

Strategic Use of Online Sales Aimed at China's Rapidly Growing Consumer Market (Volume 1)

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The Chinese consumer market is spreading from the coast to the inland regions. To be able to respond to this expansion, Japanese companies must move quickly to expand their sales channels inland and to enhance their management of sales channels that are dispersed throughout the country.

As one of the strategies for tapping the middle class market consisting of households with an annual disposable income of 50,000 yuan or more, which is rapidly expanding in the inland regions, Japanese companies should focus on the strategic use of online sales.

Online sales can lead not only to an increase in sales, but also to the ability to project future demand, which enables companies to optimize distributor inventories. It is also possible to develop brands aimed at young people within the Internet community. These effects brought about by the strategic use of online sales have already been proved in existing online shopping sites.

As of the end of June 2010, the number of Internet users in China had reached 420 million, making the country the world leader in terms of the number of users. The size of the online shopping market in China already equals that of Japan. Up to 2013, the market is projected to continue to grow at an average annual rate of 48 percent.

Currently, Alibaba Group's Taobao has an overwhelming market share of China's online retail industry. The presence of Taobao is, therefore, by no means insignificant for Japanese companies planning to conduct online sales targeting Chinese consumers.

I Reform of Sales Channels Needed to Tap the Inland China Market

1 Chinese consumer markets spread inland from the coast

(1) Rapid growth in the GDP of the inland regions underpins China's economy

The center of China's economic growth is shifting from the coast to the inland regions. Up to now, growth has been driven by the economies of the coastal cities. While the growth of the GDP (gross domestic product) of the coastal regions such as Beijing, Shanghai, Guangdong Province and Zhejiang Province has been leveling off, the economies of the inland areas such as the Inner Mongolia Autonomous Region, Chongqing and Sichuan Province have recently been growing at an extremely rapid rate, although the GDP of those areas is still relatively small (Figure 1). The growth of the inland cities and provinces is highly dependent on investment in infrastructure such as roads and buildings. In those cities at the level of provincial capitals (metropolitan regions) that function as the core of these infrastructure projects, government officials and workers who benefit from projects to develop such infrastructure are increasing their level of consumption, giving rise to a large domestic demand.

(2) At least 70 percent of future middle-class households will be in inland cities

In China, there is a tendency for households to start considering the purchase of overseas brand goods including

those of Japanese companies when their annual disposable income exceeds 50,000 yuan. Nomura Research Institute (NRI) refers to this segment as "middle-class" households. While such middle-class households have so far been concentrated on the coast, in the future they are expected to rapidly increase in the inland regions. Specifically, by the period between 2010 and 2020, about 100 million middle- and higher-class households will be created in Chinese urban areas, of which 77 percent will emerge in inland cities at the level of provincial capitals as well as in medium- and small-scale cities in the inland regions (Table 1, Figure 2).

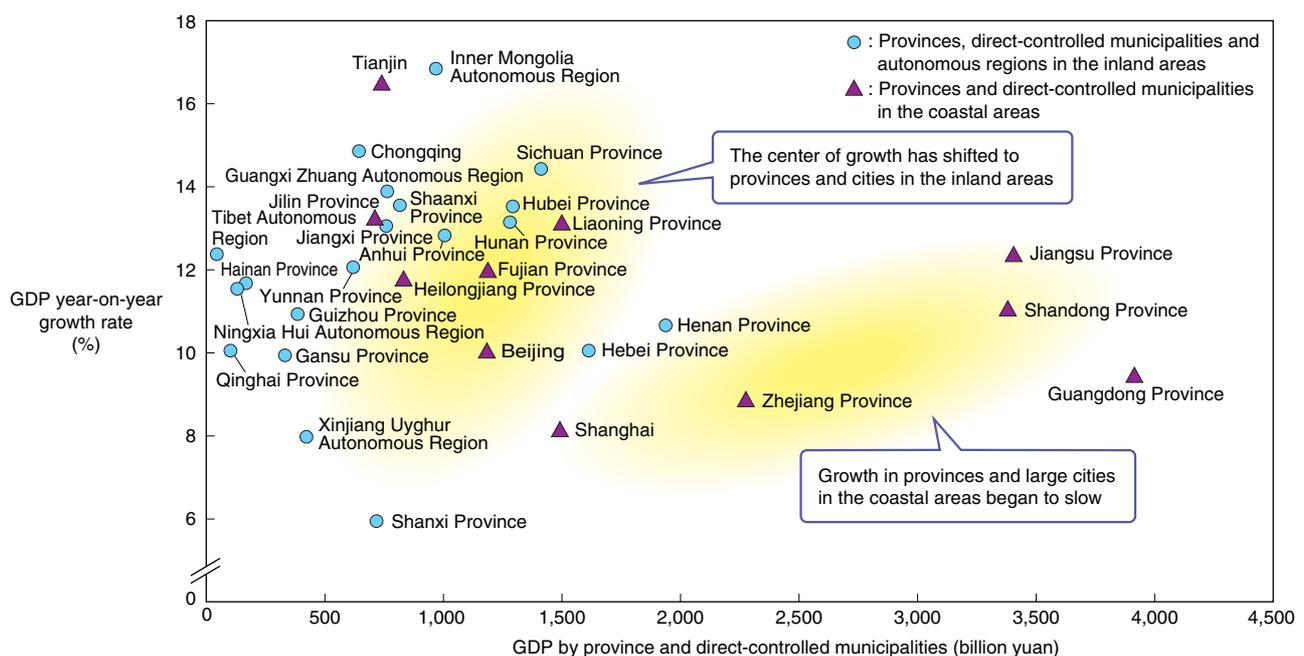
On the other hand, in the coastal cities, growth in the consumer market will sooner or later begin to slow, leading to increased competition between companies. For companies, therefore, it is no exaggeration to say that their success or failure in the Chinese market will depend on how well they can target the middle-class households that are spreading throughout the entire country.

