China Briefing

The new new thing: China's retail model

Executive summary

China's rapid economic growth has created new business and retail models. These are now being exported to other countries.

China's size and huge infrastructure push creates fierce competition. Commerce becomes "winner takes all". Winners must be able to scale into the billions and yet still localise down to the individual.

This pressure has created new ways of doing business on- and off-line. These business models are rarely examined and yet are now being exported. Understanding them shows us much of where Southeast Asia is also likely to go.

The new new thing

China's e-commerce market is, in many ways, leading the world. Part of this is the development of new business and retail models, driven by China's unique conditions and economic growth.

China's size gives it both global and national network effects. Software platforms such as WeChat have global influence. Nationally, as Alibaba's flagship brands TMall and Taobao have shown, buyers anywhere in China can access goods nationwide. It is impossible to defend advantages in one area alone. Rather, one must battle with Taobao or TMall all over the country.

Yet products in China must also be localised, limiting network effects. For differentiated markets, such as short video (discussed overleaf), one needs to take advantage of regional or local variation. Winning the nation requires going unit by unit, cluster by cluster. In both cases, China's massive internal market means that firms must survive and thrive amid fierce competition.

This can apply for fields that do not seem super differentiated. Meituan co-founder turned investor Wang Huiwen for example notes that they became China's undisputed market leader squeezing out smaller rivals in 2011. Yet even then it took them until 2014 to become market leader in Xiamen city. Network effects for group purchasing work on a city level, and some smaller, niche platforms in Xiamen owned the relationships with merchants and consumers on their platforms. Chinese firms must constantly wrestle with competition both nationally and locally.

China's extraordinarily high rate of mobile phone penetration made internet platform competition brutal and relentless. China leapfrogged certain phases of telecommunications development. Today, mobile phones are not only ubiquitous but also the main source of entertainment. Platforms compete with each other to be the place that people spend the most time, and therefore large apps try to be all things to all people. Rather than China having a YouTube, a place where you go to watch videos, its main long-video site BiliBili instead has also games, shows, comic books, blogs, bullet commentaries... everything, all in one place. The goal is to give the consumer everything they want from the app. This is very different from the typical model of trying to focus on one specific use case first and then expanding out from there.

This desire to capture nearly all of the user's attention means that the platform is power. The two giants, Tencent and Alibaba, aim to build

as large a data garden as possible, and then wall it up completely. The Chinese phrase is that there are two, and you must pick one; an allegiance is necessary. To this day, for example, WeChat still blocks Taobao. And Pinduoduo recommends and integrates with WeChat only, and JD.com doesn't support Alipay — as these are all Tencent companies. Imagine if you could never send your friend a link to an Amazon page through WhatsApp and you have some understanding of the brutal competitiveness of Chinese e-commerce.

Short video, long competition

Perhaps the best example of the competitive pressure is China's short video market, which has grown explosively in recent years; the number of users grow, on average, 291% every year for the past five years.

Consistent with what we note above, short video is therefore now a platform, with most major Chinese apps now having short video as a necessary function. This is to stop the user leaving the app. The result, however, is that news, social network, music, retail, and e-commerce companies have all tried to be the short video market leader.

Short video's market size in 2020 was over CNY 211bn. Yet the market is now consolidating after many lengthy battles for supremacy. It is dominated by two companies in particular, ByteDance (Douyin, TikTok, Huoshan, Xigua) and Kuaishou. They occupy 75% of the market between them. Yet they have very different business models.

Currently, Kuaishou is China's largest platform with more than 300 million users posting more than 15 million pieces of content per day. Its brand focuses on everyday life, highlighting China's commoners and grassroots folk, who are over 70% of the Chinese population and whose lives are often unseen and overlooked.

Kuaishou relies on segmentation. Its focus are the tier three and below cities, those far lesser known than Beijing and Shanghai but still contain millions of people. (Xiamen, discussed above with regards to Meituan, is an example).

Kuaishou focuses on telling these lower-tier city citizens' stories, on using "flat" algorithms that gives them an equal chance, and on making it as easy as possible for them to make their own video responses, instead of text-based missives. Kuaishou users trust short video ads rather than text. By focusing so clearly on differentiating these lower-tier cities, Kuaishou engendered users who are loyal, post daily, and even have their own slogan of being "blood brothers". And indeed, Kuaishou keeps active users better than other apps (just after WeChat). This creates large opportunities for rural business and e-commerce.

