-border e-commerce platforms, double the proportion in 2014.
The top five purchased categories on cross-border are health and beauty, mum and baby, health supplements, apparel and accessories, and consumer electronics. The United States, Japan and Korea are the most popular countries of origin for Chinese online cross-border purchases.
The similarities between these categories are obvious. They are all traditional strong e-commerce categories in which online shopping habits are highly developed, and where product offerings in the domestic market are not satisfactory in either price or quality.

Chinese consumers are probably the most informed and digitalised in the world, often conducting in-depth research to find the best products at the best prices. As more and more Chinese consumers are travelling to foreign countries, they are also increasingly aware of the offline prices around the world. Cross-border e-commerce provides Chinese consumers with access to the best products at the best prices without leaving home, and sometimes at an even cheaper price than when purchased while travelling overseas.

Exhibit 3: Comparison of retail price, cosmetics example

<table>
<thead>
<tr>
<th>RETAIL PRICE COMPARISON OF SK-II R.N.A POWER FACIAL CREAM (80G)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CROSS-BORDER E-COMMERCE PRICE (TAX INCLUDED)</td>
</tr>
<tr>
<td>¥1,260</td>
</tr>
<tr>
<td>MAINLAND CHINA</td>
</tr>
<tr>
<td>¥699</td>
</tr>
<tr>
<td>KAOLA.COM</td>
</tr>
<tr>
<td>¥728</td>
</tr>
<tr>
<td>XIAOHONGSHU</td>
</tr>
<tr>
<td>¥968</td>
</tr>
<tr>
<td>TMALL.HK</td>
</tr>
<tr>
<td>¥17,000 ex. tax (¥ 1,102 1)</td>
</tr>
<tr>
<td>JAPAN</td>
</tr>
<tr>
<td>¥1,140 (¥ 976 1)</td>
</tr>
<tr>
<td>HONG KONG</td>
</tr>
</tbody>
</table>

1. Exchange rate: 1RMB= 1.1682 HKD, 1JPY= 0.06486 RMB
Price checked on Jun 30, 2016

The infant milk story demonstrates how Chinese consumers have gone to extra lengths to purchase from abroad through online channels. Since the crisis of 2008, when dangerously high levels of the industrial chemical melamine were found in infant milk formula, Chinese mothers have had little confidence in domestic products. Increasingly, they have looked for quality products that they can trust from outside China. At first, they started buying infant milk formula products from Hong Kong, Japan, Australia and New Zealand. They then rejected Japanese brands due to worries about nuclear leakage and pollution. They also had serious concerns about Australian products due to the large-scale Fonterra recall of 2013. The Netherlands and Germany are now the most popular countries of origin for imported infant milk formula products.
By offering more choices at better prices to consumers, cross-border e-commerce has succeeded in completely disrupting the market dynamics in some categories. Infant milk formula is one of the categories that witnessed a wholesale reshuffle of leading brands, and an adjustment of the domestic price structure. Pricing pressure from the country of origin also limits the ability of brands to charge a premium on fully imported products. Cross-border e-commerce has become an important phenomenon, both for brands that decide to play in this market space and those that decide not to.

DIFFERENT MODELS

Four major types of cross-border e-commerce models have emerged: platform provider, self-operated play, vertical specialist, and own brand website.

Exhibit 4: Illustration of 4 major types of cross-border e-commerce operating models

<table>
<thead>
<tr>
<th>Operating model</th>
<th>PLATFORM PROVIDER</th>
<th>SELF-OPERATED PLAY</th>
<th>VERTICAL SPECIALIST</th>
<th>BRAND’S OWN WEBSITE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating model</td>
<td>Providing a platform for foreign brands/retailers to sell products from overseas</td>
<td>Sourcing products from overseas to sell locally, typically through setting up legal entities in bonded areas and managing their own supply chains</td>
<td>Selling overseas products of selected categories to Chinese consumers through its own e-commerce website</td>
<td>Selling overseas products to Chinese consumers through the brand’s international website</td>
</tr>
<tr>
<td>Profit source</td>
<td>Platform service fees + commission from brands/retailers; revenue from marketing tools</td>
<td>Mark-up from wholesale prices from brands/retailers to website retail prices</td>
<td>Mark-up from wholesale prices from brands/retailers to website retail prices</td>
<td></td>
</tr>
</tbody>
</table>

Many leading international brands launched flagship stores on Tmall International as their first step in exploring the Chinese market. High traffic flow, a well-established brand and a mature infrastructure are the main reasons for choosing Tmall.
Coming to the party relatively late, JD adopted a slightly different approach. While competing with Tmall International by providing a cross-border platform for brands and retailers, JD has also developed its own product assortment, and built a dedicated infrastructure to grow a self-operated cross-border business. The target for JD is to double the share of self-operated sales in its total cross-border e-commerce business from 30% in 2015 to 60% in 2016.

