# China Internet Sector

## 'MEMO': eCommerce's 2015 outlook and themes

Equities

China
Internet Services

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**Continued strong growth momentum for China's eCommerce segment in 2015E**
The gross merchandise value (GMV) in China's eCommerce market has grown rapidly over the past five years (a 61% CAGR), with 10.7% online penetration in 2014. The segment could record a 27% GMV CAGR in 2014-18F, driven by: 1) 4G rollouts and rising smartphone adoption; 2) a growing number of online shoppers; 3) improvements in payments/logistics; 4) rising rural consumption; 5) expanding categories; 6) growth in mobile shopping; and 7) large annual promotional events to boost online shopping. We think the main developments in 2015 will be: 1) a continued shift from consumer-to-consumer (C2C) to business-to-consumer (B2C); 2) PC to mobile migration; 3) penetration to lower-tier cities; 4) international expansion; and 5) an expansion into fresh food.

**Key themes in 2015: eCommerce ecosystem, mobile monetisation and O2O**
We think the key themes in China's eCommerce market in 2015 will be: 1) the eCommerce ecosystem (logistics, online/mobile payments, online financing that includes online supply chain financing, online consumer credit services, credit rating services and crowd-funding, and cloud computing and smart devices); 2) mobile monetisation; and 3) online-to-offline (O2O) initiatives.

**Upside/downside surprises and key catalysts**
The key upside surprises for the eCommerce market could include: 1) faster-than-expected mobile take-up and mobile monetisation; 2) a rapid expansion in the lower-tier cities; and 3) better execution on category expansion. The downside risks include: 1) rising competition; 2) margin deterioration; 3) changes in the macro environment; 4) regulatory risks; and 5) volatility in Alibaba's PC take rate (revenue/GMV). We think the potential catalysts are: 1) progress on mobile monetisation; and 2) M&As that enrich mobile offerings in the eCommerce space.

**A Buy rating on Alibaba; Neutral ratings on JD and Vipshop**
We have a Buy rating on Alibaba (BABA.N) with a price target of US$115.00. We have Neutral ratings on JD.com (JD.O) and Vipshop (VIPS.N) with price targets of US$30.00 and US$23.00, respectively. We derive our price targets from a DCF-based methodology and explicitly forecast long-term valuation drivers using UBS's VCAM tool.

**China eCommerce sector valuation comps**

| | | Price | Share | | Market | PE | | | | EV/Sales | | | | 2016/14E CAGR | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Company | Rating | target (US$) | price (US$) | Upside/ downside | cap (US$m) | 2015E | 2016E | 2017E | PEG | 2015E | 2016E | 2017E | EVSG | Sales | Earnings |
| Alibaba | Buy | 115.00 | 85.12 | 35% | 220,291 | 35.7x | 27.9x | 22.6x | 1.0x | 13.4x | 10.4x | 8.4x | 0.3x | 31% | 29% |
| JD.com | Neutral | 30.00 | 27.67 | 8% | 37,693 | NM | 91.3x | 29.7x | NA | 1.2x | 0.9x | 0.7x | 0.0x | 38% | NA |
| Vipshop | Neutral | 23.00 | 24.45 | -6% | 13,870 | 52.3x | 33.0x | 24.7x | 0.7x | 2.2x | 1.6x | 1.2x | 0.0x | 52% | 49% |

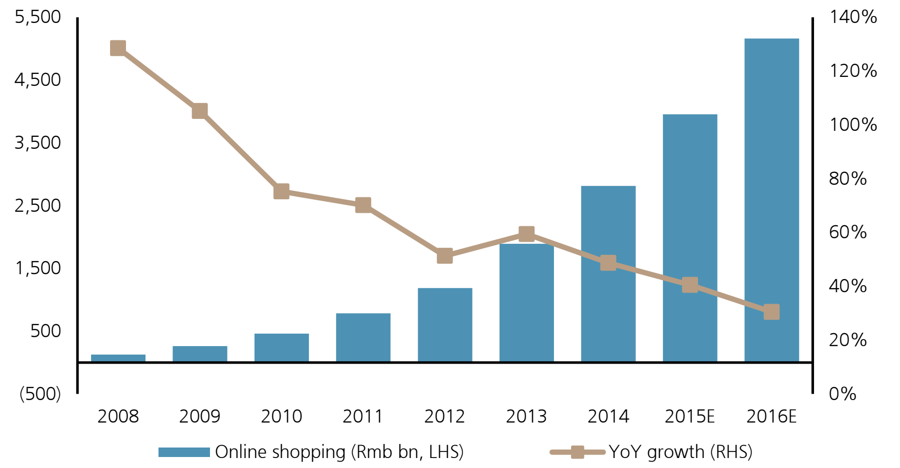
Note: Above data as of 27 February 2015.
Source: Bloomberg, UBS estimates

# 2015 outlook and central themes

The gross merchandise value (GMV) for China's eCommerce market has grown rapidly over the past five years—at a CAGR of 61% compared with 15% for China's total retail segment. As a result, eCommerce penetration has risen from just 1.1% of China's retail sales in 2008 to 10.7% in 2014 (compared to UBS's estimate of 9.8% penetration in the US).

**Growth momentum in China's eCommerce market should continue. iResearch forecasts a 27% GMV CAGR over 2014-18F**

**Figure 1: Online shopping—value of transactions and growth (B2C and C2C)**

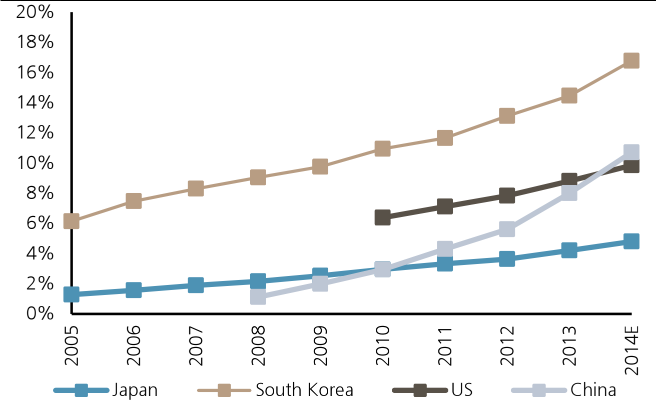



Source: iResearch, UBS estimates

**Figure 2: eCommerce GMV as a percentage of total retail**


Source: CEIC, iResearch, UBS estimates

**Figure 3: eCommerce GMV as a percentage of total**



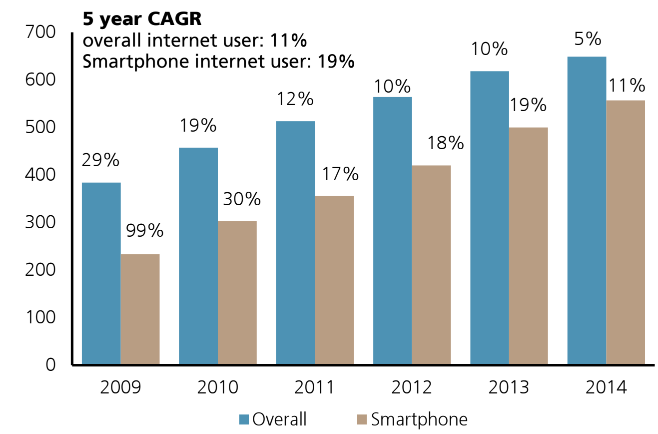

Source: Bloomberg, US Census Bureau, METI, South Korea National Statistical Office, UBS estimates

iResearch expects China's eCommerce market to record a 27% GMV CAGR over 2014-18F. Specifically, iResearch estimates the value of transactions will grow from Rmb2.81trn in 2014 to Rmb7.30trn by 2018. We believe the following factors will drive online shopping.

- The rollout of 4G services, which should drive greater smartphone adoption
- Growth in the number of online shoppers
- Highly competitive prices compared to offline, traditional retailers
- Improvements in payments, logistics and other supporting infrastructure in the eCommerce value chain

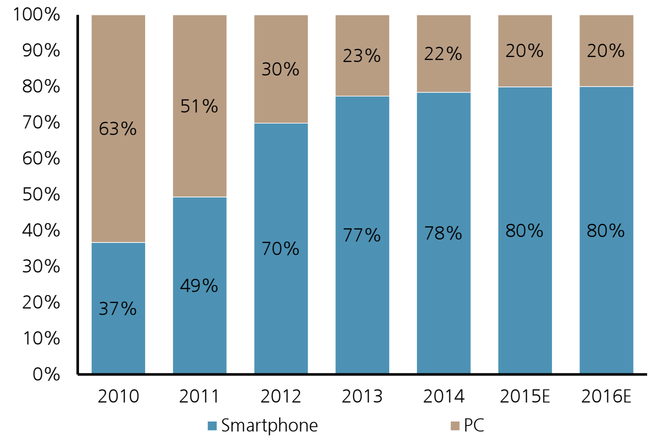
- Increasing penetration in the lower-tier cities and rising consumption in the rural areas
- The expansion of categories
- Rapid growth in mobile shopping
- The large annual promotional events held by eCommerce companies to encourage online shopping

**Figure 4: China—number of Internet users (m)**




Note: Percentage on bars denotes YoY growth.
Source: China Internet Network Information Centre (CNNIC)