2 Structural reform of sales channels and advanced distributor inventory management

(1) Changing the strategy of relying on nationwide agencies to those focusing on individual areas

To better target the rapidly expanding inland markets, an increasing number of overseas companies, including Japanese manufacturers, have been drastically reforming the structure of agency channels that they have built up to now. The companies that, in the past, relied on agencies that were responsible for the entire country are moving towards a system of agencies that are dedicated to

Figure 1. GDP and its growth rate in provinces, direct-controlled municipalities and autonomous regions in China (2009)



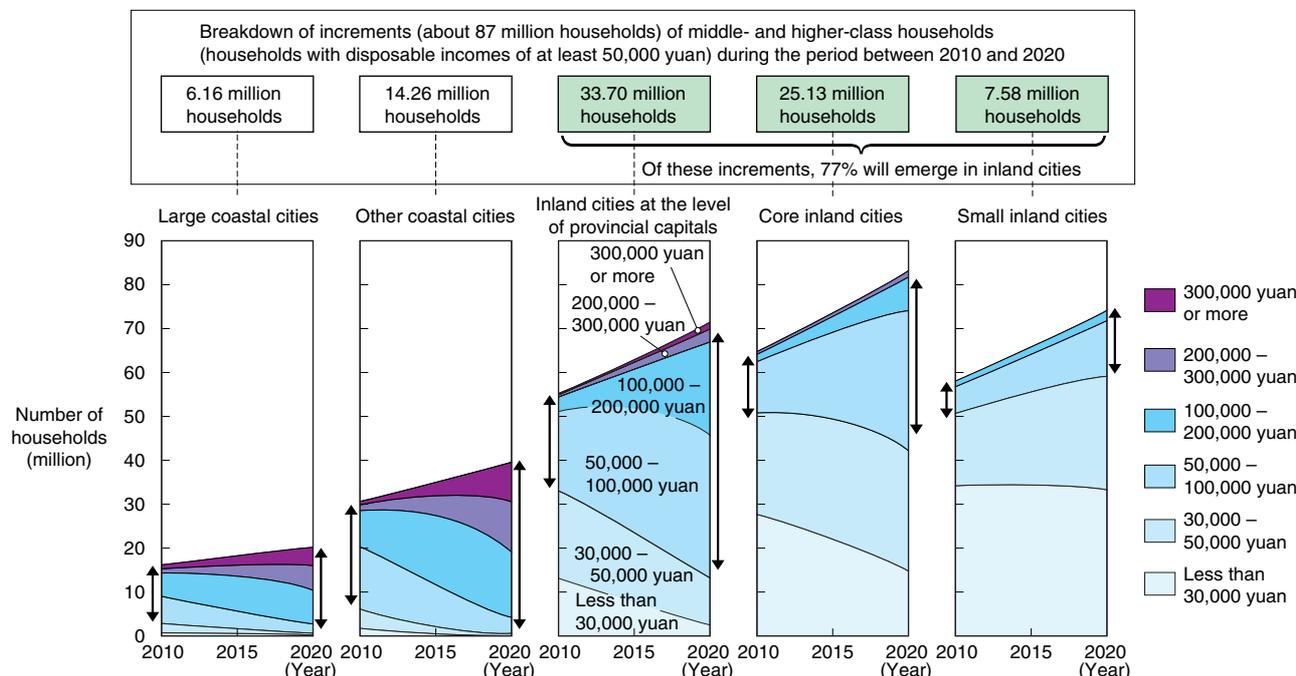
Note: GDP = gross domestic product.
 Source: Compiled based on the "Statistical Yearbook" published by the Statistics Bureau of each province.

Table 1. Five categories of 344 cities in China

	Large coastal cities	Other coastal cities	Inland cities at the level of provincial capitals	Core inland cities	Small inland cities
Representative cities	Beijing, Shanghai, Guangzhou and Shenzhen	Wuxi, Tianjin, Dalian, etc.	Wuhan, Chengdu, Chongqing, etc.	Guiyang, etc.	Xiangfan, etc.
Number of cities	4	26	56	116	142
Geographical distribution	Constituting the core of three major economic zones; located on the coast	Concentrated on the coast	Large cities in Northeast and Midwest parts of China	Core cities in Northeast and Midwest parts of China	Small cities in Northeast and Midwest parts of China
Population in urban areas (million) (Proportion)	43.00 (7%)	80.73 (14%)	143.72 (24%)	171.81 (29%)	156.61 (26%)
Number of households (million)	14.29	28.05	49.47	58.62	53.18
Total population including population in rural areas (million) (Proportion)	54.48 (4%)	118.70 (9%)	245.71 (16%)	388.52 (29%)	513.88 (39%)
Total GDP (billion yuan) (Proportion)	3,169.3 (13%)	5,703.0 (23%)	6,114.4 (25%)	5,961.8 (24%)	4,004.5 (16%)
Per capita GDP (overall average)	About 60,000 yuan	About 50,000 yuan	About 25,000 yuan	About 15,000 yuan	About 8,000 yuan

Note: In China, there are "counties" under the level of cities. While large counties are sometimes treated as cities, counties are not included in the above table. Even within each city, some people are engaged in agriculture. The proportion is calculated by regarding the nationwide value as 100 percent.
 Source: Prepared by Zhang Yi, NRI, based on the China Statistical Yearbook, the China City Statistical Yearbook and the Statistical Yearbook published by each province (2007).

Figure 2. Change in number of households by level of disposable income in China for each city category



Source: Prepared by Zhang Yi, NRI, based on the China Statistical Yearbook, the China City Statistical Yearbook and the Statistical Yearbook published by each province (2007).

individual areas by developing agencies that exclusively handle the inland provinces. A trend is also seen to move away from a single agency that handles the entire country to specialized agencies that deal with particular business categories.

One of the pioneering companies that have reformed their sales channels is the Finnish mobile phone manufacturer, Nokia. Relative to other products, mobile phones were quick to penetrate the inland markets. As a result, mobile phone manufacturers were the first to face

the challenge of developing the sales channels needed to offer their products in the inland markets.