Kuaishou's great rival Douyin on the other hand focuses on having the best technology. They have superior classification, and so users get better content recommendations. And once users are in the app, Douyin offers chat, livestreaming, livestream e-commerce, and in-app money sending. Their theory is that network effects will eventually win out over targeting smaller, more loyal, more niche audiences.

What's next? These two rivals will battle over livestreaming. Plus, as we noted above, every site in China is trying to keep users from leaving by offering every feature possible. So others are muscling in on Kuaishou and Douyin's turf. Major e-commerce platforms, such as Taobao and JD, have already opened livestreaming channels to promote goods. And gaming will rapidly adopt livestreaming (China is the world's second-largest gaming market), and games now take up one third of the total livestreaming market, growing at more than 142% YoY. Tencent, the biggest game investor, is sniffing. So Kuaishou and Douyin are making their own games. All of this highlights the points we make above; moreover, China's competition is so fierce that we expect these trends to shift outside of China's borders.

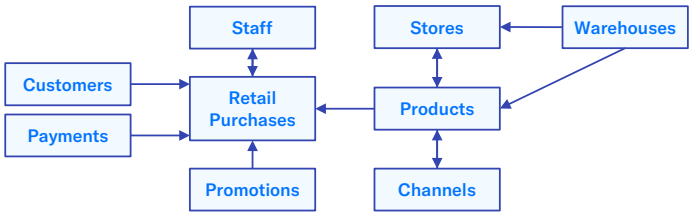
KOLs: when China is ahead of the West

China's e-commerce market has another unique factor: key opinion leaders ("**KOLs**") have far greater influence.

What are KOLs? They are individuals who build communities based on their own brand, and then use that to promote other brands in partnership with them. In China alone, one 2018 report placed the value of the KOL marketing industry at over RMB 100 billion. And people really listen to them. According to CCTV, 83% of young consumers' purchasing decisions are based on KOL recommendations, against 38% in the U.S.

KOLs change the nature of retail in China, bringing themselves into the centre of the relationship between customer and brand but not providing the product directly. A McKinsey study argues that Chinese consumers require eight touchpoints before they buy, compared to just four for Western shoppers. KOLs are thus often both inspiration and deal closer, as people look to them as during the whole process.

Traditional retail model



With KOLs entering the e-commerce market

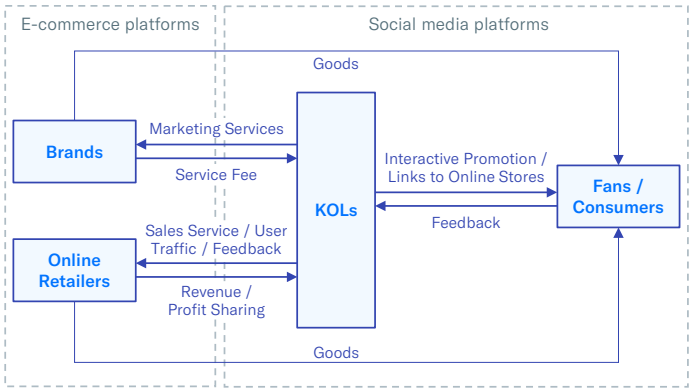


Figure One: How KOLs and MCNs are disrupting the retail industry in China

Hence, the model is becoming one of how a KOL can influence the whole supply chain. In the traditional retail model, the retailer facilitates the transactions (as all the arrows point to the retailers), whereas the new KOL e-commerce model eliminates the intermediary retailers (if not, making them of less importance) who used to play an important role in the entire transaction process. KOLs can manage pre-ordering through targeting their campaigns. This provides data to prevent over-production. Along with AI and big data, KOLs can share information on consumer demand and feedback to boost the whole ecosystem.

The other advantage that KOLs have is that they can scale and yet stay close to customers and keep them from feeling like slaves to the algorithm. Similar to Douyin and Kuaishou, there is a tension between authenticity and size.

For example, consider multi-channel networks (MCNs), agencies that connect brands and KOLs. They standardise and consolidate the fragmented market. Using AI and big data, they can better match KOL

production with their users. That seems like a good thing. And yet, MCNs struggle to turn profits. Perhaps, like Kuaishou, KOLs thrive when nimble, speaking directly to "blood brothers" (and sisters).