**Figure 5: Smartphone and PC shipments in China**




Source: iResearch

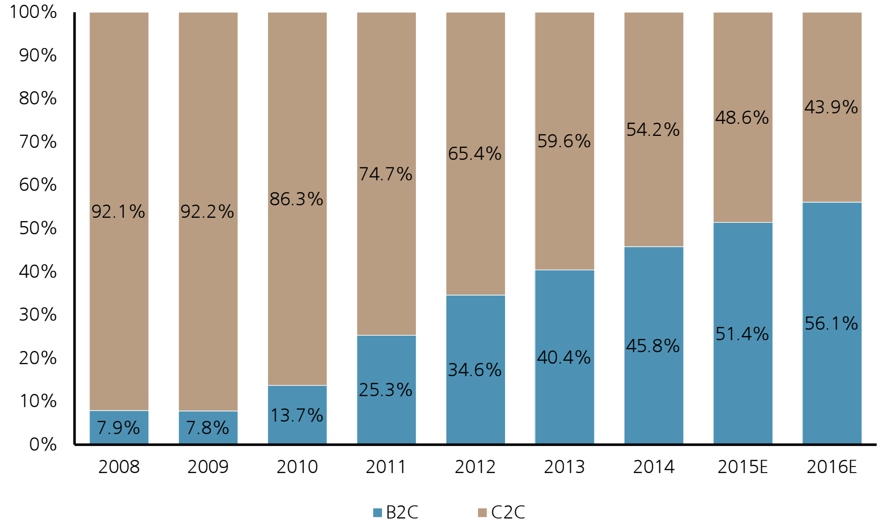
## C2C to B2C

**A continued shift from C2C to B2C in China's eCommerce industry; B2C's GMV could exceed that for C2C in 2015F**

China's eCommerce industry comprises the business-to-consumer (B2C) and consumer-to-consumer (C2C) segments. B2C contributed approximately 46% of the total GMV for the eCommerce segment in 2014, and this faster-growing segment could account for around 56% by 2016F, according to iResearch.

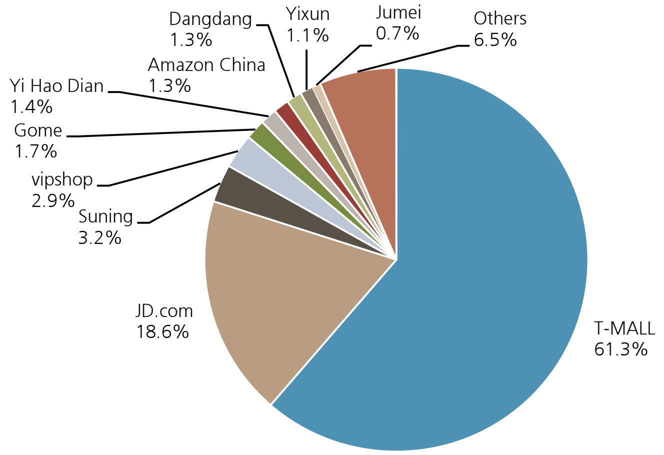
Compared to the C2C segment, suppliers and merchants on B2C platforms generally benefit from a better reputation in the safety and authenticity of their products as well as quality of services. The B2C segment includes direct sales and third-party marketplaces. Direct sales B2C companies tend to have better and direct control of the quality of their products and services (including logistics and fulfilment) to better meet consumer demand for a high-quality online shopping experience. Some direct sales B2C eCommerce companies have been expanding to the marketplace platforms in order to expand their customer base, maximise the utilisation and efficiency of self-owned logistics and warehousing infrastructure, and create new revenue streams.

Figure 6: GMV breakdown between the B2C and C2C segments in China




Source: iResearch, UBS estimates

Figure 7: China B2C eCommerce market share (2014)



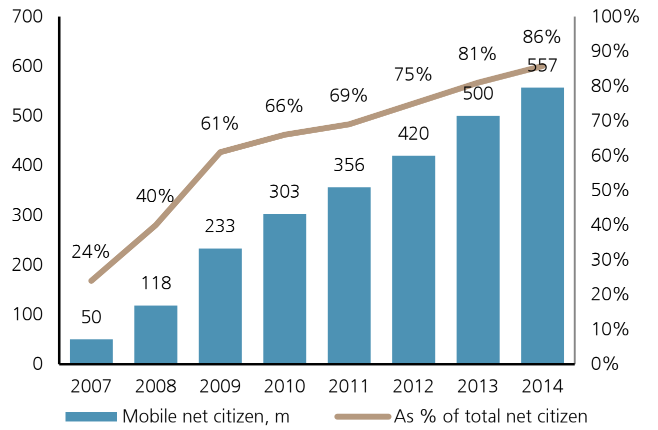

Source: iResearch

## PC to mobile

Mobile Internet penetration has risen rapidly in China, from 24% of total Internet users in China in 2007 to 86% by 2014. Along with faster mobile data access speeds through 4G services, the growing popularity of smartphones (particularly low- to mid-range models), and larger smartphone screens (which enhances the mobile shopping experience), mobile shopping is becoming more appealing to users. While mobile shopping may replace some PC shopping, more importantly, we think it could drive incremental shopping, especially during consumers' 'filler time', while away from their homes or workplaces. Thus, mobile shopping is becoming an increasingly significant element in China's eCommerce ecosystem, and should be a key growth driver going forward.

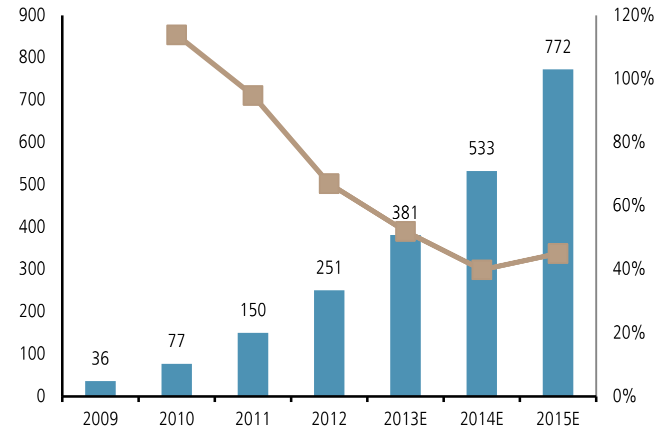
**Mobile shopping is becoming a significant element and a key growth driver in China's eCommerce market**

**Figure 8: High user penetration of mobile Internet (m)**




Source: CNNIC

**Figure 9: Fast growth of mobile eCommerce user base (m)**



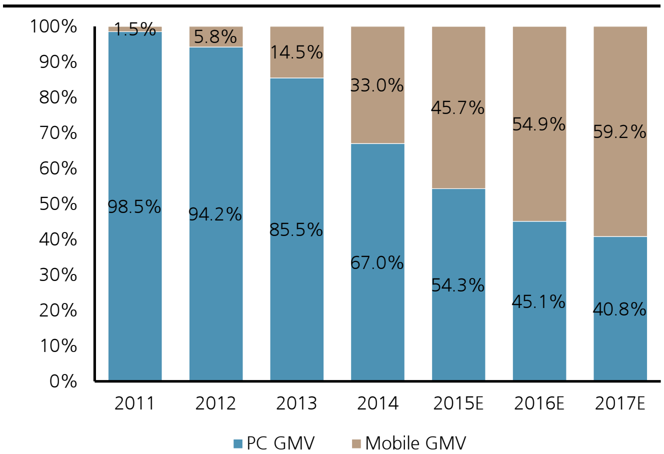

Source: China eCommerce Research Centre

Compared to online shopping on PCs, shopping on mobile devices offers a unique advantage of convenience, in the sense that online shopping can be done anywhere and anytime. Mobile shopping has gradually become the major online shopping channel among white-collar workers, who can shop during their commutes on the subway to the office and back home. Moreover, increasingly diversified consumption scenarios (for example, the reverse O2O [offline-to-online] retailing model that enables customers to try products in physical stores and make orders/payments online via their mobile devices) are also driving up the number of transactions made on mobile handsets.

**Mobile shopping penetration to continue to increase**

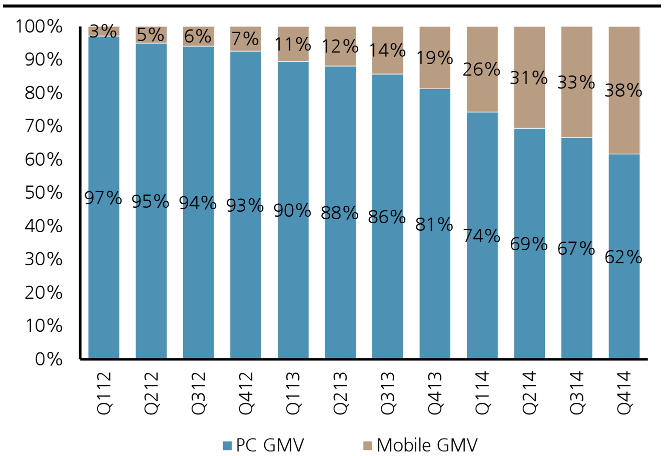
According to iResearch, mobile shopping GMV accounted for 38.3% of total GMV in China in Q414. We expect the mobile shopping penetration rate to continue to grow in 2015 given: 1) an increasing adoption of mobile terminals for online shopping; 2) the migration of user activity from PC to mobile; 3) the various initiatives by eCommerce companies to drive mobile eCommerce (not only via their own mobile apps, but also by leveraging other mobile access points like Tencent's Weixin); and 4) the increasing usage of geo-location and personalisation services.