Since Nokia entered the Chinese market in 1996 when Motorola of the US had an overwhelming 65-percent market share (based on revenues), Nokia steadily increased its market share by taking the consistent approach of increasing the number of agencies covering the entire country. In 1999, its share stood at 32 percent, closing in on Motorola's 39-percent share. Since then to 2003, however, both Nokia and Motorola have seen their market shares plummet to the level of 15 percent (Figure 3).

The reason for this decline was that, in 2000, a licensing system was changed to a declaration system for the manufacture and sales of mobile phones in China, leading to domestic Chinese manufacturers entering the market one after the other. By drawing on their ability to develop sales channels to access the rapidly growing inland markets, they were able to instantly expand their market shares. Although Nokia had seven agencies covering the whole country at that time, none of these nationwide agencies had made the necessary investment to expand their sales channels into the inland areas, and instead looked only to the expansion of their shares through price competition in the coastal markets where there was the greatest demand.

Therefore, to avoid competition among its own agencies, Nokia began to make slight changes to the products offered by each of its nationwide agencies. Unfortunately, this approach led to an increase in the number of models, making inventory management difficult. Ultimately, such increases resulted in higher stock levels.

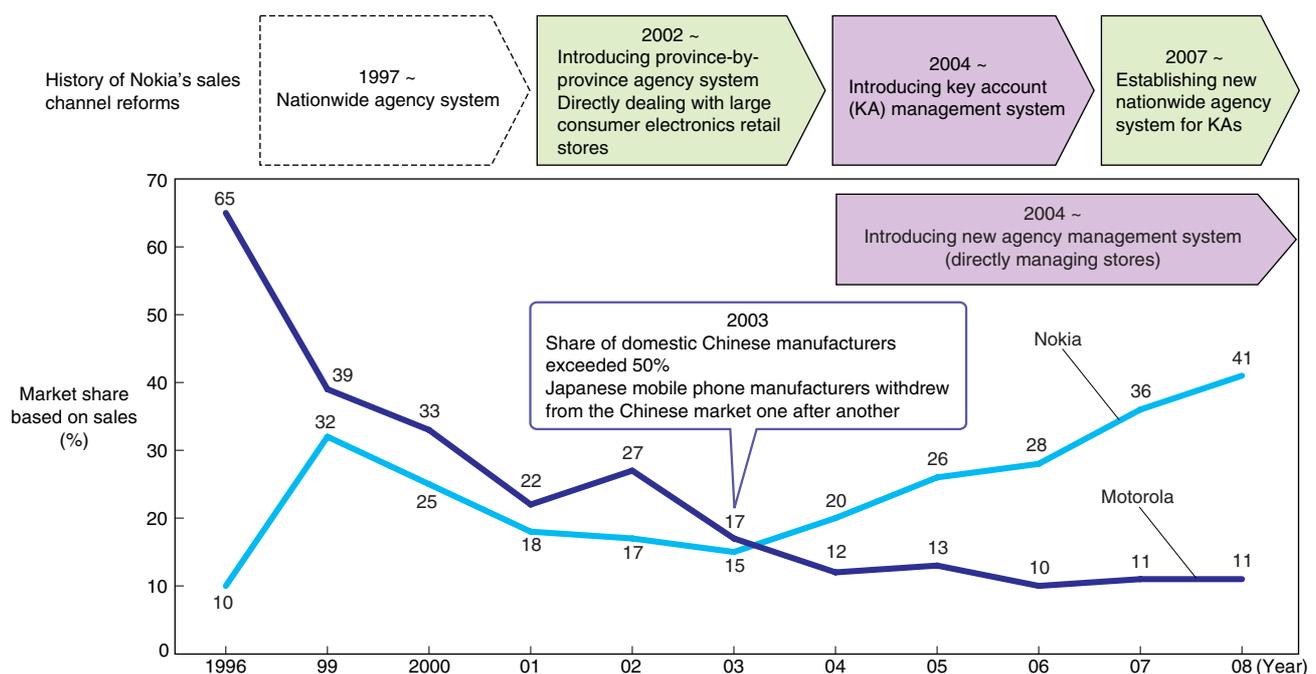
Furthermore, widening the sales areas to include the inland regions fueled an increase in total distributor inventories.

To deal with this situation, in 2002, Nokia undertook structural reform of its existing nationwide agencies. First, the company introduced a province-by-province agency system to accelerate the development of the inland market. As a result, it became possible to introduce newly developed models to all of its provincial agencies. Because there was no overlap of regions, the company could avoid price competition among its own agencies and could reduce the number of models.

Second, the company started to deal directly with large consumer electronics retail stores that had been growing rapidly at that time without making use of its own agencies. At that time, by buying up inland stores one after another, these large consumer electronics retail stores had rapidly grown to a level of forming chains that could purchase a large volume of products and could exercise considerable pressure on the mobile phone manufacturers in negotiating prices. Therefore, it was not possible for individual agencies to successfully negotiate prices for only the product models that they handled. Accordingly, Nokia moved to negotiate directly with these large retail stores collectively for all of its models, thereby enhancing its price negotiating ability. At the same time, the company established sales tie-ups with these large retail stores to strengthen sales in the inland regions.

Third, stores with excellent sales records were designated as "key accounts (KAs)," and the company itself provided sales support to these key accounts, although

Figure 3. Changes in mobile phone market share in China by manufacturer (Nokia and Motorola)



Note: Key accounts (KAs) refer to those stores with excellent sales records.
 Source: Compiled based on interviews with company representatives and other materials.

such support was previously provided by nationwide agencies. Normally, the number of sales promotion staff members was 5,000, rising to 40,000 on national holidays such as China's National Day (Guo Qing Jie). These staff members provided store-based sales support to agencies including those in the inland regions. In addition, to further strengthen support for key accounts and to enable those stores to grow, special agencies that were dedicated to key accounts were established. The management of key accounts was passed from the former agencies to these new agencies. While, not surprisingly, there was resistance to this shift, the company closed some agencies that rested on vested rights and performed only few functions.

These sales channel reforms proved effective. Nokia recovered from its lowest market share of 15 percent in 2003 to an overwhelming share of 41 percent in 2008.

