E-commerce strategy and must-haves in China
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From brick-and-mortar to click-and-mortar

Being one of the fastest expanding economies in the world, China's growth is echoed in the global online market as well — it is right at the center of the e-commerce boom sweeping the world. As per Forrester, China displaced the US to become the world's largest online retail market in 2013, with total sales reaching USD307 billion. Exceeding USD453.61 billion in 2014, this figure is estimated to continue growing at a compound annual rate of about 20% every year projected to reach USD1 trillion by 2019.

In 2010, 23% of China’s urban population shopped online. The figure is expected to go up to 44% (nearly double) by 2015.


In this report, we look at the trends prevalent in China's e-commerce sector while analyzing the strategies to maximize profit. The report also provides a detailed explanation of the e-commerce operation model.

EY conducted a study to gain market insights and identify best practices in relevant e-commerce industries in China.

China first and Asia next
Based on the survey results, the interviewed executives have adopted a country-centric e-commerce approach in China. The focus is less on other Asian countries, often based on market readiness and infrastructure constraints. Many global companies consider that “if we can do China, then the rest of Asia is easy”. The Chinese market is already large enough to capture.” Japan and Korea rank second and third, respectively, as Asian countries that are e-commerce ready. They also have country-centric operations due to local language preference. Due to its small size, Singapore's market is not the main focus; however, Indonesia and Malaysia are high potential markets.

Virtual giants’ investment in brick-and-mortar
China’s urban e-commerce market is nearing saturation after years of explosive growth, a trend leading China’s online retailers to explore the less tapped markets in rural areas.

Nearly 50% of the country’s 1.36 billion population lives in rural areas, less than 30% of rural residents are online and only 10% have bought things online. According to an AliResearch report, China's rural e-commerce market will reach RMB180 billion (about USD29 billion) by 2014 and exceed RMB460 billion by 2016. Alibaba expects to invest RMB10 billion (about USD1.6 billion) in constructing infrastructure and logistics systems in rural China. Other Chinese e-commerce giants like JD, Dangdang, Yihaoqian and Suning have plans to explore the rural areas by setting up hubs, e.g., Taobao villages – offline physical service centers that cluster local merchants, and other third-party service providers to resolve the logistical problem of the last mile to the customers’ door and improve its after-sales service in lower-tier cities. The trend of the internet giants seem to be going back to “brick-and-mortar.” Collaboration through strategic alliances is the key to success. In order to provide a seamless customer experience, there is the need for increased collaboration between merchants and platform providers. Larger companies that have a large existing customer base form strategic alliances with other large players, completing their ecosystem to increase and activate the customer traffic. Next to moving to the west and lower-tier countries, they start expanding in the rest of Asia.

Branding and learning on third-party platforms
Retailers and apparel companies are competing fiercely on third-party e-commerce platforms like T-mall. They have a low bargaining power with the platform providers. Less well-known brands have a hard time getting the third-party sales consultants to support in selling their products, and are dependent on customer reviews. More and more companies are hiring the experts to increase customer traffic and write reviews in order to increase their popularity. Being on the third-party platform is the first step for companies to learn and build their own in-house capability. Particularly with apparel brands, competition is so fierce that they try to improve their brand image to differentiate themselves from others. Since they earn low margins, the main purpose is “branding” and drawing customers to their own webshop or physical store.

New ecosystem platforms
Large market players like financial institutions or super/hyper markets, do not typically sell their products on the third-party platform. Since they own a large customer database, i.e., availability of customer traffic, their focus is on online customer traffic activation to buy and on cross-selling products. They are urged to build their own omnichannel (multiple customer purchase points with seamless integration) and find the right partners to complete their ecosystem. E-commerce leaders advocate D2D meaning ‘Go Digital or Die’ as the need of the hour.

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Luxury brands are urged to tap into the e-commerce market. Though some luxury brands dare to make bold moves, most brands are still redefining the e-commerce strategy. The overall strategy seems to place relatively lower priced, standard and outlet products online.