**Figure 10: Online shopping GMV—PC versus mobile**




Source: iResearch

**Figure 11: Online shopping GMV—PC versus mobile**




Source: iResearch

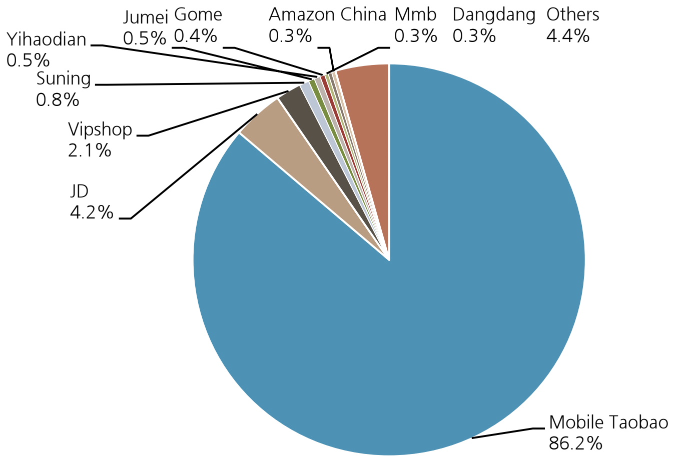
Most eCommerce companies in China have implemented initiatives to push the shift from PC to mobile. In Q314, mobile orders made up 29.6% of total orders on JD's platform. In Q3 FY15, Alibaba's mobile GMV contribution reached 41.6%,

while the GMV for mobile accounted for 66% of Vipshop's total GMV in Q414 (Q314: 57%).

Alibaba dominates the mobile shopping segment in China, with an 86.2% market share in 2014 (2013: 76.1%), according to iResearch. JD was No. 2 with a 4.2% market share in 2014, while Vipshop maintained its 2.1% market share in the mobile shopping segment.

**Alibaba is the dominant operator in mobile shopping, followed by JD**

**Figure 12: Mobile shopping market share (2014)**




Note: Alibaba owns Mobile Taobao.
Source: iResearch

## Penetration into the lower-tier cities and rural China

With the rapid expansion of eCommerce in China's Tier 1-2 cities, penetration in the developed areas has been relatively high, with greater competition. As a result, eCommerce companies have been eyeing the lower-tier cities and even the rural areas for their growth potential. We believe the integration of rural China into the eCommerce ecosystem is already underway.

**The integration of lower-tier cities and rural China into the eCommerce ecosystem is already underway**

### Alibaba is extending into rural China

Alibaba is aggressively exploring new market opportunities in rural China. As part of the group's offline logistics network initiative, Alibaba signed a cooperative partnership agreement with China Post in June 2014. According to 100EC.CN, China Post has 118,000 outlets nationwide covering China's most remote villages. This cooperation will further expand the capacity of Alibaba's China Smart Logistics Network (CSN), building a basic-level public logistics platform, leveraging China Post's extensive coverage, and penetrating the lower-tier cities and rural areas.

**Alibaba has a cooperative partnership agreement with China Post for rural China**

Alibaba has also announced in 2014 that it plans to invest Rmb10bn (about US$1.6bn) in infrastructure and logistics in rural China in three to five years, in order to build 1,000 county-level operating centres and 100,000 service outlets, to expand its rural eCommerce business.

### JD's ambitions in the lower-tier cities and rural markets

JD has been tapping the eCommerce market beyond China's Tier 1-2 key cities, by aggressively rolling out its warehouse coverage into the Tier 3-4 cities to shorten the logistics process.

JD and China Post announced their partnership on eCommerce and O2O for Tier 3 and lower cities. JD will provide merchandise that includes computer, electronics and home appliances to China Post's eCommerce platform. Leveraging China Post's nationwide delivery service and network of outlets, JD will be able to expand its presence into towns and villages. We believe this partnership is important for JD as an expansion to the lower-tier cities is essential for eCommerce companies in the new phase of the O2O model.

**JD's fulfilment coverage of the lower-tier cities is largely completed; initiatives for rural China**

According to JD's management, the bulk of the geographic expansion in terms of delivery coverage to the lower-tier cities is largely completed—thus, we think it is unlikely to incur significant incremental fulfilment costs going forward. As order density improves, JD should be able to benefit from greater operating leverage.

Meanwhile, JD is actively launching initiatives that target China's rural eCommerce market.

- In November 2014, JD launched its first 'Jingdongbang' service outlet in Hebei province, to extend its last-mile delivery capability into the rural area, and plans to expand to 1,000 service outlets covering Tier 4-6 cities nationwide. The 'Jingdongbang' service outlets are run on a franchise basis, providing consumers with one-stop services including home appliance sales, deliveries, installations and maintenance services.
- In January 2015, JD announced that it has opened county-level operating centres in the Jiangsu, Hunan, Sichuan and Shangdong provinces, and aims to build 500 county-level operating centres by end-2015. Those county-level operating centres are owned by JD, which play the key roles in sales/marketing, delivery, customer service, product displays and illustrations, and staff training of rural promoters.

We expect the combination of its self-owned, county-level operating centres and the franchised 'Jingdongbang' service outlets to help JD effectively expand its rural presence, especially along with increasing consumer demand for authentic and high-quality products in the lower-tier cities and rural areas. Going forward, we expect JD to not only play the role of last-mile delivery, but also provide customer services, micro loans and consumer credit loans (among others) in the rural areas, once the supply chain matures.

Investors are often concerned with how this expansion might optically impact GMV per user, given the levels of income in most rural areas of China. However, we note that these areas also suffer from a lack of physical/offline retail infrastructure (and thus, lesser product availability). Due to this lack of infrastructure, we expect consumers in lower-tier cities to allocate a larger portion of their disposable income to online retail compared to consumers in China's larger cities.

## International expansion

With the rapid development of eCommerce in China as well as a maturing and supportive value chain, more Chinese eCommerce operators have been expanding globally—with the aim of gaining a foothold overseas, including in the developing ASEAN markets and the developed US and European markets.

## Alibaba's cross-border expansion

Alibaba is making investments in both the developed and emerging markets

Alibaba has stated that all proceeds from its recent IPO are intended for use outside of China. As for the more competitive developed markets (the US and Europe), we expect Alibaba's approach to be more measured over the near to medium term, absent a sizeable acquisition (which we would not rule out). As for an expansion in the emerging markets, we believe the combination of less competition and faster growth could make these markets more addressable in the near term.

## Online overseas imports

The major eCommerce operators in China are becoming aggressive in the online import market

To meet the rising demand for international brands, eCommerce companies in China have also started to expand their businesses into the overseas import market, putting them in competition with vertical websites. Alibaba has launched Tmall International, while JD, Jumei and Vipshop are implementing initiatives to penetrate the market. We expect continued growth for China's online import market in 2015, while competition should intensify.

In October 2014, Alibaba announced its cooperation with Costco (the leading consumer retailer in the US) to launch a Costco flagship outlet on its Tmall Global platform. This collaboration is part of Alibaba's international expansion plans, providing a channel for users to buy overseas products directly on the Tmall Global platform, especially food and healthcare products. In implementing this strategy, Alibaba's 48%-owned China Smart Logistics Network operates bonded warehouses in China that store inventory for Tmall Global merchants (such as Costco), in order to ensure availability and faster shipping for key, high-volume items.

At end-October 2014, Amazon China also announced the introduction of direct shipment channels to enable Chinese customers to purchase from Amazon's six overseas websites directly (the US, Germany, Spain, France, UK and Italy websites).

## JD is becoming more aggressive on the international market

JD has launched initiatives on imported food, leveraging its leading logistics network

JD has been aggressively exploring opportunities in international businesses, and one of its strategic focuses is on high-quality imported food.

JD stands out for the authenticity and safety of the products on its platform, which is essential for imported food. JD aims to be the leader in verticals such as imported food. In order to source for and supply high-quality imported products, JD entered into a number of partnerships with international food producers and trade promotion agencies in 2014 (for example, the Australian Ministry of Agriculture for imported milk, and Chilean fruit producers for blueberries).

- In January 2015, JD launched major initiatives to bring imported food to its Chinese customers. Embassies representing six countries led by the US (and including Australia, Canada, Chile, France and New Zealand) joined JD's event to promote the online sale of imported food through the platform. For example, the categories of US-produced products include Boston lobsters, Californian wines, and US-grown fruits, while the brands include Ocean Spray, Ghirardelli, Silk, Starbucks, Organic Valley, Mars, Quaker, Dead Guy Ale, Sun-Maid and Pringles. JD is also partnering with leading global producers of fine wines to sell their products to its customers online.

- In January 2015, JD announced the acquisition of a 30% stake in Yangmatou (an eCommerce operator in China focused on imported goods) to strengthen its capabilities in the international imports business.

- In February 2015, JD announced the launch of French Mall, a platform on its website dedicated exclusively to the sale of authentic imported French products. At the same time, JD and the French government have also made a joint statement pledging to uphold the highest quality standards and focus on product authenticity. JD's French Mall offers authentic French goods such as wine, food, cosmetics, perfume and fashion products. The company expects its French wine sales in 2015 to more than double from that in 2014 (4m bottles).

We believe JD will leverage its industry-leading logistics network to control and shorten supply chains and ensure product quality of imported food. We think JD’s same- and next-day standard delivery system as well as its strong reputation for product quality should help it attract more international food producers and brands eager to tap China's consumer market via JD’s platform.

## Expansion into the fresh food category

**JD has started trial fresh food sales**

We believe Amazon Fresh's success is indicative of significant opportunities in the fresh food categories. We think online fresh food retailing would involve relatively frequent and consistent consumption, and improve user stickiness. As such, it is an important category for eCommerce operators.