(2) IT system support of management of distributor inventories

In expanding sales areas into the inland regions, the careful management of inventories becomes increasingly important so as to optimize distributor inventories. An enlarged inventory results not only from an increase in the size of a sales territory, but also from the fact that the best-selling products vary depending on the weather conditions that prevail in different locations as well as on cultural differences. Any failure to recognize such differences could result in uneven regional distribution of inventory. Appropriate management of distributor inventory based on market needs in each region is essential. To this end, it is necessary to “visualize” what is selling well and what is in inventory, which is the area where an IT system can make a major contribution. Starting in 2004, Nokia restructured its agency management system to fully visualize stock levels in each store.

Toiletry manufacturer Procter and Gamble (P&G) has installed POS (point of sale) terminals in stores in order to systematically support the sales management efforts of agencies. At the same time, the company skillfully uses these systems to acquire data on stock levels in each of the agencies' stores. In addition, the company strives to gather data that are more accurate by including the accuracy of the data entered into the systems in the indices used to evaluate agencies.

While many Japanese companies lamentably say something like “because accurate data are not available in China, it is difficult to understand the Chinese market,” European and American companies are going one step ahead and making efforts to gather data on their own. These efforts enable them to create competitive advantages.

Since the global financial crisis that followed the collapse of Lehman Brothers in the fall of 2008, Japanese companies have imposed strict credit limits (the upper limit of funds that are not yet recovered for products that were delivered to an agency). As a result, it is no longer

possible for agencies to maintain large inventories in their stores or warehouses, which was usual in the past. At the same time, companies must use data more effectively so that only the products that sell well are offered at stores from among the small inventories carried by the agencies. Failure to do so could result in poor sales, leading to a situation where the company has to buy back the unsold inventory that agencies have when they launch a new model. Faced with both the growth of the inland markets and the squeezing of agency credit as necessitated by the global financial crisis, the visualization of store inventories and advanced distributor inventory management constitute issues that must be urgently addressed by Japanese retail companies operating in China.

3 Strategic use of online sales

For those Japanese companies that are not yet ready to increase the number of stores or agencies to tap the growing inland markets, “online sales” offers the promise of becoming an extremely useful tool. However, within the current Chinese market, online sales should be seen as being little more than a supplementary sales channel for “bricks and mortar” stores. Accordingly, when planning to move into the inland markets, the reform of agency sales channels as described in Section 2 is the first thing that must be done. It must be noted that the range of products that can be successfully sold only through online sales is considerably limited.

A company that has made effective use of online sales to move into the inland markets is Fast Retailing (Uniqlo). Uniqlo first opened a store in Shanghai in 2002, and went on to concentrate its efforts on the coastal regions. While the company had opened more than 30 stores on the coast by April 2009, it had no stores in the inland regions. To help overcome this shortfall, in April 2009, the company launched two shopping sites—a shop in the Taobao Mall, which is China's largest online shopping site, and a site directly operated by the company.

According to a report published by Taobao, which operates the Taobao Mall, Uniqlo recorded 3,000 transactions in its first 11 days of operation, accounting for sales of 300,000 yuan. In October 2009, Uniqlo became the first apparel company in the Taobao Mall to exceed 10 million yuan in monthly sales, a feat that received considerable coverage in China's media such as Internet news.

Two-thirds of Uniqlo's online sales come from areas where there are no “bricks and mortar” stores, clearly showing the effectiveness of online sales in the inland markets. Even if putting aside the fact that selling Uniqlo products in its mall serves as a good advertisement for Taobao, it is unquestionable that for those companies that have already established a foothold in the coastal regions such as Uniqlo, online sales are a highly effective means of moving into the inland markets.

Uniqlo has chosen not to largely discount its online prices as compared to the prices in its stores. Nevertheless, online sales have been growing. This is because Uniqlo was successful in attracting consumers who are not near a Uniqlo store such as those who live in the inland regions as well as those who do live close to its stores but are just too busy to shop there.

Sony, in the same way as it does in Japan, is offering its products through online sales in China. In the face of fierce price competition provoked by large consumer electronics retail stores, Sony has adopted a sales policy that is feasible only with the use of the Internet. Specifically, the company sells its highly popular “VAIO” laptop computers that are customized to individual specifications, and offers an engraving service whereby consumers can apply online to have a message engraved above the screen of their computers. Rather than aiming at volume sales, Sony is using the Internet as a powerful means of maintaining and expanding its fan base, which is located throughout China including the inland regions.

Sony has proven to be successful in using the information that the company gathered through its online sales to produce sales projections for the entire Chinese market. By taking online orders for new products before the launch of these products, preferences that are difficult to project such as color and design can be more accurately determined, and such information is reflected in the production plan.

Because there is a wide variation in consumer preferences throughout China, as mentioned in Section 2, making incorrect sales projections can lead to a company being saddled with large amounts of unsold inventory. Japanese companies, as exemplified by Sony, attempt to differentiate themselves from those Chinese companies that aim to increase their market share by selling low-priced, single-model commodities by offering a greater variety of commodities (products) with different features such as color and design. To successfully implement these strategies, sales projections become increasingly important. Color presents a particularly difficult challenge. Regardless of how many times market research is conducted before a product goes on sale, it is almost impossible to improve prediction accuracy above a certain level because the persons responding to the survey are not real consumers.

Through online sales, Sony is able to take advance orders before actually putting a product on the market, create highly accurate sales projections and then reflect such projections in the production plan. This approach represents a strategic use of online sales in which Sony’s experience and expertise in offering online sales in Japan were effectively utilized.

On the other hand, Sharp was successful in improving its brand image in the Chinese market by offering a limited number of mobile phones with special designs on the Internet. Intended for launch on Valentine’s Day in

February 2010, Sharp manufactured a mobile phone with a jeweled heart in cooperation with Swarovski, a major Austrian jewelry company. This special product was publicized on Sharp’s website, with advertising also based on actual units on display in showcases in four locations in Shanghai. Because the company provided prior notice that “only a limited number of units are available and only online,” the rarity became a major talking point in the Internet community. The result was that basically the entire stock had been sold on the release date despite some agencies asking 1,000 yuan more than the suggested retail price.