New retail to your door

Finally, all of this competition online is starting to shift offline markets, too. Take fresh grocery delivery. In China, the retail grocery market is estimated by McKinsey to be worth RMB 5.2tn (USD 794bn) in 2019, with only 10% of that currently online. Online groceries have remained a niche e-commerce offering today in much of the world, catering to the time-poor but cash-rich. This remains the toughest issue in Chinese retail.

Yet the tech giants are competing furiously and investing billions in social e-commerce, or "community group buying". This is a new business model whereby members in a community pool their orders through a social network to get a lower price. It has grown explosively.

China has the comparative advantage of having a high urban density, and deliveries can be clustered, which cuts on logistics costs. Tencent invested Xingsheng Youxuan for example estimates that "the delivery cost per order for the home delivery mode is 7-10 RMB. This part of the cost is relatively rigid, and other fulfilment costs such as storage are about 1-2 RMB. The community group purchase model with a better order density can achieve less delivery cost of than 1.5 RMB per order"

Community group buying however relies enormously on WeChat. The format is that a self-designated community leader creates and maintains a WeChat group. The community leader sign-ups individuals from their local region (usually within their regular walking distance) and picks up bulk orders, unpacks them, and delivers individually to group members. For their work, the community leaders get 10% commission from their group orders. Given the hands-on nature of the work, a community leader can typically only manage three WeChat groups well at any one point.

Community leaders and customers take care of the last-mile delivery, shaving off precious additional logistics costs (lowering logistics costs is often the sole driver of profitability in marketplaces). Retailers have to carry less brands and units. The produce stays fresh, keeping customers happy.

This highlights again how China needs both localisation and national network effects, at the same time. Online groceries need robust cold supply chains, quick turnarounds in distribution centres and swift last-mile delivery. Even giant super companies like Tencent struggle with this form of new retail, despite having vast numbers of potential customers — WeChat has the best community capability, but WeChat is not made to be an e-commerce platform. E-commerce behemoths such as Alibaba on the other hand are good at commerce but not very good at making communities. And finally, the natural players in this game are the grocery supermarkets who have the produce supply chain already, but they are far weaker at IT, hindering their ability to create national network effects.

What comes next

China's conditions may be unique, but they breed business models that can be exported. The first time we saw this happen was with smartphones. After replacing the US as the smartphone manufacturer for the world in 2011, China began also to go out, starting with Huawei. In 2015, the internet platform companies began also to globalise. In both cases, only the winners of China's dog-eat-dog domestic market got to leave.

We think the new retail models aforementioned may offer similar lessons for many Western companies. There are already billions of dollars of capital deployed in the new new things. Fresh grocery delivery for example has seen tech giant Alibaba become a player with their Freshippo range, as well as recently investing in Nice Tuan, a key startup player in the field. The short video firms Kuaishou and Bytedance (Douyin) are moving in to fresh groceries also. Tencent has invested twice as much as everyone else already.

We are expecting similar transformations in Southeast Asia. Innovation is a product of enabling infrastructure, economic opportunity, and accessible talent. The next decade for Southeast Asia could be just like the 2010s for China, where we saw the Meituans, Kuaishous, and ByteDances emerge.

Chinese investors are joining these dots. Chinese super investor Zhang Lei recently shifted to investing more in Southeast Asian companies as they thought there was some comparisons to China, and his firm Hillhouse could add value. They have invested in Traveloka, Indonesia's version of Chinese company Qunar (an online travel firm); in ride share company Grab, and connected them with Didi Kuaiche; South Korean food delivery company Woowa Bros (Baedal Minjok), and linked them with Meituan.

We expect to see far more of this connections, and indeed, are seeing and working with some already now. Akulaku, for example, combines Chinese backend online services with Indonesian localisation. Pressure makes diamonds, as the saying goes. Companies that survive China's pressure cooker business environment may yet prove even more valuable.

Disclaimer

This document, and the information contained in it, is prepared by Silverhorn Investment Advisors Limited ("**Silverhorn**") and is strictly confidential. As such, this document must not be issued, circulated or distributed to any other person other than the intended recipient under any circumstances without prior written consent of Silverhorn.

This document is not directed to any person in any jurisdiction which (by reason of that person's nationality, residence or otherwise) is prohibited by law to access such information.