JD has started trial fresh food sales projects on a case-by-case basis. Its cold chain logistics is on trial, and while last-mile delivery is relatively easy to build, it will take longer for warehousing to be established.

- **SF Cold Chain**

On 25 September 2014, S.F. Express (S.F.) launched its cold chain service ‘SF Cold Chain’ in China. S.F. has been investing and building its cold chain infrastructure over the past two years, and the launch of ‘SF Cold Chain’ suggests that S.F. has completed the build-out of its cold chain system and started commercialisation. We see this development as an opportunity, but also potential competitive pressure for other eCommerce operators, particularly in the fresh food segment. A number of eCommerce operators have been eyeing opportunities in the fresh food segment, but are restricted due to the lack of a third-party cold chain in China, and the build-out of their own cold chain would require heavy investments. S.F.’s new cold chain system could provide an opportunity for the industry and other fresh food eCommerce companies, especially vertical operators. On the other hand, S.F.'s ambitions in the eCommerce market and its dominance in the cold chain segment would give the company strong bargaining power compared to other eCommerce operators.

To ensure the quality and timeliness of services, we expect JD to continue rolling out its own cold chain, rather than depend on third-party cold chain providers.

## Other notable trends

We expect other trends in China's eCommerce industry to continue in 2015.

(1) **The emergence of and increasing competition from vertical eCommerce operators.** This includes: 1) the expansion of online discount flash sales platforms, Vipshop and Jumei; 2) vertical eCommerce platforms

that exclusively sell cosmetics, products for mothers and babies, alcohol, and fresh fruits.

(2) **The expansion of categories** such as fast-moving consumer goods (FMCG).

(3) **The expansion into services and the online retailing of virtual goods.**

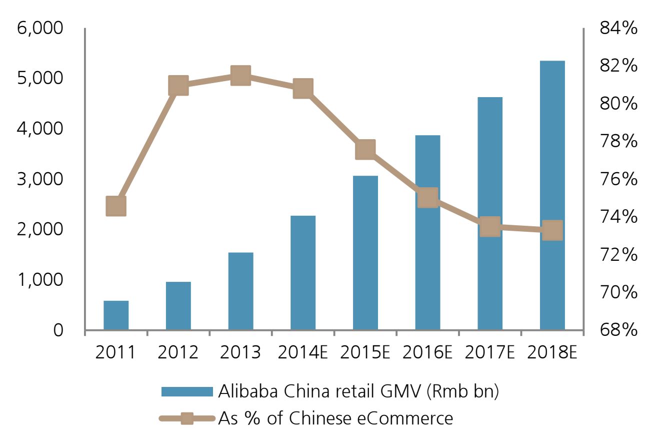
## UBS eCommerce market model

**Figure 13: China eCommerce sales (2011-18E)**

| Rmb bn | 2011 | 2012 | 2013 | 2014 | 2015E | 2016E | 2017E | 2018E |
|---|---|---|---|---|---|---|---|---|
| Online shopping transaction volume | 785 | 1,187 | 1,892 | 2,815 | 3,955 | 5,160 | 6,295 | 7,300 |
| YoY % growth rate | 70.2% | 51.3% | 59.4% | 48.7% | 40.5% | 30.5% | 22.0% | 16.0% |
| | | | | | | | | |
| C2C | 586 | 776 | 1,128 | 1,525 | 1,922 | 2,265 | 2,543 | 2,767 |
| % of online shopping GMV | 74.7% | 65.4% | 59.6% | 54.2% | 48.6% | 43.9% | 40.4% | 37.9% |
| B2C | 198 | 411 | 765 | 1,289 | 2,033 | 2,895 | 3,752 | 4,533 |
| % of online shopping GMV | 25.3% | 34.6% | 40.4% | 45.8% | 51.4% | 56.1% | 59.6% | 62.1% |
| | | | | | | | | |
| Alibaba China retail GMV | 585 | 961 | 1,542 | 2,274 | 3,068 | 3,871 | 4,626 | 5,350 |
| YoY % | | 64.3% | 60.5% | 47.5% | 34.9% | 26.2% | 19.5% | 15.6% |
| As % of Chinese eCommerce | 74.6% | 81.0% | 81.5% | 80.8% | 77.6% | 75.0% | 73.5% | 73.3% |
| | | | | | | | | |
| JD GMV | 33 | 73 | 126 | 253 | 362 | 517 | 707 | 933 |
| YoY % | | 124.2% | 71.2% | 101.7% | 43.0% | 42.8% | 36.8% | 31.9% |
| As % of Chinese eCommerce | 4.2% | 6.2% | 6.6% | 9.0% | 9.2% | 10.0% | 11.2% | 12.8% |

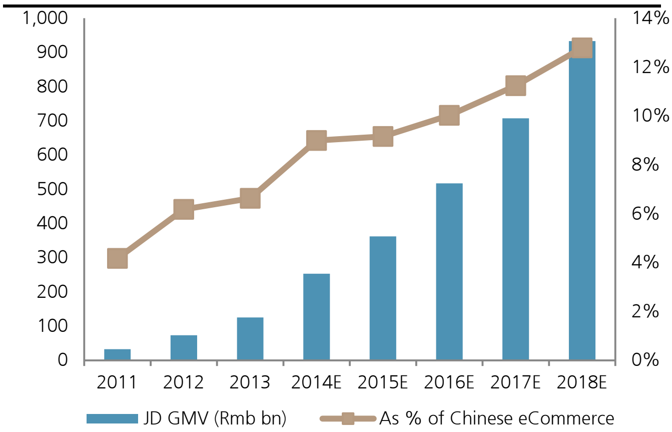
Note: JD GMV includes Paipai and Wanggou.
Source: iResearch, UBS estimates

**Figure 14: Alibaba's China retail GMV and market share**




Source: iResearch, UBS estimates

**Figure 15: JD GMV and market share**




Source: iResearch, UBS estimates

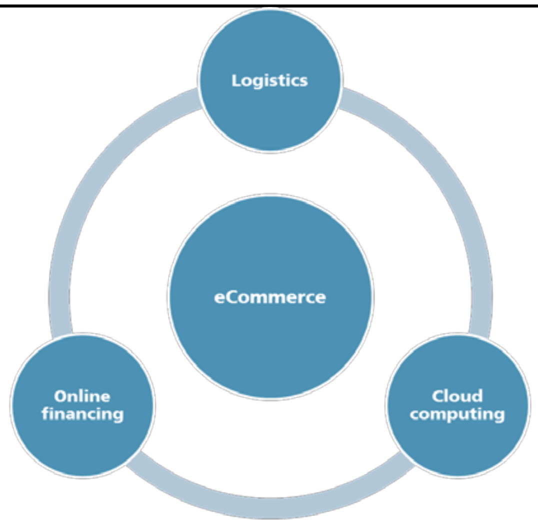
# Key themes in 2015

## I. The eCommerce ecosystem

We believe the eCommerce market in China has grown beyond a pure online shopping platform. Instead, we are seeing the formation of an entire integrated eCommerce ecosystem that consists of supporting infrastructure (logistics, online payments, cloud computing and big data) and monetisation channels such as online financing that leverage eCommerce operators' large databases. We believe the further development and expansion of an integrated and healthy eCommerce ecosystem will be the key theme in 2015 and over the longer term.

**An integrated eCommerce ecosystem consists of supporting infrastructure (logistics, online payments, cloud computing) and monetisation channels**

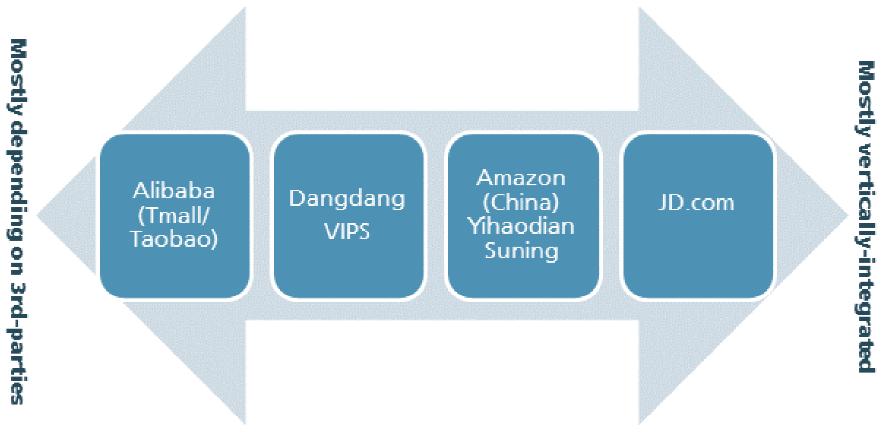
**Figure 16: eCommerce ecosystem**




Source: UBS

### 1) Logistics

**Figure 17: China eCommerce's fulfilment spectrum**




Source: UBS

There has been debate in the market on the pros and cons of self-owned fulfilment infrastructure, especially last-mile delivery versus outsourcing to third-party courier companies. We believe JD and Alibaba stand at the two ends of the eCommerce fulfilment spectrum. We expect the debate to continue for some time.

- **Alibaba's Cainiao network**

**Alibaba is cooperating with courier companies in China to build the China Smart Logistics Network (CSN)**

Rising transaction volumes and substantial demand for logistics services on Alibaba's marketplaces suggest that it would be difficult for an independent courier company to handle all of Alibaba's delivery needs. In May 2013, Alibaba together with a number of courier companies in China established a joint venture, Zhejiang Cainiao Supply Chain Management (Cainiao), to build the China Smart Logistics Network (CSN). CSN is a long-term project that will take 8-10 years to complete. CSN will connect sellers and consumers by integrating the services of logistics partners, and utilising a proprietary logistics information platform. Alibaba aims to offer its third-party sellers a scalable logistics platform and information system to provide high-quality delivery services to consumers on a large scale.