Through this activity, Sharp succeeded in creating an image of a fashionable, high-grade brand among Internet users in China. Usually, for sales promotion, a company rents event space in a department store and dispatches sales promotion staff members, which incurs considerable expense. However, by making good use of the Internet, Sharp achieved excellent sales promotion on a very limited budget. This is a good example of the optimum use of online sales as part of a company’s branding strategy.

II Rapidly Expanding China’s Online Shopping Market

1 China has the world’s largest population of Internet users (420 million)

According to the Statistical Report on Internet Development in China published by the China Internet Network Information Center (CNNIC), the number of Internet users in China stood at 420 million as of the end of June 2010, overtaking the United States and making China’s population of Internet users the largest in the world (Table 2). In 2009, China’s online population increased by 21 percent over 2008, with more than 86 million extra people going online in a single year. This number almost equals the 94.08 million users in all of Japan (according to the “Communications Usage Trend Survey” conducted by the Ministry of Internal Affairs and Communications at the end of March 2010.)

Nevertheless, the percentage of the total Chinese population who are Internet users is only 32 percent (as of the end of June 2010), meaning that there remains considerable room for growth when this figure is compared with 78 percent in Japan (as of the end of March 2010; Ministry of Internal Affairs and Communications) and 77 percent in the United States (as of the end of 2009; Internet World Stats). This rate of penetration corresponds to Japan’s situation around 2000. Since then, Internet-based businesses such as Rakuten, one of Japan’s largest online shopping malls, have grown considerably. It should also be pointed out that the proportion of Internet users in urban areas in China is 44.6 percent, which is very different from 15 percent in rural

Table 2. Characteristics of Internet users in China (as of the end of June 2010)

Item	Current situation in China	Suggestions for companies regarding online sales
Total number of Internet users	420 million (year-on-year increase of 21%)	<ul style="list-style-type: none"> World's largest population of Internet users; such population is still growing with an annual increase of 86 million 360 million fixed-line broadband Internet users and 270 million mobile Internet users (there is an overlap in users of both types)
Penetration rate	32%	<ul style="list-style-type: none"> Compared to 78% in Japan and 77% in the US, future increase is highly likely 44.6% in urban areas and 15.0% in rural areas (as of December 2009)
Availability of broadband networks	90%	<ul style="list-style-type: none"> Possible to use video, music, game and rich communications Average weekly connection time is 19.8 hours (connection time has been increasing year by year)
Percentage of female users	45% (20% ten years ago)	<ul style="list-style-type: none"> The number of female users—the major target of online sales—has been increasing Increased purchasing of sundries, apparel, cosmetics, powdered milk, etc.
Age distribution	Teens or younger: 31% Twenties: 28% Thirties: 23%	<ul style="list-style-type: none"> The SNS and game generation, who were born in the 1980s, constitutes the majority of users The percentage of users in their thirties is increasing (from 17% at the end of 2008 to 23%)
Occupation	Students: 31% White-collar workers: 37%	<ul style="list-style-type: none"> The percentage of students is high, but is decreasing (from 33% at the end of 2008 to 31%) The percentage of white-collar workers with steady income is high
Monthly income	500 yuan or less: 29% 3,000 yuan or more: 15%	<ul style="list-style-type: none"> The percentage of people with a monthly income of 3,000 yuan or more is growing (13% at the end of 2008) 63 million users (420 million × 15%) are earning a monthly income of 3,000 yuan or more

Notes: SNS = social networking service.

Source: Compiled based on a survey conducted by the China Internet Network Information Center (CNNIC).

areas. Accordingly, the Internet is a very attractive means of approaching the rapidly growing middle-class consumer segment in inland urban areas.

2 Most users are in their 20s and 30s, with female users constituting nearly half

When we look at the age distribution of Internet users in China in the report published by the China Internet Network Information Center, we find that 31 percent are in their teens or younger, 28 percent are in their twenties, and 23 percent are in their thirties, which indicates that the overwhelming majority of Chinese Internet users are young people. Those in their late twenties and thirties who are employed and are receiving an income are thought to be the main target for online sales. Over the last few years, the ratio of users in their teens and twenties, most of whom are students, has come to constitute a smaller proportion of users, while those in their thirties have gradually been making up an increasingly greater proportion. This trend can be seen as good news for those companies planning to move into online sales.

Female users now constitute 45 percent of all Chinese Internet users. When we consider that the figure was only 20 percent in the survey conducted ten years ago, we can assume that the increase in the number of female users is a major factor in the rapid expansion of the online shopping market over the last few years. According to the survey of Taobao's top-selling items, which was undertaken by China's research company, iResearch, the top sellers in 2006 were commodities aimed primarily at men such as mobile phones, laptop comput-

ers and digital cameras. By the first half of 2009, however, the top sellers had been replaced by goods that are aimed at women, such as sundries, apparel and cosmetics (Table 3).

3 Among all Internet users in China, 28 percent have online shopping experience

According to the results of the survey conducted by iResearch, as of the end of 2009, 110 million people had made at least one online purchase within the past six months, accounting for slightly more than 28 percent of all Internet users in China (Figure 4). Compared to 70 percent in the US, 57 percent in South Korea and 54 percent in Japan (according to the 2009 report of the Asia Pacific Internet Research Alliance (APIRA)), the ratio of Chinese users using the Internet for shopping is still relatively low.