According to the speech made by Chinese Premier Mr. Li, “Internet+, means connecting and integrating everything, which is the future development and trend for internet that may lead Chinese enterprises to explore the international markets in all aspects of people’s life.” Despite the fact that globalization, knowledge institutionalization and intellectual property laws are ruled by the West, Premier Li stressed that our focus has to be on building the ecosystem around “internet+” including technology, people, institutions, systems and platforms.

Collaboration with outsourcing partners
In order to provide a seamless customer experience, the internal capabilities need to be complemented with outsourcing partners, to increase coverage especially in lower-tier cities.

The decision-making of insourcing versus outsourcing depends on the physical footprint and capabilities the companies have in China. The value drivers/activities of a more strategic nature are typically performed in-house, i.e., brand management, pricing and merchandizing, and inventory management.

Retailers and apparel companies with limited capabilities face fierce competition on the third-party platform, and are dependent on their third-party platform’s provider to serve their customer. Therefore, they try to work closely with them and provide specific training. Their e-fulfillment and logistics are often performed through their original channel; e.g. if they used a third-party logistics (3PL) before, they will keep using that 3PL until the conditions change significantly.

Luxury brands that mostly sell their lower value items and standard items online, look for high-value third-party platforms. Luxury brands have a high bargaining power since the platform can generate more traffic with these brands. However, the last-mile delivery aspects remains a concern, for example, dissatisfaction of customers with the actual product compared to the picture presented online can lead to a relatively high-return goods flow when the platform does not meet the luxury standard.

Large companies will focus on building marketing, IT and logistics capabilities. They have a critical mass to compete with the platform providers, especially if they can collaborate with other large players. Although slightly behind in the game, they can build in-house capabilities if the required talents are available in the market. Large branded companies that entered China through third-party distributors often use these parties to represent them online. Luxury brands often outsource their IT and logistics functions. In particular, the customer service, after-sales service and return goods flow are critical processes. Different measures are being taken to lower the risk, for example, improved images and content descriptions online, selection of low-risk, standard products to sell online, closer collaboration with third-party platforms, improved training to platform personnel, and the selection of high-quality 3PL.

Planned investment correlation with size and e-commerce as value-driver
The investment amount varied among the interviewees from USD500,000 to USD1 billion. The answer depends on the size of the company, but more importantly, on the importance of e-commerce as a value driver in the organization. There is a tendency of a rising share of the technology budget dedicated to the omnichannel. Larger companies are fully investing in different O2O channels to provide all-round delivery with multiple pick-up options in different locations which requires large investment. With smaller companies that have not yet captured market share, their
investment is, on an average, below USD500,000. It can be considered as a learning fee to interpret and act on insights from new customer behavior. If companies want to be successful in e-commerce, the focus of KPI’s should be in the customer experience area, including identifying the customer lifetime value, regency, frequency and share of the wallet. Investments are currently made in visualization, skills training and capability building. The interviewees mentioned that the next wave of value drivers for online retail channel is based on:

1. Enhancing their capability in understanding customer insights (e.g., through predictive modeling)
2. Adding value proposition of their product/services by incorporating new visual technology (e.g., display of 3D image when a customer hovers the mouse on their product)

**Scarcity of talents in innovation and quality**

Among the interviewees, 83% mentioned scarcity of talents in the Chinese market as a crucial factor to success. These companies were mainly large, represent luxury brands and are looking for innovation. Certain companies mentioned that nowadays, they scout for talents on university campuses for “affordable” but smart labor.

Quality is the other critical factor that companies are looking for. The increased coverage in rural China provides problems for companies that are less developed in the logistical area. They are largely dependent on local rural pick-up spots, and have less control over the quality of the delivery experience. Companies may even have a high selection criterion but transforming people to have a luxurious mindset and providing qualitative service remain challenging.

**Soft human touch replaced by social technology**

A seamless customer experience requires a soft touch provided by hard technology. The mix of social marketing, data analytics and personalizing products is key to design the customer experience at each touch point in the omnichannel.

Particularly, for the last-mile delivery, a variety of delivery options are being built, where managing multilayer and multitier logistics is key. Especially when the customer touch point is outsourced, companies may put more efforts in personalizing the product, providing added value to compensate the lost value of outsourcing the delivery/customer intimacy through 3PL delivery.