- **JD's self-owned logistics infrastructure**

**JD's nationwide fulfilment infrastructure is its most differentiated strength**

We think self-owned fulfilment systems could offer an advantage to eCommerce companies with a nationwide presence. JD's nationwide fulfilment infrastructure is its most differentiated strength, in our view. By Q314, JD's self-owned fulfilment network covered 1,855 counties. Its nationwide logistics network provides integrated fulfilment services covering all the suppliers, merchants and buyers on its platform, which is more efficient than its peers' current point-to-point strategy, which merely connects individual merchants and end-customers. Growing demand for third-party delivery services will also likely lead to a shift in bargaining power to courier companies, and exert cost pressure on merchants.

About 30% of all parcels from JD's third-party merchants were fulfilled by JD in Q2-Q314. We expect this ratio to remain stable or trend upwards slightly. Further upside to fulfilment service revenue should mostly come from warehousing services rather than delivery, in our view.

In October 2014, JD announced that it has launched operations for the initial phase of its first 'Asia No.1' warehouse in Shanghai, with a total floor space of 100,000 sqm. The warehouse is capable of sorting up to 16,000 packages per hour with 99.99% accuracy. Construction has begun on its 'Asia No.1' warehouses in Guangzhou, Wuhan and Shenyang, with additional facilities planned for Beijing, Chengdu and Xi'an. The construction of its 'Asia No.1' warehouses should lead to more cost savings once higher utilisation rates are achieved. JD aims to launch warehousing services for third-party merchants in 2015, which should bring in incremental revenue and improve its overall take rate.

- **Vipshop's aggressive warehouse expansion plan**

**Vipshop is accelerating its warehouse expansion and scaling up its last-mile capability**

To meet the requirements from rapidly-growing customer orders, Vipshop is accelerating its warehouse expansion ahead of its original schedule. Vipshop has warehousing space of 1m sqm and plans to expand to 1.6m sqm by end-2015. Should there be excess warehousing space, the company has the flexibility to lease to brand suppliers. It is also running a flash sale business on a consignment basis with an around 50% sell-through rate—thus, the co-location of inventory with brand suppliers could efficiently reduce its logistics costs for the return of inventory.

Vipshop has adopted a hybrid approach to fulfilment—it operates warehouses and outsources deliveries to third-party courier companies. To gain better control of its last-mile delivery, Vipshop has invested in regional courier companies, and supplemented them with its own delivery staff. The company aims to scale up its last-mile capability to support more than 70% of its total orders by end-2015. We

believe this should give Vipshop more flexibility to adjust its delivery capacity during peak seasons. However, it is unclear whether this indirect control of last-mile delivery will actually improve customer experience.

## 2) PC and mobile payments

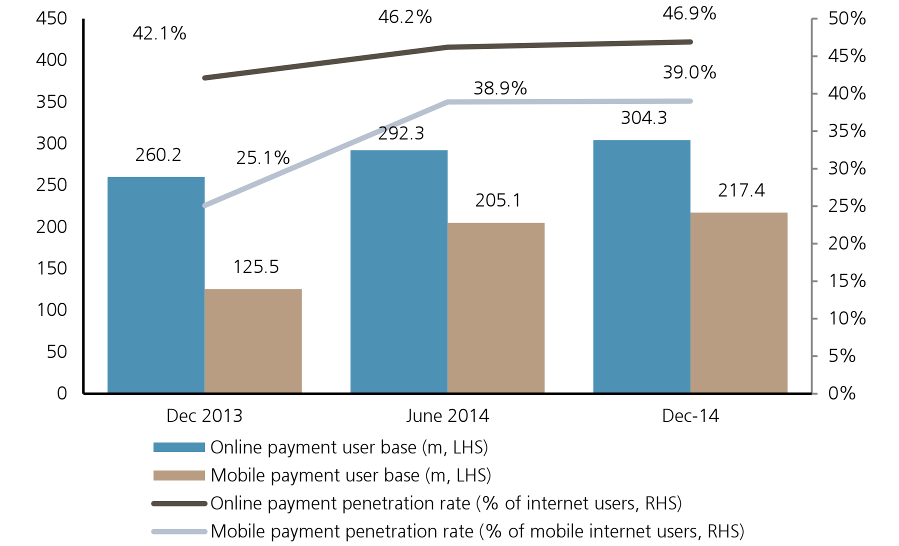
**Rapidly growing online payment services (e.g. Alipay and Tenpay) facilitate eCommerce growth in China**

Online PC and mobile payments are an essential part of the eCommerce ecosystem as online transactions rely on fast and secure payment methods. Rapidly-growing online payment services such as Alipay and Tenpay have increased the acceptance of online shopping among consumers and supported eCommerce transaction volume growth in China.

We think mobile payments should become increasingly important as eCommerce companies expand their O2O businesses and push into the offline segment, as it is an essential part of the closed loop for O2O services. We believe O2O initiatives are reliant on fast and convenient payments at mobile terminals, on the back of improving technologies.

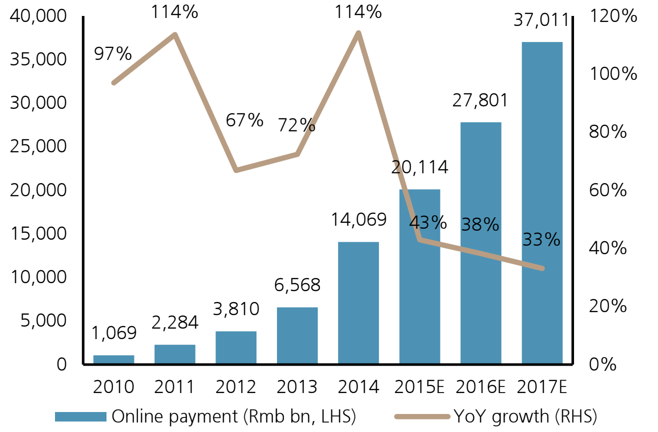
For more details, please refer to *Alibaba Group Holding Limited: A global eCommerce leader emerges* published on 14 October 2014 by Erica Poon Werkun.