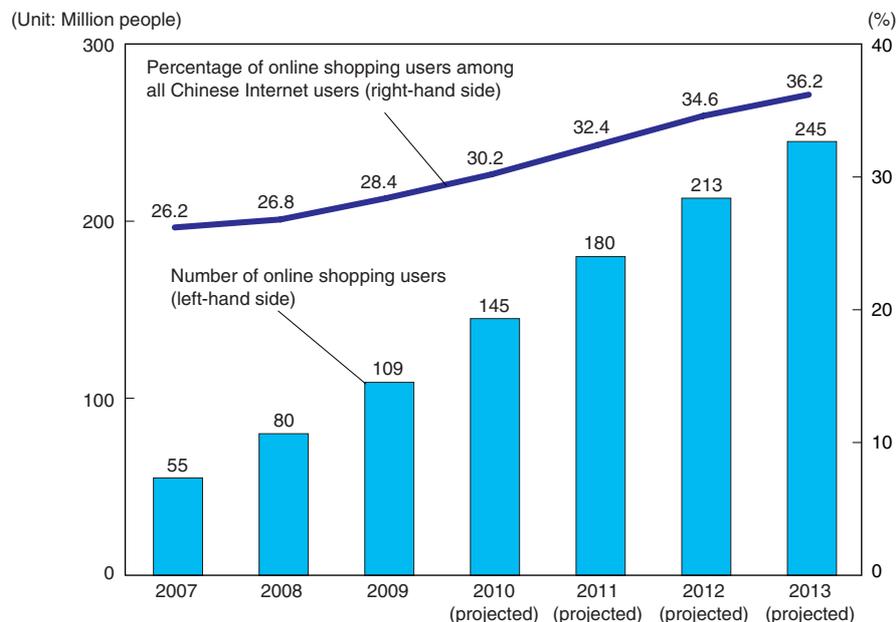
On the other hand, according to the survey conducted by the China Internet Network Information Center in September 2009, 86 percent of all Internet users have " browsed for a product online within the last six months," although only 26 percent ultimately made a purchase. Of those users who did not purchase online, 45 percent stated "there is no such custom." This reason does not imply patent refusal.

In the future, with the development of service infrastructure for payment and distribution systems, and provided that consumers can be sufficiently educated about online shopping to the point where they can trust it, it is considered that online retailing will grow tremendously in China. The forecast of iResearch points to the ratio of

Table 3. Change in ten top-selling items in the Taobao Mall (2006 – first half of 2009)

Rank	2006	2007	2008	2009 (1st half)
1	Mobile phones	Apparel	Apparel	Sundries
2	Laptops	Mobile phones	Mobile phones	Apparel
3	Apparel	Cosmetics	Cosmetics	Mobile phones
4	Cosmetics	Sundries	Sundries	Cosmetics
5	Digital cameras	Home appliances	Sporting goods	Sporting goods
6	Health food	Prepaid cards for mobile phones	PCs and peripheral devices	Jewelry
7	PCs and peripheral devices	Digital cameras	Jewelry	Books, music
8	Sundries	PCs and peripheral devices	Laptops	Laptops
9	Groceries	Laptops	Small home appliances	Small home appliances
10	Prepaid cards for mobile phones	Health food	Prepaid cards for mobile phones	Digital cameras

Note: Shaded items are product categories aimed at women.
Source: Compiled based on data published by iResearch.

Figure 4. Changes and projected increases in the number of Internet shopping users in China

Source: The “number of Internet users who used online shopping in the last six months” estimated and projected by iResearch (these figures represent the total number of users who were engaged in B2C (business-to-consumer) and C2C (consumer-to-consumer) transactions; B2B (business-to-business) transactions are not included).

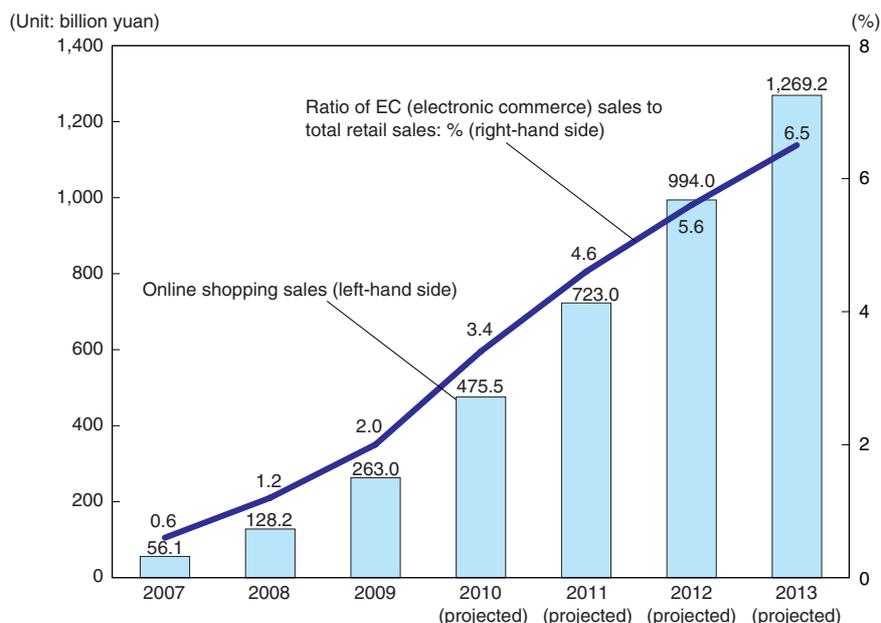
Internet users using online sales rising to 36 percent by 2013, that is, around 250 million users.

4 The size of the online shopping market reached 263 billion yuan in 2009

In 2009, the size of the Chinese online shopping market reached 263 billion yuan (Figure 5). This amount corresponds to 2.1 percent of China’s total retail sales of consumer goods, worth 12.5343 trillion yuan, in the same year (according to data published by the National Bureau of Statistics of China). In Japan, the ratio of online sales to all retail sales is 1.5 percent, while that in the US is 3.1 percent (both figures are as of 2007).

Accordingly, the 2009 Chinese ratio is by no means inferior (the 2007 ratio was 0.6 percent).

As the above comparisons suggest, China is similar to the United States in that it has a vast land area and is unlike Japan where bricks and mortar stores can be found densely packed together. Accordingly, we can assume that China has a greater social need for online shopping than Japan does. Furthermore, in China, it is common for both a husband and a wife to be working, and relatively few people own cars (as of the end of 2008, car ownership in China stood at about 4 percent, while it is 60 percent in Japan and 80 percent in the US)—another reason for there being a major potential need for online shopping. According to the forecast

Figure 5. Changes and projected increases in the size of the online shopping market in China

Source: The above figures are estimates and projections made by iResearch; the "Total Retail Sales of Consumer Goods" published by the National Bureau of Statistics of China are used (these figures are the total of B2C and C2C sales; B2B sales are not included).

made by iResearch, by 2013, the size of the online shopping market will reach 1.3 trillion yuan, about a five-fold increase over the 2009 figure.