For investors in Hong Kong: Any products and services contained and described in this document are intended only for "**professional investors**" as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong).

For investors in Singapore: Any products and services contained and described in this document are intended only for "**institutional investors**" and "**accredited investors**" as defined in section 4A of the Securities and Futures Act (Chapter 289 of the Laws of Singapore).

For investors in Switzerland: This marketing communication and any products contained and described in this document are intended for "**qualified investors**" as defined under Article 10 of the Swiss Federal Act on Collective Investment Schemes (Collective Investment Schemes Act, CISA) of 23 June 2006 (SR 951.31) and the FINMA Circular 2013/9. The offering document, the articles and the annual report of the fund(s) listed in this document may be obtained free of charge from the Swiss representative.

For the purposes of Title 5 of the Swiss Federal Act on Financial Services (Financial Services Act, FinSA) of 15 June 2018 (SR 950.1), in relation to distributing the fund(s) listed in this document, Silverhorn is affiliated with Finanzombudsstelle Schweiz (FINOS), Talstrasse 20 CH-8001 Zürich, Switzerland. Investors have the rights to initiate mediation proceedings through FINOS pursuant to Article 79 of FinSA.

Not intended for U.S. Persons: Any products and services contained and described in this document are not intended for any U.S. Person under Regulation S of the U.S. Securities Act of 1933, as amended.

This document is provided for information purposes only and does not constitute an offer to anyone, or a solicitation by anyone, to make any investments in securities. Such offer will only be made by means of a personal, confidential memorandum. The content of this document has not been audited or reviewed by any regulatory authority in Hong Kong, Singapore or elsewhere.

Investing involves risk

You should remember that the value of investments can go down as well as up and is not guaranteed. Past performance is not a guide to future performance and may not be repeated. The actual performance realised by any given investor depends on, amongst other things, the currency fluctuations, the investment strategy invested into and the classes of interests subscribed for the period during which such interests are held. Emerging markets refer to the markets in countries that possess one or more characteristics such as certain degrees of political instability, relative unpredictability in financial markets and economic growth patterns, a financial market that is still at the development stage, or a weak economy. Respective investments may carry enhanced risks and should only be considered by sophisticated investors.

No liability

This document is intended for information and discussion purposes only and is not intended to be promotional material in any respect. The views and opinions contained herein are those of the author(s), and do not necessarily represent and may differ from the views of Silverhorn as expressed or reflected in other communications and promotional materials. Information contained herein is believed to be reliable, but Silverhorn does not warrant its completeness or accuracy.

Nothing contained in this document constitutes financial, legal, tax, investment or other advice, nor should any investment or any other decisions be made solely based on this document. This document does not provide any advice or recommendation as to whether any securities or investment strategy referred to in this document is suitable for the intended recipient.

Although all information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, no representation or warranty, express or implied, is made as to its accuracy or completeness and no liability is accepted for any direct or indirect damages resulting from or arising out of the use of this information. All information as well as any prices indicated are subject to change without notice. Any information on asset classes, asset allocations and investment instruments is only indicative. Before entering into any transaction, investors should consider the suitability of the transaction to their own individual circumstances and objectives. We strongly suggest that you consult your independent advisors in relation to any legal, tax, accounting and regulatory issues before making any investments.

Contact Silverhorn

If you have any enquiries concerning the document, please contact your Silverhorn client advisor for further information. Any communications with Silverhorn (including telephone conversations) may be recorded.

investments@silverhorngroup.com
silverhorngroup.com

Silverhorn Investment Advisors Limited
Incorporated in Hong Kong with registration number 1456284 and licensed by the Securities and Futures Commission under CE Number AWE828 to carry on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong)

18/F, 100QRC
100 Queen's Road Central
Hong Kong

Tel: (852) 2599 9100

Silverhorn Investment Advisors (Singapore) Private Limited
Incorporated in Singapore, licensed by the Monetary Authority of Singapore with licence number CMI100970 to carry on fund management regulated activities under the Securities and Futures Act (Chapter 289 of the Laws of Singapore) and exempt from holding a financial adviser's licence under the Financial Advisers Act (Chapter 110 of the Laws of Singapore)

168 Robinson Road
#20-11 Capital Tower
Singapore 068912

Tel: (65) 6977 6902