Delivering on today’s customer expectations is forcing retailers to focus on a holistic experience across all customer touch points. EY tunes into the trends and can support the clients in identifying the market niches, key customer segments, and integrating the different omnichannels and IT systems.
Omnichannel is the new multichannel

The study revealed that China-based consumer companies are redefining their e-commerce strategy and exploring the newest channels and platforms to maximize customer traffic and capture the market in China. Retailers are willing to restructure their operating model and deliver a customer experience that transcends channels. Focus is on collaboration between e-commerce platform providers, merchants and vendors to provide a seamless omnichannel customer experience – called unified e-commerce that combines point-of-sale, mobile and web into one platform to deliver a single transaction that follows the customer through every interaction with the retailer at multiple touch points.

E-commerce success factors

The EY Operating Model Effectiveness group interviewed 25 senior executives of global companies located in China. From the outcome, it appears that 65% of the companies have actively involved global C-level executives in their e-commerce strategy. 45% of the companies have the local market team to define the strategy. New e-commerce functions are being introduced with different multidisciplinary backgrounds, i.e., sales and marketing, IT and procurement. The value driver and the e-commerce experience determine the governance structure.

The winning combination – interview findings

1. Close collaboration with third-party platform providers to ensure accuracy and consistency with brand image presentation
2. Provision for appropriate compensation and installation of control mechanisms at various touch points with the customer to avoid potential loss of brand value by 3PL delivery
3. Strategic direction and management commitment rated most important in case of a self-owned webshop
4. Merchandizing and pricing considered most important with third-party platforms
5. Innovative capabilities to provide “talk of town” experiences
6. Building of own database with correct and trustworthy customer data
Internet penetration
E-commerce growth is closely linked with the number of people connected to the internet.

According to a 2015 work report issued by the Chinese Government, there are 649 million internet users and 557 million people surfing the internet through mobile phones with an internet penetration rate (estimated total number of internet subscribers on the total population of a country) of 85.8%.

Understandably, the internet penetration rate in the rural areas is a meagre 19% while it is 76% in tier-1 and tier-2 cities, and 47% in tier-3 and tier-4 cities. However, it is interesting to note that more than 60% of China's rural digital consumers are e-commerce users who are as active online as their urban counterparts, as per a recent McKinsey research.5

China is at the forefront of mobile internet development
The phenomenal e-commerce growth could not have been possible without a catalyst – the smartphone. The first half of 2014 saw 26% of China's online purchases being made through its 780 million active mobile devices. Of those, 58% were registered in lower-tier cities, where the users’ first experience of the internet was likely to be on a cellphone. Indeed, there has been a strong correlation between online shopping and smartphone penetration since 2011. Faster and cheaper 4G network connections should help accelerate mobile usage.6

It is primary for e-commerce companies in China to invest in mobile apps as more and more people have started accessing the internet through mobile devices. According to Forrester, in 2014, 25% customers made online purchases through a mobile phone on a weekly-basis at least. 15% logged in daily while 4% went online several times during the day.7

In China, the so-called business model of “O2O+X” means that the operating model of combining online and offline could be linked to various public sectors like government services, public relationships, traffic, education, medical services, media, finance institutions and other offerings. For instance, by the end of 2014, the Government provided public services through more than 20 thousands public accounts on WeChat. The Government also targets to connect 1.2 billion people (85% of the population) to 3G or 4G mobile internet by 2020.8

E-commerce upswing

China’s e-commerce industry will account for 18% of the country’s retail sales in 2018, up from 8% in 2013. It projects that during this period, the industry will contribute 30%–40% of incremental retail sales annually, becoming one of the key drivers in China’s USD3 trillion consumption market.9