Compared with Japan, Europe and the US, China still has some catching up to do regarding the proportion of people who use the Internet for shopping. Nevertheless, online sales constitute basically the same ratio of all retail sales. In view of this fact, we consider that current online shoppers are relatively big spenders and heavy online sales users who have a large income and high purchase frequencies.

5 A majority of the current online shopping market involves transactions between individuals

It is significant to point out that most of the online shopping market referred to in Section 4 involves C2C (consumer to consumer) transactions, i.e., selling and buying between individuals. According to estimates for 2009, C2C transactions accounted for about 87 percent of the entire online shopping market. In the Chinese C2C market, there are only few cases in which used goods are sold, such as occurs in Japanese online auction sites. Instead, the majority of sales involves small business owners selling new merchandise. Manufacturers' agencies have also conducted sales activities in this C2C market.

In other words, there are still few cases in which companies such as manufacturers systematically use the Internet for sales, accounting for only about 13 percent of the entire online sales market. With an increasing number of companies engaged in online sales, it is expected that the B2C (business to consumer) market

will grow at a faster pace. In 2008, Taobao launched its Taobao Mall (mentioned in Chapter I) where only companies' brand products are sold. Because it is difficult to collect taxes from C2C transactions, the Chinese government has also started to take measures to promote B2C transactions by companies.

III Trends in the Online Sales Industry in China

1 Alibaba Group's Taobao boasts predominant position

When talking about the online sales market in China, it is impossible not to mention Taobao of the Alibaba Group. The survey conducted by iResearch revealed that Taobao had a 92 percent share of the C2C market in 2009, while Taobao Mall had 37 percent of the B2C market, both top-ranking positions in their respective markets.

Alibaba Group, which is led by Jack Ma, chairman and CEO, is a conglomerate that operates an electronic commerce (EC) business in China. Alibaba.com, one of the group's affiliates, is the world's largest business-to-business (B2B) site in terms of monthly page views (PV) with a market capitalization of \$12.2 billion (listed on the Hong Kong Stock Exchange) as of the end of 2009, already surpassing that of Japan's Rakuten (\$9.7 billion). Alipay, another affiliate that offers online payment services (service details will be explained in NRI Paper No. 164), has an overwhelming 25.5 percent share of China's online sales settlement business (as of the end of 2008).

Taobao, also owned by Alibaba Group and enjoying the greatest share of the C2C market, offers a platform for individuals and agencies to sell goods online, as described in Chapter II. According to material published by the company, as of the end of 2009, there were 170 million users, more than 2 million stores that offer goods on the site, and around 400 million items for sale. With a monthly turnover of around ¥250 billion, the mall represents a huge trading market. Although this site appears to be similar to Japan's Rakuten Ichiba, one of the largest online shopping malls in Japan, it neither charges fees to open a store on the mall nor takes sales commissions. Instead, it relies on a mechanism whereby revenue is generated by advertising and Alipay, a group company.

Tencent's Paipai ranked second in terms of market share. Tencent offers "QQ" instant messaging service (about 1 billion domestic and foreign registered users; recorded over 100 million users simultaneously online, which was first worldwide). With its massive user base, Tencent is attempting to minimize the differences between Paipai and Taobao. Just like Taobao, third-ranked Eachnet, which was acquired by eBay, does not charge a fee for opening a store on its site. However, even with the global brand power of eBay, the company has to fight hard to compete with Taobao.

Softbank of Japan has a stake of about 30 percent in the Alibaba Group, with President and CEO Masayoshi Son being one of the directors of the Alibaba Group. Because of such capital ties, since June 2010, the information system of Yahoo! Japan Shopping has been connected to that of Taobao. Taobao users can now purchase products offered by Yahoo! Japan Shopping through the site that was translated into Chinese. Similarly, Japanese users of Yahoo! Japan Shopping can browse through the products offered on the Taobao site that was translated into Japanese.

As of the end of 2010, online sales overseas still face several problems such as the time required for delivery,

limited payment methods and customs clearance issues. Nevertheless, online sales are expected to spread throughout all of Asia. As a pioneering case, the future movement of this tie-up between China's Taobao and Yahoo Japan promises to be interesting.

2 Launching the Taobao Mall for large companies

Despite having an overwhelming market share, Taobao had a major concern. Because Taobao adopted the C2C business model in which neither fees for opening stores nor sales commissions are charged, the company's income was not stable. Furthermore, the ease of opening and closing stores has resulted in providing an avenue for sellers of counterfeit goods. This situation has made it difficult for major enterprises to select Taobao as a sales channel.

To resolve this issue, in 2008, Taobao established its Taobao Mall, a B2C shopping mall, where only genuine brand goods are offered. On this site, stores can only be opened by manufacturers and agencies that are licensed by the manufacturer. Although there is no fixed fee for opening a store, a commission of 2 percent to 5 percent of sales is collected, as well as another 0.5 percent of sales to finance a point program for purchasers of goods from the mall (Table 4).

Chief Financial Officer Zhang Yong, who is responsible for the site, visits the top executives of companies that he wants to participate in the site and encourages them to use the services offered by the Taobao Mall. Currently, participating manufacturers include Uniqlo (apparel), Lenovo (PCs), Levi Strauss (apparel) and Jack & Jones (apparel). A massive Taobao user base of around 170 million people (as of the end of 2009) is guided to browse through the stores on the site, giving successive rise to stores with monthly sales of one million yuan or more.