Not only have all the major domestic platforms started cross-border businesses, but specialised cross-border players and overseas retailers have also entered the field. Xiao Hong Shu is one of the most successful non-platform cross-border retailers in the past two to three years.

Launched in 2013, Xiao Hong Shu (Little Red Book) was initially an online community, focusing on fashion and lifestyle, designed for users to share information on products they came across while travelling abroad. Today, it has grown into one of the most popular cross-border retailers, offering food, health and beauty and mum and baby products, as well as personal electronics that target young female consumers.

To help users avoid being taxed for high-value purchases, Xiao Hong Shu offers an automatic order splitting function that ensures each order is below the tax-free threshold. One order may arrive in several packages. Those bright red boxes now overflowing in office buildings speak volumes.
There are two major logistics models for cross-border e-commerce: direct mail and storage in a bonded warehouse. As each of the two models has its own advantages and disadvantages, many retailers adopt both at the same time.

The latest regulations have forced the two models to be further differentiated. Storage in a bonded warehouse will require full compliance with Chinese product standards (for food categories, in particular) and a complete set of registration documents. Value-added tax (VAT) is inevitably applied to products delivered through this model. Although lead time from order placement to delivery is shorter, this model is more demanding for retailers and more costly for consumers.

Direct mail is an easy solution for those players which do not have the capabilities to operate through a bonded warehouse. It is administered as if for personal use. Postage tax is applied to the products delivered by direct mail. This is usually lower than the VAT for the same category. Consumers need to pay postage tax only when the purchased amount is above the tax threshold. However, not every direct mail will be inspected and taxed. Many consumers, as well as cross-border e-commerce players, therefore regard direct mail as a cheaper or even “tax-free” option compared to storage in a bonded warehouse.
Exhibit 7: Comparison between direct mail vs warehouse model under new regulation (effective on Apr 2016)

<table>
<thead>
<tr>
<th></th>
<th>BONDED WAREHOUSE MODEL</th>
<th>DIRECT MAIL MODEL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mode of customs clearance</td>
<td>Cross-border e-commerce</td>
<td>Personal product</td>
</tr>
<tr>
<td>Nature</td>
<td>Trade</td>
<td>Personal use (Non-trade)</td>
</tr>
<tr>
<td>Subject to “White List”</td>
<td>Yes</td>
<td>No - subject to a &quot;Black List&quot; (refer to normal import regulations)</td>
</tr>
<tr>
<td>Customs check rate</td>
<td>100% (through electronic transaction, payment and logistics information)</td>
<td>&lt;= 100%</td>
</tr>
<tr>
<td>Tax rate</td>
<td>Within threshold: 70% of VAT and consumption tax</td>
<td>Personal tax: 15%/30%/60% depending on category</td>
</tr>
<tr>
<td></td>
<td>Above threshold: normal import tax</td>
<td></td>
</tr>
<tr>
<td>Tax waive</td>
<td>No</td>
<td>Yes, if tax amount &lt;50 RMB</td>
</tr>
<tr>
<td>Mode of tax payment</td>
<td>Paid by customer or brand</td>
<td>Paid by customer or brand if checked</td>
</tr>
<tr>
<td>Delivery time required from order placements to receiving</td>
<td>1–2 days</td>
<td>From HK: 3–5 days</td>
</tr>
<tr>
<td></td>
<td></td>
<td>From US: ~20 days</td>
</tr>
</tbody>
</table>

1. Tax free threshold for cross-border e-commerce: Value of a single purchase - RMB 2,000; Personal purchase in the year - RMB 20,000
Source: TP interviews, Ministry of Finance, General Administration of Customs, 財关税[2016]18号, Oliver Wyman analysis

NEW CHALLENGES

INCREASING ENTRY BARRIERS

Cross-border e-commerce used to be a low-cost model that was equally accessible to everyone, making it an extremely attractive channel for small brands, who could enter the huge Chinese market and build a brand quickly with minimal risk. However, after several years of development, some platform players or e-commerce specialists have become large enough to be more demanding when it comes to the business potential of their potential tenants.

If we take Tmall International as an example, then the Taobao Index, the Baidu Index, and sales on other cross-border platforms are the three usual factors for deciding whether a brand would qualify as a Key Account. Not qualifying as a Key Account results in limited access to Tmall resources, such as key brand exposure slots, traffic redirection and major promotion events. Without this support, a new entrant brand is unlikely to build a successful Tmall.hk store. Moreover, if the turnover of the first three months fails to reach the target set by Tmall, the store may even be asked to close.
Rapid growth has been the norm for the China e-commerce market for a long time. Leading players have become accustomed to such success, and do not now have the patience to wait for a new brand to grow gradually. Other platforms or players might be less demanding, but would be likely to ask for a higher commission rate instead.