**Figure 18: User base for online and mobile payments in China**



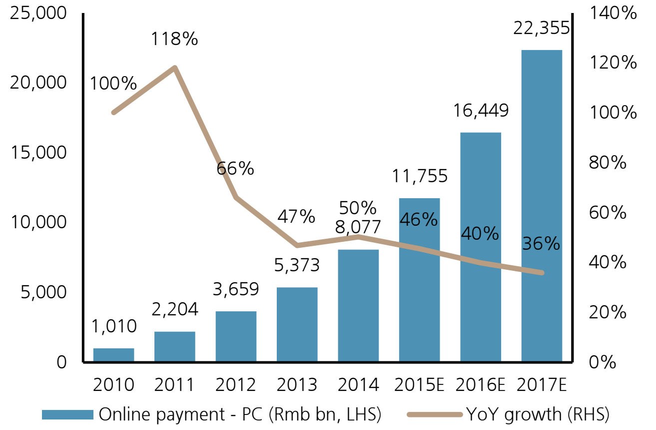

Source: CNNIC

**Figure 19: Third-party online payments (PC and mobile)**



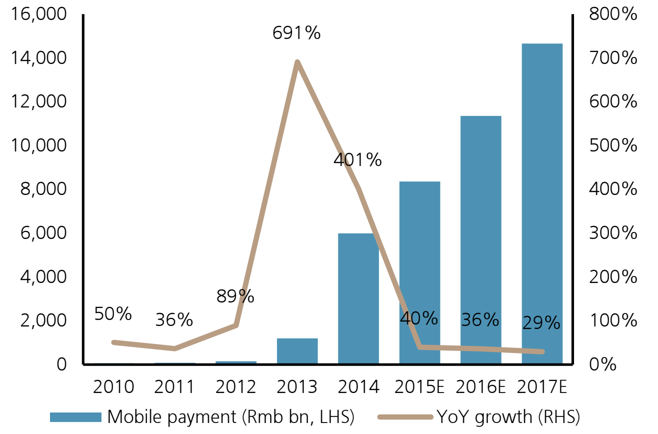

Source: iResearch, UBS

**Figure 20: PC online payment volume forecasts**



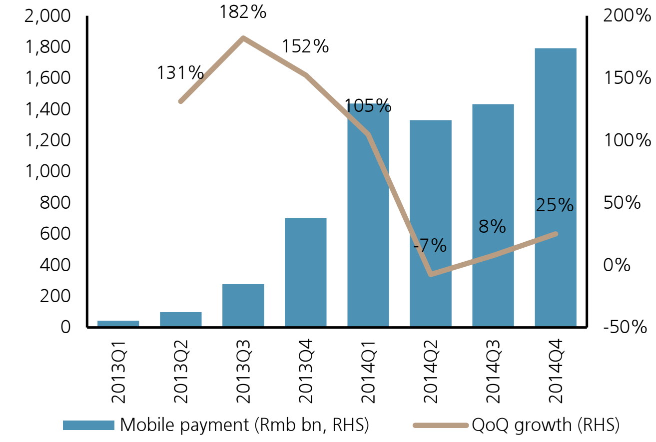

Source: iResearch, UBS

**Figure 21: Third-party mobile payment transactions**



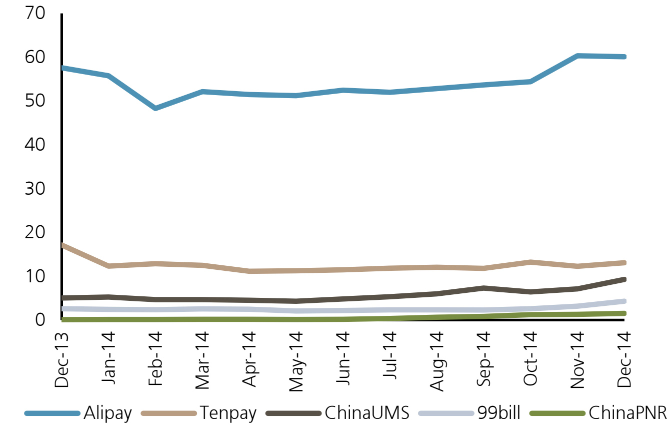

Source: iResearch, UBS

**Figure 22: Quarterly mobile payment transactions**



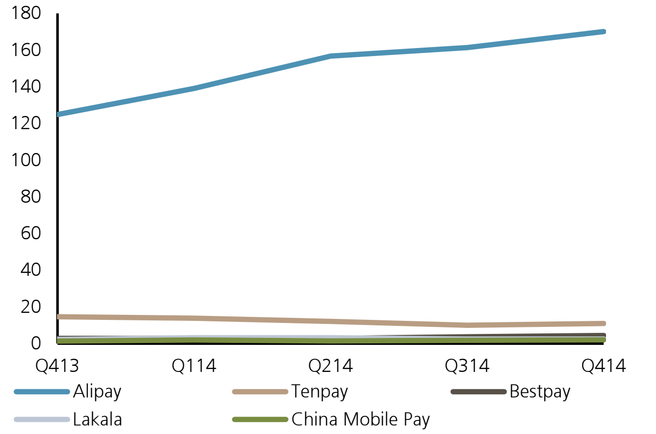

Note: Quarterly mobile payment data excludes SMS payment. Source: iResearch, UBS

**Figure 23: MUV of major online payment platforms (m)**




Note: MUV stands for monthly unique visitors.
Source: iResearch

**Figure 24: MUV of major mobile payment platforms (m)**




Source: iResearch

## 3) Online financing

Online financing includes peer-to-peer (P2P) financing, crowd-funding, online supply chain financing, and consumer credit loans. The last two are financing services provided by eCommerce companies to their sellers and buyers, based on credit assessments and risk controls that utilise the transaction data on their platforms. We expect the expansion in small and micro financing products to generate new profit streams for eCommerce companies.

### i) Online supply chain financing

**eCommerce companies provide online supply chain financing based on transaction data**

Online supply chain financing is a service provided by eCommerce companies to sellers and merchants (especially SMEs) on their platforms, utilising their own cash balance and/or external capital.

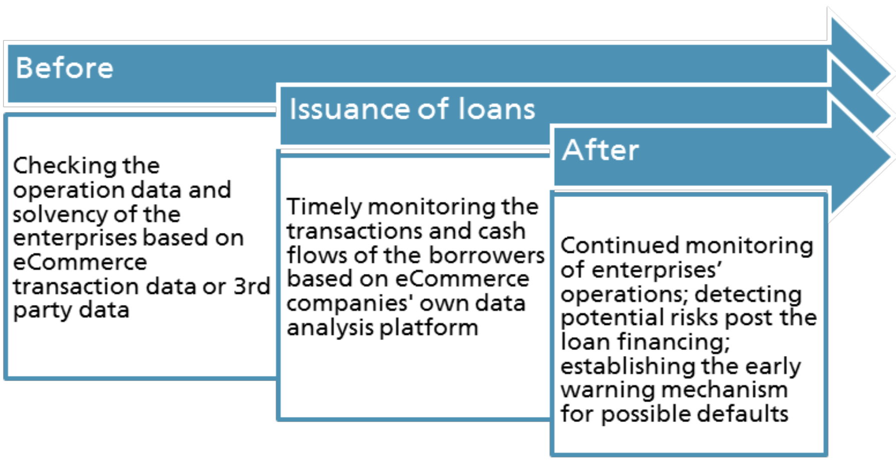
Alibaba was the first eCommerce company to offer supply chain financing services in China, using both internal and external funding sources. HC360 provides supply chain financing to more than 100,000 sellers on its platform, in cooperation with commercial banks. Meanwhile, JD offers financing services for sellers on its direct sales platform, via its supply chain financing product 'Jingbaobei'.

Compared to traditional offline supply chain financing, online supply chain financing from eCommerce companies has different advantages.

**Credit risk control is undertaken not only before loans are issued, but over the whole process**

- Online supply chain financing lowers the threshold of credit for borrowers and minimises credit and default risks for lenders, as credit assessments are based on the real transaction data of borrowers on the eCommerce platforms. Thus, credit risk control is undertaken not only before the loans are issued, but throughout the whole process.

**Figure 25: The credit assessment process**




Source: UBS

- Unlike traditional financing services, online supply chain financing transactions are all done on the eCommerce companies' platforms, or the cooperative banks' operating systems. Electronic operations and increasing digitisation should increase the efficiency and convenience of the financing process.

- **Alibaba (Ant Financial)'s micro loans**

**Alibaba's micro loans' funding sources had been evolving via its own small loan companies and financial guarantee companies**

The funds for Alibaba’s micro loans mainly came from: 1) small loan companies registered in Chongqing and Zhejiang, which borrow from banks directly and then provide loans for SMEs (however, the funds raised from banks may not exceed 50% of their net capital); 2) financial guarantee companies, with the outstanding guaranteed amounts limited to 10 times their net assets; and 3) the securitisation of outstanding loans with relatively good credit quality.

As of June 2014, Alibaba's SME loans service covered 400,000 borrowers with a total outstanding loan balance of Rmb14.6bn—it is the first and largest scale online supply chain financing service in China. SME loans was an essential part of Alibaba’s eCommerce ecosystem, and the characteristics of micro loans (fast processing and small amounts) had been effectively helping Alibaba increase the turnover rate of the group’s capital.

On 10 February 2015, Alibaba and Ant Financial announced a closure of the relationship between the two companies. As part of the restructuring, Alibaba sold the SME loans business to Ant Financial. Alibaba will no longer consolidate the financial results of the SME loan business.

- **JD's 'Jingbaobei' service**

JD introduced its online supply chain financing service ‘Jingbaobei’ at end-2013. Through 'Jingbaobei’, JD cooperates with other financial institutions to provide financing services to its suppliers, based on their historical purchasing, sales and other financial data on JD’s platform, with no need for physical assets as collateral. According to JD's management, the annualised effective interest rate for its online supply chain financing service is roughly 9%. Thus, ‘Jingbaobei’ is not really a pure financing product, but also a service provided to JD's suppliers as part of the company's efforts to build a healthy eCommerce ecosystem, in our view.

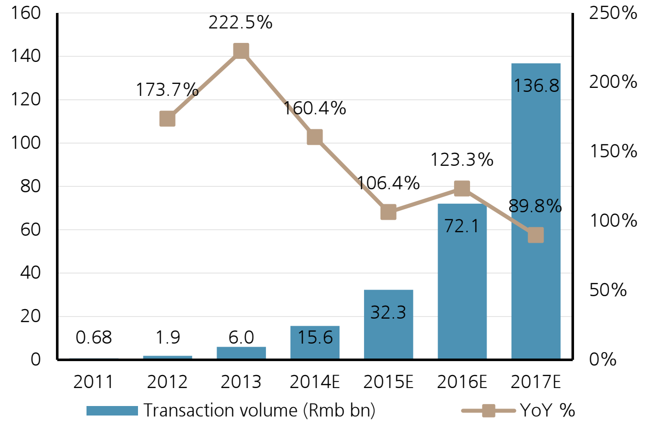
### ii) Online consumer credit services

**Some eCommerce companies also offer consumer credit loans**

In addition to the supply chain financing service provided for SMEs, some eCommerce companies also offer consumer credit loans.

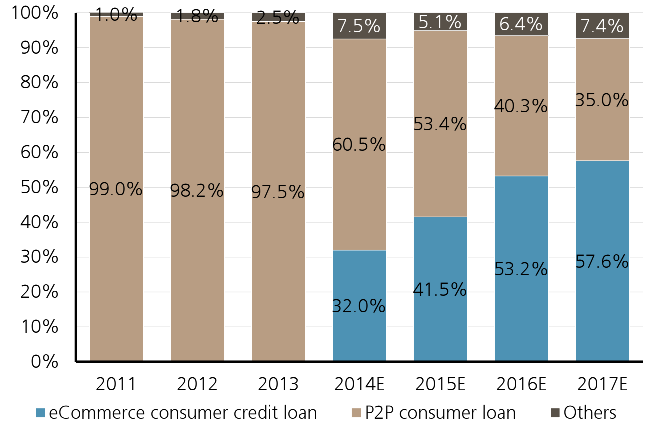
According to iResearch, the total transaction volume of online consumer credit services reached Rmb6bn in 2013, driven by the emergence of P2P financing. The market witnessed continued rapid growth in 2014, fuelled by new consumer credit services from eCommerce operators, led by JD and Alibaba. iResearch estimated that total transaction volume rose 160% YoY in 2014, partly driven by the rapid growth of China's eCommerce industry, leading to rising consumption and demand for online consumer financing services.