Table 4. Fees required to open a store on Taobao Mall, online shopping mall, in China

Conditions	Description
Sales commissions: 0.5 – 5 % of sales (no fixed fee for opening a store)	<ul style="list-style-type: none"> Percentage differs by product category <ol style="list-style-type: none"> (1) Apparel, accessories, outdoor goods, furniture and baby goods: 5% (2) Cosmetics: 4% (3) IT-related products such as PCs, stationery, groceries, consumer electronics, jewelry, books and music CDs: 2% (4) Prepaid cards for mobile phones: 0.5% Deposit of 5,000 – 15,000 yuan is necessary when opening a store About 1% reduction in sales commissions is given when the annual minimum sales target is set. If the participating company fails to achieve this target, it must pay sales commissions for that target
Contribution to a point program: 0.5% of sales	<ul style="list-style-type: none"> A uniform rate of 0.5% is applied for all products (all amounts collected are returned to purchasers) to finance a point program for promoting sales and improving customer loyalty
Settlement fees	<ul style="list-style-type: none"> When Alibaba Group's payment service (Alipay) is used, settlement fees are included in the above sales commissions When other payment services (credit cards, cash on delivery, etc.) are used, settlement fees are charged separately

Note: Each participating company is responsible for website maintenance, responding to inquiries, order management, shipping orders, logistics costs and management of returned goods (subject to a seven-day cooling-off period).

Source: Compiled based on interviews with Taobao representatives.

According to the data published by the Taobao Mall, as of the end of 2009, about 10,000 companies had opened stores on the site, and monthly sales reached 18.9 billion yuan. For Japanese companies that have not yet built brand power that is strong enough to attract a considerable number of users even if they have set up their own shopping sites in China, the use of an online mall such as the Taobao Mall is very effective.

3 Comparing the Taobao Mall model with the Amazon model

The business model adopted by major Chinese B2C sites is not the one that offers a shopping mall such as Taobao Mall, but is one that resembles that of Amazon.com, which is a retail site where both stocking and sales are performed.

In the US where online selling is very advanced, Amazon, which is an online retailer and has its own distribution functions, is surpassing eBay, which is an online auction site, in terms of stock prices. The reason for this difference is that Amazon has once again been on the right track toward achieving growth by launching new services. These include outsourcing services, in which Amazon offers its online sales functions including logistics/distribution centers and call centers to other retailers, and cloud computing services, in which surplus computer resources are offered. Naturally, Chinese businesses are very interested in these developments in the US. Recently, there has been an increase in the number of online retailers in China that are pursuing this Amazon model.

A classic example of a company that pursues this Amazon model is 360buy Jingdong Mall (360buy.com), which ranked second in 2008 in terms of B2C market share. This company is an online retailer that sells consumer electronics, mobile phones, digital cameras, etc. at prices that are around 10 percent cheaper than bricks and mortar stores. In 2009, its sales were around 4 billion yuan, about a three-fold increase over its 2008 sales of 1.4 billion yuan. In April 2009, the company established a logistics subsidiary in Shanghai and began developing three logistics system platforms and nationwide distribution centers. This means that the company has begun to steer its way towards the Amazon model.

One of the reasons behind the establishment of its own logistics centers is the poor level of small-lot delivery services currently offered in China. Small, high-value goods such as digital cameras and mobile phones are often stolen in the process of being delivered to the destination. Because this reflects badly on delivery companies, most of these companies are unwilling to handle such goods. To gain a good reputation for customer service, 360buy.com needed to build its own high-quality delivery service without relying on third-party distribution systems.

Another reason for establishing its own logistics centers is that because price competition in the area of information home appliances such as mobile phones and digital cameras is so fierce, the margin on these products is very slim. Therefore, unless a company expands the areas in which it offers its services, it is unlikely to generate any profit. In addition, to differentiate itself from top-ranked Taobao and other online shopping sites and to attract many investors and proficient employees, the company had to pursue an original business model. Starting in 2010, 360buy.com has been increasing the number of product categories that it handles in addition to consumer electronics. The company is aiming to become like Amazon with its initially offered products being consumer electronics rather than books.

For Japanese electrical manufacturers, B2C sites such as 360buy.com can be positioned as large consumer electronics retail stores on the Internet. For them, it is not desirable that these online sales sites grow to have too much power, although depending on what business conditions are applied. Furthermore, because consumers can very easily compare the prices of goods in each product category, such ease of comparison puts considerable pressure on manufacturers.

4 Considerable funding is poured into the industry, expanding management scale

Massive funding is required for online sales companies such as 360buy.com to develop a distribution infrastructure and information systems. Furthermore, online shopping sites incur huge promotion costs to improve their initial visibility and rating. As one might expect, given the high growth rate of the online sales industry, funds are flooding in from both domestic and overseas sources.

In 2008, venture capital investment amounting to \$21 million was injected into 360buy.com. In 2010, Tiger Global Management of the US invested \$150 million into the company. In 2008, Sequoia Capital of the US invested \$80 million in M18.com, the fifth-ranked B2C site in terms of market share (the company name is Mecox Lane, which markets mainly women's apparel and also conducts a mail order business), making Sequoia the largest shareholder.

With this inflow of capital from and management guidance and supervision by American venture capital firms, the corporate governance of online sales companies will improve, promoting the standardization of rules for the entire industry in China. A further benefit is that consumer trust in the industry will also increase. This healthy development of China's online retail industry is good news for any Japanese companies thinking of utilizing such sales channels.

As described thus far in this paper, the Chinese consumer market is rapidly spreading inland from the coastal regions. In response to this trend, enterprises

must speed up the expansion of their sales channels to the inland regions. To this end, Japanese companies should place greater emphasis on the strategic use of online sales. The size of the Chinese online shopping market is already equal to that of Japan, and is projected to expand rapidly in the future.

Furthermore, online sales can lead not only to increased sales, but also to the ability to project future demand, which enables companies to optimize distributor inventories. It is also possible to develop brands aimed at young people within the Internet community. These various kinds of effects of online sales have already been proved in existing online shopping sites.

In NRI Paper No. 163, we will describe the challenges, such as the laws and regulations applicable to this business and operation systems in China, that Japanese companies are expected to face when moving into

and operating in the Chinese online sales market as well as the details of how best to address such challenges.

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