ADVISOR PERSPECTIVES

The Rise of E-Commerce in Asia

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It's no surprise that Asia—home to two of the world's most populous countries—holds great potential for e-commerce. Much of this growth has been driven by the fact that e-commerce, particularly in India and China, has helped serve as a bridge between what people want and what people can get offline. This is especially true for those who live outside major urban areas.

Consumers have historically been drawn to e-commerce for more competitive price points, but increasingly, other factors, such as wider selection and ease of use on mobile platforms, have attracted a new wave of online consumers. The explosion of e-commerce in Asia provides opportunities for businesses that can cater to local tastes. However, along the way, these companies will need to overcome challenges such as logistics and payment services to ensure their long-term survival in this competitive arena.

In 2012, global e-commerce sales surpassed US$1 trillion dollars, with the U.S. taking the biggest share of this fast-growing segment. Although global e-commerce sales continue to grow at a healthy pace, Asia's growth eclipses that of the rest of the world. Asia's largest market, China, officially overtook the U.S. in 2013 as the world's biggest e-commerce market, raking in a total of US$200 billion in sales.

China's e-commerce market has been growing at a pace of more than 70% annually since 2009 and is expected to reach approximately US$530 billion in 2015. Some estimates show that by 2020, it may be as large as that of the U.S., Japan, U.K., Germany and France combined.

Two years ago, China's e-commerce market already accounted for more than 5% of the country's overall retail sales, edging out the U.S. Growth of the Chinese market has also been facilitated by factors such as high levels of Internet penetration, rising broadband access and growing consumption demand coming from a burgeoning middle class population. In India—the world's second most populous consumer market—e-commerce is still in its early stages. With the proliferation of low-cost smartphones, India's online consumer base of 20 million shoppers is expected to grow to 300 million over the next decade. Companies are seeing strong demand from areas outside major cities where many people are accessing the Internet for the first time through mobile devices. In India, many companies see half of their transactions done on mobile platforms, and over half of the mobile users are first-time users.

Not a One Size Fits All Model

Due to differences in Internet penetration, competitive landscapes, levels of affluence and consumer preferences, there are obviously variations to each of Asia's e-commerce markets. Different business models have evolved throughout the region, and the growth trajectory for e-commerce development appears strong.

Online consumer-to-consumer "marketplace" sites, akin to eBay, have made up a significant 70% share of China's market. For most other countries, such platforms compose just a single-digit share of e-commerce. In the U.S., business-to-consumer sites are most dominant, and marketplace portals two years ago held just 24% of the market share.

Japan's e-commerce businesses were started in the late 1990s. They have served as platforms for small and medium enterprises to sell their goods online. During the past 15 years, Japan's leading e-commerce players have expanded to areas such as travel, credit, banking and securities. They employ sophisticated information technology, analyzing user-specific data to make individual recommendations for target marketing, and attract customers with successful loyalty programs.

However, the marketplace format has worked less effectively in other parts of Asia due to differences in consumer behavior. In Korea, for example, local companies have had more success providing focused and curated items on a business-to-consumer platform. Local companies have pushed to take on more inventories and sped up delivery times, transitioning to an Amazon-type model and away from the Groupon-type model that they were initially established upon. The fact that major Korean cities have high population density helps to enable fast and cheap delivery costs, which further encourages a strong population of online shoppers.

Challenges

There are significant hurdles to overcome, particularly for companies operating in less mature e-commerce markets whose rapid growth rates have put significant strain on the under-developed infrastructure network. There is a dearth of quality warehouses, particularly in lower-tier cities where the demand is strongest. In China, for example, over 70% of warehouses were built before the 1990s and fewer than 2% of those meet international standards. Last-mile delivery coverage is also lacking in smaller cities or rural areas. Retailers often need to rely upon a fragmented network of multiple, small-scale, third-party logistics providers. An online order can be handled by a number of such providers, increasing the chances of mishandled packages, resulting in poor and inconsistent quality of service.

The November holiday known as Single's Day is the largest online sales event in China. Last year, it generated close to US$6 billion in 24 hours, besting records in the U.S. for Black Friday and Cyber Monday combined. Single's Day alone resulted in 180 million parcels for transport with 60 million of them sent out on the same day. The total number of parcels during the week of Single's Day exceeded 300 million. Logistics companies had to set up new sorting centers and had over 1 million workers process the parcels. To address such a shortcoming, many e-commerce companies have been building their own logistics networks from the ground up—a costly and time-consuming procedure. This asset-heavy model can substantially impact profits. But companies see this gap in infrastructure development as an opportunity to create competitive advantages against local and global entrants.