**Figure 26: Growth of online consumer credit loans in China**




Source: iResearch

**Figure 27: Expansion of consumer credit loans**




Source: iResearch

eCommerce platforms provide database and credit data to help facilitate credit assessments, which shortens the credit checking process. Compared to bank credit cards, we think the convenience and flexibility in payments, lower interest rates, and simplified credit checking process could help drive the adoption of online credit loans. Consumer credit loans on eCommerce platforms are expected to contribute more than 50% of the total market by 2016F, according to iResearch.

Alibaba launched its consumer credit service in May 2013, providing overdraft facilities for its Alipay users. In July 2014, Alibaba announced the launch of a new instalment service on Tmall, which allows consumers to choose between: 1) all interest charges being exempted for the first three months; or 2) instalment payments over six or nine months.

The popularity and development of online consumer credit services should lead to an improving user experience and stronger consumer purchasing power, thus increasing the GMV on eCommerce platforms. In addition, the introduction of online consumer financing services on eCommerce platforms is an effective way to monetise the large accumulated databases via big data analysis.

### iii) E-banking and credit rating services

- **Private banks**

**Private banks offers new opportunities for eCommerce companies, along with challenges**

The Chinese banking regulator granted licenses to five companies to open private banks in H214. While Alibaba was not on the first list in July 2014, it obtained permission in September 2014 to set up Mybank. Mybank is led by Ant Financial (which has a 30% stake), and is run in cooperation with Shanghai Fosun Industrial Technology (25% stake), Wanxiang Group (18%) and Ningbo Jinrun Asset Management (16%).

Advantages and opportunities

(1) Mybank focuses on individual and SME customers, who are not the typical targeted customers for traditional commercial banks.

(2) Mybank utilises the large transaction database on Alibaba's eCommerce platforms to aid in borrowers' credit risk evaluations.

(3) As Mybank is fully Internet-based, less investment is needed with regard to its physical layout and expenses for maintaining daily operations.

Concerns and challenges

(1) **Regulation risk.** Given a lack of operating history, there may be higher regulation risk for Internet-based banks, compared to traditional banks that have an existing regulation framework.

(2) **Cooperation with traditional banks.** Due to a lack of physical branches and ATMs, MyBank may need to cooperate with commercial banks.

- **Consumer credit rating services**

**eCommerce companies have an advantage in the consumer credit rating business, via addressable databases and big data analysis**

In January 2015, the Chinese government granted licenses to eight companies (including Alibaba and Tencent) to provide consumer credit rating services in China.

We believe eCommerce companies like Alibaba have a unique advantage in the consumer credit rating business. Firstly, they have accumulated addressable databases on their platforms (e.g. general customer information, purchase histories and preferences, and track records of payments). Secondly, big data systems can conduct real-time analysis and assessments of customers' income levels, consumption capacity, and ability/willingness to make payments. Credit assessments by eCommerce companies are based on all aspects of its users' daily transactions and behaviour on their platforms—we think this is a key asset and can offer a competitive advantage to companies given a lack of integrated credit data in China.

### Case study: JD's Internet financing initiatives

**JD's Internet financing initiatives: rural financing; online consumer credit product "Jingdong Baitiao"; crowd-funding, etc.**

JD Finance is a strategic focus for the JD group, according to the company. According to media reports, JD plans to apply for a consumer credit rating service license. Its equity-based crowd-funding platform will be launched in Q215. We expect JD to increase its presence in the Internet finance sector in 2015, with a focus on the following three areas—rural area financing, campus financing and equity-based crowd-funding. According to the company, it currently has no plans to apply for a private bank license.

- **Rural financing**

JD's self-owned logistics system has reached China's lower-tier cities and rural areas. There should be opportunities for JD to launch Internet financing services in those targeted areas on its platform (e.g. SME supply chain loans to merchants).

In December 2014, JD announced a strategic partnership with Grameen China—the China-based entity of Grameen Trust, the global leader in microfinance committed to poverty alleviation—in order to provide financial services in China's rural areas. The partnership uses JD's crowd-funding platform to raise money for its ground operations, and will also leverage JD's platform to provide micro loans to entrepreneurs in the rural areas of China, which have been underserved by the traditional banking system. JD is aiming to leverage Grameen's expertise in microfinance, combined with its own large user base, multiple online channels, logistics network, as well as its reach in targeted areas, to strengthen its microfinance efforts to empower rural entrepreneurs.

In general, we are positive on the upside potential from Internet financing in the rural areas. On the other hand, JD also faces risks in the underdeveloped rural financial market such as: 1) higher default risks due to lower income; 2) lower profitability in rural financing; 3) potential competition from Alibaba, which is also expanding its presence to the rural areas; and 4) regulatory risks.

- **Jingdong Baitiao**

In February 2014, JD launched China's first online consumer credit product on an eCommerce platform, 'Jingdong Baitiao', based on its customers' personal records of consumption, delivery details, return rates, and shopping feedback (among others). The maximum credit offered is Rmb15,000, and customers can choose to delay payments by 30 days or pay in instalments over 3-12 months. The latter entails an interest rate of 0.5% per month, which is only half of normal bank rates. 'Jingdong Baitiao' is processed utilising JD's own funds, without cooperation with commercial banks.

Its consumer credit product is well accepted in the market. JD is also actively expanding the scope for its Internet financing services. In January 2015, it launched a new 'Jingdong Baitiao' service solely for college students. This differentiated service aims to provide instalment services to college students (who typically have lower purchasing power), and is expected to bring in incremental revenue and profit to the group.

- **Crowd-funding**

eCommerce operators started entering the crowd-funding sector in China in 2014. JD's product-based crowd-funding service was launched in July 2014 and has collected more than Rmb100m by early December 2014, according to media reports. According to 01caijing.com data analysis, JD's market share in China's product-based crowd-funding segment was 63% by December 2014, only five months after its launch.

According to management, JD will launch its equity-based crowd-funding platform in Q215, including both private and public equity, and hopes to introduce some innovative crowd-funding models. JD has accumulated a number of crowd-funding customers through its product-based crowd-funding platforms. We expect the company to grow its equity-based crowd-funding business quickly by leveraging its existing crowd-funding users.

We believe JD has the following unique advantages in China's crowd-funding market: 1) a strong reputation for customer service; 2) a large database; 3) significant traffic and a large user base; and 4) multiple crowd-funding models that are focused on 3C[1] products and smart devices.

- **Credit rating service**

In February 2015, JD's management said the company is planning to apply for a consumer credit rating service license. Like Alibaba, we believe JD is well-positioned to provide consumer credit rating services, by leveraging its large transaction database of buyers. JD is also actively developing back-end technologies—such as a risk management system required for credit rating services—in cooperation with partners in China and overseas.

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[1] 3C refers to computers, communication and consumer electronics.

- **Others**

In December 2014, JD's wholly-owned online payment subsidiary, Chinabank Payment, announced a cooperation with Pacific Securities to launch the online sale of securities products, which should further expand JD's business scope in Internet financing.

In January 2015, JD Finance launched a new insurance wealth management product, 'Baonizhuan', in cooperation with insurance companies, with annualised interest rates of up to 7.1%.

## 4) Cloud computing in eCommerce

**Developing eCommerce cloud solutions to facilitate offline retailers to shift online**

Demand for professional solutions in the eCommerce value chain has triggered the emergence and development of cloud services in the eCommerce sector in China—these are cloud-based solutions to help traditional retailers to shift from offline to online, including a choice of eCommerce platforms, setup and operation, online marketing, and even logistics and fulfilment.

In July 2012, Alibaba launched the first eCommerce cloud in China, cloud.tmall.com, leveraging its market-leading resources in the Aliyun and Tmall B2C marketplace. Alibaba's cloud.tmall.com had benefited from its first-mover advantage, and the group's stronger resources in the eCommerce market.

The eCommerce cloud market is growing rapidly. By 2013, over 80% of the merchants on Taobao and Tmall have moved their operating and management systems onto Alibaba's eCommerce cloud platform.

In January 2014, JD officially launched its eCommerce cloud solutions for traditional offline retailers. JD's cloud platform aims to provide a full range of services from online to offline to eCommerce merchants, including opening online shops on an eCommerce platform, launching online outlets on Weixin/Wechat, and even offering logistics and fulfilment solutions on the back of its robust fulfilment infrastructure.

## 5) Smart devices

**JD is focusing on the evolution of a matured value chain and ecosystem for smart devices**

JD has been focusing on the development of smart devices and the evolution of a matured value chain and ecosystem for smart devices. JD's smart device division consists of two parts—JD Smart (in January 2015, JD rebranded its smart device arm NSNG to JD Smart) and the crowd-funding platform. JD is integrating its resources including chipsets, cloud computing, mobile apps, as well as the upcoming equity-based crowd-funding service, in order to build a smart value chain, and provide one set of solutions for entrepreneurs in the smart device market.

JD Smart focuses on three areas.

(1) **"JD+" smart hardware project**—this is JD Smart's key business, focused on introducing innovative smart hardware and R&D teams.

(2) **JD smart cloud platform**—JD cooperates with more than 100 Tier-1 brands in China (e.g. Midea) in planting JD chipset modules into traditional home appliances and get them connected via the JD smart cloud, so as to allow consumers to control all the connected products of different brands via a single app.

(3) **Investments in associates**—JD invested in around 10 companies in 2014, and will continue investing in start-up companies in the smart device industry via minority stakes.

We believe JD has the following differentiated advantages in the development of a smart value chain.