CHANGING REGULATORY ENVIRONMENT

After a booming period, cross-border e-commerce has arrived at a tipping point. The future of the channel now seems unclear to many of the players. The trigger has been a series of regulations announced by the Government in the past year, with the goal of placing the channel back in government control. These regulations cover a wide range of topics, including tax, product safety, manufacturing standards and logistics. Some of the newly announced regulations are not fully defined and are subject to further elaboration, leaving substantial room for speculation.

Betting the future of a Chinese business entirely on the basis of cross-border e-commerce is therefore not recommended. A “Plan B” is needed in case the market dynamics change completely due to new regulations.

Exhibit 8: Recent regulatory changes on cross-border e-commerce

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014.03</td>
<td>AQSIQ issued draft for public opinion on compliance of Chinese (GB) food standard and Chinese labelling of imported food via cross-border e-commerce</td>
</tr>
<tr>
<td>2015.05</td>
<td>CFDA released a draft for public opinion, echoing that imported food via cross-border should be compliant with any domestic regulation</td>
</tr>
<tr>
<td>2015.06</td>
<td>Ministry of Finance, General Admin. of Customs, State Administration of Tax jointly announced the new tax regime on cross-border e-commerce, with a 4-tier VAT ratio and no exemptions; Postal tax still applies to posts for personal use</td>
</tr>
<tr>
<td>2015.10</td>
<td>Ministry of Finance released for the first time the timeline of GB compliance as 2018.1.1</td>
</tr>
<tr>
<td>2015.12</td>
<td>State Council issued document calling for stricter policing on “grey overseas purchasing”</td>
</tr>
<tr>
<td>2016.04</td>
<td>General Admin of Customs announced the delay of implementation of new cross-border tax (announced on Apr 8, 2016) till May 11, 2017</td>
</tr>
<tr>
<td>2016.05</td>
<td>Customs enforced application of postal tax to cross-border e-commerce parcel with tariff and VAT exempted, as long as purchase is for self-use and under value of 1,000 RMB</td>
</tr>
<tr>
<td>2016.10</td>
<td>State council issued three documents of guidance on stimulating the development of cross-border e-commerce</td>
</tr>
</tbody>
</table>

Despite this changing regulatory environment, cross-border e-commerce still presents great opportunities for international players. It allows new players to build presence much faster than through traditional channels, and to test the market at lower risk and cost. It also enables existing players to complete their portfolio in China, using their winning propositions from around the world.
WHAT IT MEANS FOR YOUR BUSINESS

Many new brands have already entered the market via cross-border e-commerce. We expect many more brands to do so in the future, and change the market dynamics.

CONSIDERATIONS FOR INCUMBENTS

As far as incumbents are concerned, new entrants today could easily and quickly become key competitors tomorrow. It is crucial for the incumbents to decide quickly whether they also want to operate in cross-border e-commerce.

Even if the answer to this question is negative, they will still need to pay close attention to the development of the channel. Hero SKUs (the most popular products) on cross-border channels are good indicators of the latest consumer preferences or unmet needs, and offer inspiration for new product development. Prices in this channel could also place immense pressure not only on the regular e-commerce market, but also on offline pricing.

If incumbents do decide to operate in cross-border e-commerce, then they need to consider the following series of key questions if they want to succeed. Operating cross-border e-commerce in China could be a double edged sword, prompting international players both to rethink their China strategies and also to adopt a more global perspective.

- Determining the role of cross-border. Above all, incumbents will need to define what role cross-border e-commerce should play in their overall China business. Will it become a major channel? Is it a low-risk solution for launching new products and testing the market? Or is it just nice to have? A well-defined role would help players to quantify the scale of resources they should divert to cross-border e-commerce.

- Establishing a complementary portfolio. Products and prices offered in the cross-border channel should complement the existing portfolio. Introducing products similar to the current offering would not only confuse the Chinese consumers, but also risk cannibalising the existing business. Launching products that are differentiated from the current portfolio could help the players to focus on a wider range of consumer needs.

- Ensuring global price harmonisation. Although Chinese consumers are willing to pay some premium for an easy and quick access to quality imported products, they have excellent information on prices in different countries, and have access to different channels to obtain those products. Charging Chinese consumers a large premium has become impossible. Pricing in China needs to be maintained within a certain price differential vis-à-vis pricing in the countries of origin.