China’s favorite websites

<table>
<thead>
<tr>
<th>Rank</th>
<th>Website</th>
</tr>
</thead>
<tbody>
<tr>
<td>01.</td>
<td>TMall</td>
</tr>
<tr>
<td>02.</td>
<td>JD</td>
</tr>
<tr>
<td>03.</td>
<td>Amazon China</td>
</tr>
<tr>
<td>04.</td>
<td>Dangdang</td>
</tr>
<tr>
<td>05.</td>
<td>51buy (Yixun)</td>
</tr>
<tr>
<td>06.</td>
<td>Yihaoedian</td>
</tr>
<tr>
<td>07.</td>
<td>Vancl</td>
</tr>
<tr>
<td>08.</td>
<td>Suning</td>
</tr>
<tr>
<td>09.</td>
<td>Vipstore</td>
</tr>
<tr>
<td>10.</td>
<td>KMALL</td>
</tr>
</tbody>
</table>


Behaviors and buying patterns of online buyers

<table>
<thead>
<tr>
<th>Category</th>
<th>Purchased in past 3 months (%)</th>
<th>Average number of purchases per year</th>
<th>Average annual (1000) spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large appliances</td>
<td>13</td>
<td>1</td>
<td>¥1.88</td>
</tr>
<tr>
<td>Luxury</td>
<td>1</td>
<td>1</td>
<td>¥1.25</td>
</tr>
<tr>
<td>Insurance</td>
<td>7</td>
<td>2</td>
<td>¥0.68</td>
</tr>
<tr>
<td>Small appliances</td>
<td>29</td>
<td>4</td>
<td>¥0.53</td>
</tr>
<tr>
<td>Consumer electronics</td>
<td>29</td>
<td>4</td>
<td>¥1.88</td>
</tr>
<tr>
<td>Travel products</td>
<td>21</td>
<td>7</td>
<td>¥3.75</td>
</tr>
<tr>
<td>Skin care &amp; cosmetics</td>
<td>37</td>
<td>18</td>
<td>¥1.50</td>
</tr>
<tr>
<td>Books &amp; A/V</td>
<td>26</td>
<td>18</td>
<td>¥0.63</td>
</tr>
<tr>
<td>Household care products</td>
<td>27</td>
<td>19</td>
<td>¥0.84</td>
</tr>
<tr>
<td>Apparel</td>
<td></td>
<td>22</td>
<td>¥2.70</td>
</tr>
<tr>
<td>Mom &amp; baby products</td>
<td>10</td>
<td>23</td>
<td>¥2.25</td>
</tr>
<tr>
<td>Fresh food</td>
<td>14</td>
<td>24</td>
<td>¥1.08</td>
</tr>
<tr>
<td>E-tickets</td>
<td>21</td>
<td>25</td>
<td>¥1.13</td>
</tr>
<tr>
<td>Games</td>
<td>9</td>
<td>32</td>
<td>¥0.36</td>
</tr>
<tr>
<td>Packaged food</td>
<td>40</td>
<td>34</td>
<td>¥1.50</td>
</tr>
</tbody>
</table>

Chinese Singles Day (11/11) is China's biggest online shopping day of the year.

It is much bigger than America’s Cyber Monday.

In 2014, Alibaba.com reported a record sale of USD9.3 billion – a 62% rise from the previous year’s USD5.75 billion.


Delivering on today’s customer expectations is forcing retailers to focus on a holistic experience across all customer touch points. EY tunes into the trends and can support the clients in identifying the market niches, key customer segments, and integrating the different omnichannels and IT systems.
Nowadays, success is not defined in margin but in terms of online traffic, knowing how to play the online game as a globally connected business and being able to deliver seamless experience.

Winning strategies

EY investigated the strategic road map per industry – in retail, apparel, super/hyper markets, food chains and luxury.

Top five strategic objectives

- Expand customer reach
- Customer engagement
- New customer experience
- More sales channels
- Increased visibility and internet presence
E-commerce in these industries can be divided into four groups:

- **Pioneers**
- **Fast movers**
- **Slow movers**
- **Non-movers**

There are hybrid versions also which generally follow a certain strategy that impacts their organizational decision-making and restructuring of their operating model for different functional areas.

1. **Pioneers’ strategy: maximize traffic and explore new markets**

Platform giants such as Alibaba, JD.com, YHD and Suning are the pioneers in the Chinese e-commerce market. They are the main channel for buying commodity items and are increasingly considered as search engines, providing convenience, low-priced items and a high service level.