Constraints in payments also continue to pose an obstacle for Asia's developing economies. India, for instance, remains predominantly a cash-based economy because of low banking and credit card penetration. Most consumers simply cannot pay for their goods online. Those just becoming familiar with the concept of online shopping are suspicious of the model. To resolve this issue, Indian e-commerce vendors have offered cash collection on delivery (COD) options for orders, used in over two-thirds of online transactions.

On the surface, COD solves challenges related to developing e-commerce in a mostly cash-based society. But COD adds other layers of complexity in running an e-commerce business. Vendors need to pay up front for goods but do not collect cash until goods are delivered, putting pressure on cash flow as they grow rapidly. Vendors then need to take on the difficult task of tracking cash handled by multiple local logistics providers.

In India, the process of increasing banking penetration is painstakingly slow; so firms have been pushing efforts for alternative payment mechanisms. Mobile-based money transfer services seem a likely option given India's high mobile penetration rate, but development in this area has also been slow. As consumers gain more comfort in online shopping and as alternative payment channels become more developed, COD as a percentage of total transactions should decline.

Staying Competitive

In South Korea, the world's most wired country, time-pressed commuters can take advantage of "virtual grocery stores" in some subways and bus stops. Shoppers use a smartphone app to scan barcodes on products that are displayed virtually, their accounts are charged and the deliveries are sent home. This futuristic retail model is one unique response to rising competition from many emerging e-commerce firms. Brick-and-mortar shops throughout much of Asia are increasingly seeking ways to stay competitive as the growth of e-commerce is making meaningful changes to consumer behavior.

Like Korea's virtual subway grocer, many offline retailers in China have seen noticeable disruption to their businesses given the emerging popularity of e-commerce. Chinese consumers remain largely price sensitive and have embraced the virtual shopping experience since online savings have been meaningful for their web-related purchases. On top of pricing competition, many traditional retailers are struggling to stay competitive as they battle rising rents and staffing expenses. To lure online bargain hunters to shop in person, department stores in China, for instance, are trying to build bigger retail formats, including facilities such as movie theatres and food courts in the typical mall style. The idea is to create a one-stop shopping environment that would draw customers by offering additional entertainment outlets.

Japan's notable convenience stores are taking advantage of their extensive physical networks by utilizing brick-and-mortar shops as pickup points for items purchased online. They also increase the number of web-only offerings to complement products at their physical stores. For example, online shoppers can find 150 different varieties of rice from regions across Japan available online.

E-commerce may be challenging traditional retailers and its impact to retailers can be negative. On the other hand however, studies have found that online transactions have the ability to generate incremental consumption. To extrapolate from China's case, a McKinsey study found that cities with higher e-commerce penetration tend to also have higher overall consumption. In addition, the study found that online shoppers in smaller and less affluent cities tend to spend the same amount online as their peers in wealthier cities. The e-commerce phenomenon could also debunk the notion that consumer sentiment is weakening in China, given lower retail sales growth. This is because the value of online retail sales is typically not captured in traditional measures for retail sales and hence this metric may underestimate total retail sales demand in the country.

Online sales may also encourage the growth of peripheral industries, such as logistical and technology services involving payment solutions and online advertising. Ecosystems built around e-commerce seem likely to develop in Asia and should contribute to further economic growth.

To capture growing retail opportunities, many of Asia's e-commerce firms started out with business models similar to those in the U.S. However, local e-commerce players have demonstrated the ability to localize their business models to adapt to local preferences. This may explain, to a large degree, why local players tend to have stronger track records than their foreign venture peers. E-commerce companies in more mature markets tend to grow more slowly, but incur less capital expenditure due to already existing infrastructure. Investors may be interested to know that several of them pay dividends and the dividend growth rates have been attractive given that e-commerce continues to enjoy secular growth in Asia's markets. For growth-oriented investors, many e-commerce companies in Asia's developing countries are experiencing rapid growth. Their cash flow is less ideal given that their corresponding markets are still young. Many are tapping public markets to raise the funds to build out their brand and infrastructure. Regardless of the companies, at Matthews Asia, we continue to focus on quality management teams that can adapt and modify their business models amid an ever-shifting industry landscape.

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As of June 17, 2014, accounts managed by Matthews Asia did not hold a position in Amazon.com, Inc., Groupon, Inc. or eBay Inc.

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