- Ensuring a scaleable supply chain. Due to the enormous scale of the China market, a business with 1% market share in China can be several times larger than the total market in some countries. At the same time as growing the business in China, it will be necessary to carefully plan the global supply chain in order to balance demand between China and other countries. A difficult situation could arise, for example, if the player is faced by a shortage of supply, and has to choose between meeting Chinese demand and the needs of the country of origin.
• **Adopting a truly global organisation.** Developing and executing your China strategy in such a global setting requires adjustments to your organisation. It is important to decide whether China or the country of origin should take Profit and Loss (P&L) responsibility for the cross-border business in China, and therefore who should have the principal strategic decision-making authority. A global team could also be assigned to take responsibility for all relevant markets, including China, making sure that different interests and needs are well managed. The China team also needs to be empowered to participate in the key decision-making process, thus ensuring that global strategies do not counteract local market development in China.

**CONSIDERATIONS FOR NEW ENTRANTS**

For those who choose to enter the China market through cross-border e-commerce, the unique ecosystem of this channel poses additional challenges not encountered in a traditional market entry strategy:

• **Selecting a product portfolio that fits the channel.** The selected products need to appeal to online shoppers in China. When assessing the potential profitability of the business model, you also need to consider logistics costs and the lead time for shipment. It would be a major advantage if there is already strong awareness of the brand among Chinese netizens, or if the brand has a leading market position in the country of origin.

• **Ensuring global price harmonisation.** As with incumbents, new entrants need to make sure that the prices of their cross-border offerings are maintained within a certain price differential vis-à-vis pricing in the country of origin. If this is not the case, it will be impossible to compete with other major retailers, or even traders, in the cross-border space. The era of charging a significant price premium in China is over. Even luxury brands significantly reduced their prices in China in 2015, partially as a result of outbound travel and growing cross-border e-commerce.

• **Creating hero SKUs.** Most successful e-commerce players on Taobao or Tmall have their hero SKUs. Hero SKUs often constitute a majority of store sales. They also serve as important drivers of traffic, and help to increase brand exposure on the platforms. This is extremely important, as major platforms are always crammed with hundreds and thousands of brands and SKUs. A successful hero SKU strategy enabled Costco to become the leader in the grocery category on Tmall International. With 10 SKUs contributing 60% of total store sales, Costco’s Tmall International store quadrupled its Double-11 sales between 2014 and 2015. Assorted nuts and dried cranberries are two examples of such star products.
• Using highly digitalised and social media brand building. Coverage on mass media is probably less important than having strong and clear exposure on the most popular social networks such as Wechat and Weibo, or digital media websites such as Youku. Vertical sites that are relevant to the product categories, or attract the same type of target consumers, should not be overlooked either.

• Ensuring consistency of branding. Authenticity is a must for the survival of any cross-border e-commerce business. A consistent brand story in both China and the country of origin will help to convince Chinese consumers that they are choosing the right products or retailers.

• Choosing the right third-party provider. Outsourcing some part of the operation is very common in the China e-commerce industry. Many well-established service providers are available, with strong regional players and category specialists, as well as several national leaders. Choosing a right partner could make the journey a great deal smoother.

• Deciding on an omnichannel route-to-market strategy. Despite the rapid growth of e-commerce, offline channels still account for a significant share of the market for most consumer categories in China. New entrants need to plan whether and when they should launch an offline business to supplement the business. Launching an offline channel could also serve as a “Plan B” if the cross-border channel becomes less favourable.

• Deploying a dedicated and localised China team. The cross-border e-commerce model in China is likely to be new for any new entrant to this market. Almost all the key stakeholders along the value chain are local players. The team responsible for building the cross-border e-commerce business in China must understand the local mind-set and adapt to the local working style. It might also take some time for new entrants to identify the right team structure to support the business.

• Being aware of regional differences. We have mentioned that the changing regulations have a major influence on the development of cross-border e-commerce. Moreover, policies can also be introduced by local governments. National regulations can be implemented in various ways across the country. For example, many cross-border players have found that the inspection rate for direct mail, and required documents for custom clearance, differ markedly among the twelve cities approved for cross-border e-commerce. A new entrant needs to choose a city that is best placed to help the business to physically transport the products across the border of China.

Recent news suggests that a one-year grace period (until May 2017) will be permitted until the new tax regime is fully implemented. After this period, entry barriers and operating costs of cross-border e-commerce will no doubt increase.

The winners in the fast-changing China e-commerce market are those who have a deep understanding of what Chinese consumers want, who are creative and courageous in attempting new models to satisfy consumers, and who remain sufficiently nimble and agile to respond quickly to the latest changes in the market.
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