Their main challenge is to innovate fast delivery options while competing with other platform giants on increasing coverage, online traffic, and operational and back-office support at a fast pace.

Key changes in the operating model:

- Building empires, such as Taobao villages, in lower-tier cities, and partnering with local logistics providers and merchants, in order to serve rural customers on the last-mile delivery.

- Main income consists of merchants’ entrance fees, buy-sell commission, promotion fees, and with certain platforms, operational costs for managing inventory.

- Mainly provide supporting services in marketing and promotion, e-fulfillment, inventory management, particularly on replenishment planning, and after-sales service.

2. **Fast movers’ strategy: brand own third-party platform and draw online members to own (web)shop**

Fast movers are the scalable retailers and apparel companies that sell products through third-party platforms created by the pioneers or platform giants to attract and divert customer traffic to their own online shop (if any) and/or physical store.

Fast movers in China are in the process of transforming their business model to develop a robust e-commerce strategy and create new digital/e-commerce teams, targeting the rapidly changed consumer behavior in China. The challenge is that a key part of the value chain, i.e., the client-facing “front office,” the brand communication and the customer service, is managed by a third party. As a consequence, companies are required to install control mechanism on touch points with customers.
E-commerce strategy and must-haves in China

Key changes in the operating model:

- Focus on brand management
- New processes and procedures put in place for a better delivery experience
- Third-party payment models not aligned with internal customer payment policy
- Logistics mostly managed by the merchant’s current logistics arrangements and by third-party logistics (3PL) providers that cover the lower-tier cities
- Despite the fact that IT is a key factor in e-commerce, the technology-related tasks are often outsourced
- Need to balance close collaboration/relationship building and strict guidance/agreement with third-party platforms
- Inventory management in a third-party platform is based on the services of the platform provider; inventory previously stored in distribution centers (DCs), particularly in free-trade zones, are urged to be imported into the country and stored in the flagship store or local shops, in order to keep up with the timely delivery promised to the customer

3. Slow movers’ strategy: activate own members through online-2-offline (O2O) collaboration with ecosystem complementary partners

This group consists of traditional large retailers, institutions, service providers and super/hyper markets. They own a comprehensive website to presenting their products and services, while having limited options for delivery. Existing DC and logistics network are in place, and sometimes, they also sell their in-house brand products.

Slow movers in China are currently renewing their e-commerce strategy, increasing the capacity in marketing, IT and logistics, and upgrading their existing e-commerce platform.

The next step is to upgrade their online shop with more delivery options, i.e., home delivery, store and/or DC pickup.
Key changes in the operating model:

- Search for ecosystem-complementary collaboration partners to increase product portfolio.
- Focus on their customer database and further build internal capabilities on data analytics to predict customer behavior and personalize their omnichannel experience.
- Outsourcing brand management to professional companies.
- Supply chain mainly consists of in-house activities.
- Have more bargaining power on third-party platforms, thus providing different options.
- Use a hybrid model (i.e., physical store, online store and third-party platform).

4. Non-movers’ strategy: navigate members through O2O experience

The non-mover group consists of luxury brands and food chains. The key selling point is characterized by customer experience. They use digital strategy, where possible, in value chain to attract customers. As such, the use of digital hologram catwalks or social media and a flawless online and offline experience is important to entice a customer to perform an impulsive buy.

Key changes in the operating model

Food chains
- Restaurants with a home delivery service employ innovative ways to attract customers to create the “talk of town” experiences; this boosting turnover.
- In case of in-house delivery, GPS systems are for smooth navigation on the delivery route.

Luxury brands
- Selective items, i.e., basic items, sales items or lower quality products (meant for outlet sales) sold through the online channel.
- Focus is on improved picture quality and information presented online to reduce the flow of goods returned (can increase online sales to up to 30% compared to offline sales).
- High-quality couriers selected for last-mile delivery and/or a personalization factor is added to the delivery.
- High-value third-party platforms used.
- Online sale handled through social media engagement or social commerce.
**Must-haves for e-commerce companies**

Companies are renewing their e-commerce strategies and deciding which new capabilities need to be built in-house for the future.

**How to cash in on the e-commerce boom?**

- **Strategic direction and management commitment**
- **The right outsourcing providers to fill in the gaps**
- **Effective merchandizing and pricing**
- **Online and offline product selection**
- **IT and e-marketing capabilities**

**Limitation of the distribution channels to a controllable amount**

**Call for action creating the “talk of town” experience**

**One view of truth in inventory availability**

**Data analytics capabilities**

**New e-commerce capabilities to be built for the future**

Companies are renewing their e-commerce strategies and deciding on which new capabilities to be built in-house for the future.

The continuum depicted below shows the capabilities to be built from scalable to large companies.

A. IT: data analytics to achieve predictive modeling and personalization

B. Supply chain logistics: increased control on quality at touch points with the customer in the “last mile delivery,” improved vendor management and omnichannel logistics, reorganization of DCs and physical store inventory

C. Marketing: brand and online content management

D. Customer service: improved training and personalization in product as well as customer knowledge

E. New social/soft IT skills: transforming innovative branding ideas and delivering this through an omnichannel

<table>
<thead>
<tr>
<th>Low Investment in capabilities</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scalable retailers and apparel</td>
<td>Luxury brands</td>
</tr>
<tr>
<td>C (Premium branding)</td>
<td>A (not build in-house), B (not build in-house)</td>
</tr>
<tr>
<td>E</td>
<td>C, D, E</td>
</tr>
<tr>
<td></td>
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</tbody>
</table>
How can EY help?

We design digital growth strategies in China, support our customers end-to-end from the definition of e-commerce strategy to the execution with a results-oriented approach.

**EY e-commerce practice Europe–China**

Enabling “branded” consumer experience for all digital interactions enabling capabilities to support these customer experiences

<table>
<thead>
<tr>
<th>Aware</th>
<th>Discover</th>
<th>Engage</th>
<th>Purchase</th>
<th>Loyalty</th>
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<tbody>
<tr>
<td>Digital China-entry strategy</td>
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<tr>
<td>E-commerce operating model design</td>
<td></td>
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<tr>
<td>Digital marketing and social CRM</td>
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<tr>
<td>Omnichannel transformation implementation</td>
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<tr>
<td>Change management</td>
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<td>Digital China-entry strategy</td>
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<tr>
<td>------------------------------</td>
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<td>------------------------------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>Define digital China-entry strategy</td>
<td>E-commerce operating model design</td>
<td>Digital marketing incorporating acquisition, retention &amp; loyalty</td>
<td>Omnichannel process design implementation</td>
<td>Program management</td>
</tr>
<tr>
<td>China market research &amp; target customer profiling, product category, channel &amp; traffic management, revenue model</td>
<td>Operational and tax efficient corporate/holding structure design (incl. transfer pricing, import &amp; customs compliance)</td>
<td>Closed loop analysis &amp; continuous improvement</td>
<td>Business process management</td>
<td>Organization/operations review</td>
</tr>
<tr>
<td>Customer experience journey design</td>
<td>Capability, process &amp; organization design</td>
<td>Market mapping, company profiles, benchmarking, data collection Data analysis, focus groups</td>
<td>Partner/vendor contract definition</td>
<td>Adoption – including customers, channel partners, employees</td>
</tr>
<tr>
<td>Omnichannel selection</td>
<td>Online channel review &amp; optimization</td>
<td>Social listening &amp; monitoring, social marketing, social commerce</td>
<td>Master data management</td>
<td>E-commerce training by Velvet</td>
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<tr>
<td>Omnichannel business case development</td>
<td>Platform/system/vendor selection &amp; management</td>
<td>Platform framework design</td>
<td></td>
<td>Support in recruitment e-commerce organization</td>
</tr>
<tr>
<td>Quality assurance</td>
<td></td>
<td>System landscape design, system upgrade and development</td>
<td></td>
<td>Onboarding and knowledge transfer during transition</td>
</tr>
</tbody>
</table>
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