- **Database:** JD has accumulated large transaction data on users, which would help companies that develop products better understand user demand, based on the JD smart cloud.
- **Users are the target group for smart devices:** JD started with 3C products and has accumulated a large number of high-quality users with higher 'stickiness'. More importantly, these users match the targeted group for smart devices.

### JD's cooperation with Midea

In December 2014, JD announced its cooperation with Midea. The two companies will further expand their scope for cooperation to include smart appliances, channels and distribution. Midea is a leader in the industry chain and channels, and intends to enter the Internet and smart home appliance business, which we believe is essential for the cooperation and is highly valued by JD.

## II. Mobile monetisation

Along with the rapid growth of mobile shopping, the focus of eCommerce companies have shifted towards the monetisation of mobile traffic via: 1) expanding the entry points on mobile; 2) improving mobile app interfaces and the user experience; 3) increasing the mobile conversion rate; 4) increasing the mobile shopping basket size; and 5) improving the accuracy and ROI of mobile advertising.

**Focuses of mobile monetisation:**
**- expanding mobile entry points**
**- improving the user experience**
**- improving mobile conversion rates and basket size**
**- higher mobile ads ROI**

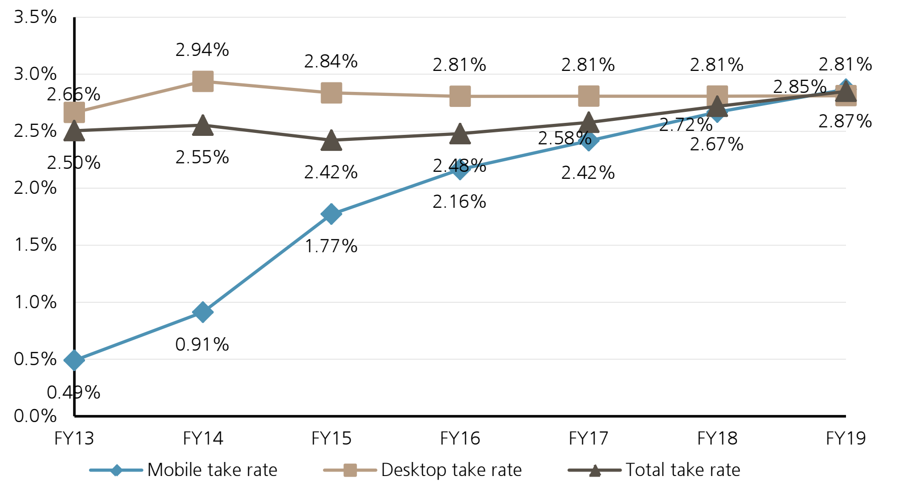
- **Alibaba**

Alibaba has made a number of investments to gain mobile entry points to commercial activities—these include UCWeb, Weibo, Momo, Xiami, and Umeng. Alibaba has also maintained efforts to keep its leading position in mobile apps.

a. Alibaba's Tmall/Taobao mobile apps have benefited from its mobile payment system. Alipay can provide a secure mobile shopping environment for Tmall/Taobao customers.

b. Alibaba and UCWeb launched the mobile search engine "Shenma", which displays related sales information and directs users to Taobao/Tmall's shopping webpages, serving as another entry point to Tmall and Taobao. In September 2014, UCWeb updated the browser with enhanced integration of both Taobao and Tmall services. Specifically, users can now log in via their Taobao accounts. In the longer term, we think UCWeb could become an increasingly important source of mobile users and traffic for Alibaba.

**Figure 28: Mobile versus desktop monetisation ('take rate')**

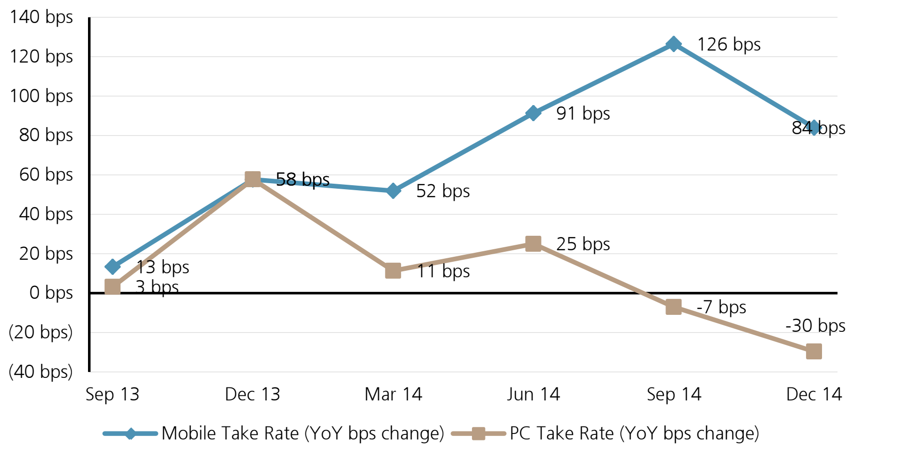



Source: Company data, UBS estimates

**Alibaba's PC and mobile monetisation rate gap could narrow over the coming years**

We forecast a narrowing gap between Alibaba's PC and mobile monetisation rate over the coming years. There are five key factors that are supportive of both mobile transaction growth and advertisers' ability/willingness to pay higher CPC[2] on mobile—geo-location and personalisation, larger screen sizes on phones, innovations in payments, O2O services, and digital content.

**Figure 29: Mobile and desktop take rate trends over previous quarters**




Source: Company data

**Recent changes in advertiser tools and ranking algorithms have put near-term pressure on PC take rates, but should ultimately improve ROI and repeat purchases**

During June and July 2014, Alibaba made a series of changes to its platform related to both advertiser tools and its search result algorithms. While these changes have put near-term pressure on PC take rates, we believe they will ultimately provide better ROI for advertisers/merchants and increase repeat purchases from consumers (through more relevant search results and increased product selection). We detail the changes made by Alibaba that are likely to impact PC take rates as follows.

a. **Merchant/advertiser bidding system-related.** Alimama, the advertising platform used by merchants selling on Alibaba's

[2] CPC = cost per click

marketplaces, allows merchants to bid (on a CPC basis) on keywords related to their product inventory. Beginning in June 2014, the system began suggesting longer-tailed keywords to advertisers, effectively more specific search terms. These longer tail keywords are generally able to be bid on at lower CPC levels (as there is less demand for them), effectively reducing the cost for merchants. Keeping costs lower allows smaller merchants to maintain their positioning and continue providing inventory to Alibaba's marketplaces. On the consumer side, shoppers on Alibaba's marketplaces are now more likely to receive relevant results when typing in more complex search terms (which is supportive of conversion, and ultimately, GMV).

b. **Paid-search ranking algorithm-related.** All searches provide a series of both paid and unpaid (organic) results. Within paid search results, Alibaba simply tweaked its algorithm to increase the weighting applied to the quality of the results (and simultaneously reduced the weighting applied to the bidding level; the price the merchant was willing to pay). This helps to provide more relevant paid search results, improving the user experience. This change was made in July 2014.

c. **Improved personalisation of organic search results.** By improving the personalisation of its organic search results (unpaid search results), Alibaba is able to increase the relevancy of its overall search results displayed to consumers. While this customisation can lead to improved conversion and GMV, it could also lead to fewer CPC-based (paid) clicks compared to organic (unpaid) clicks.

- **JD**

**JD enriches its mobile offerings via five entry points, including both centralised and decentralised platforms**

Enhancing mobile offerings remains a key priority for JD. JD has enriched its integrated mobile offerings, comprising five entry points.

a. **Three centralised platforms:** 1) JD mobile app; 2) Tencent's Weixin Level-1 access; and 3) Mobile QQ Level-1 access.

b. **Two decentralised platforms:** 1) JD Weidian for B2C merchants; and 2) Paipai Weidian for C2C sellers.

**Management said the progress of Tencent's Weixin/Mobile QQ access has been better than expected**

JD's management is optimistic on the progress of Tencent's Weixin/Mobile QQ access. During the UBS Greater China Conference in January 2015, JD shared that development on Tencent's mobile level-one access has been better than expected, aided by flash sales, as indicated by an increasing number of active customers as well as rising mobile GMV in the past quarters. JD said that Tencent's Weixin/Mobile QQ access have contributed 'meaningfully' to incremental customer accounts, facilitated JD's penetration into the lower-tier cities, and appealed to younger consumers. Its penetration to lower-tier cities via Weixin has turned out to be effective, at similar levels as that for Mobile QQ. Orders from JD's native mobile app still account for the bulk of JD's total orders from mobile. On mobile, the fastest-growing categories are apparel and general merchandise (smaller ticket sizes). Impulse purchases typically have smaller ticket sizes.

Mobile orders contributed to 40% of JD's total orders during Singles Day on 11 November 2014. However, management highlighted that this is not indicative of its mobile contribution in Q414, as certain promotions and campaigns were specific to mobile users.

In 2015, JD has continued to launch mobile initiatives to drive mobile traffic and improve monetisation.

a. In January 2015, JD launched a mobile app for its mobile shopping C2C marketplace, Paipai Weidian. Paipai Weidian is a mobile marketplace that provides merchants with traffic on Tencent's various social networking service (SNS) platforms like Weixin/WeChat, Mobile QQ and Qzone, while payment services are supported by Tenpay and Weixin Payment. JD is investing Rmb100m in Paipai Weidian to attract merchants to set up stores on the platform.

b. In January 2015, JD also announced that the social marketing system for its Paipai Weidian platform is now accessible on JD's Wexin official accounts. The new function allows Wexin users to earn a commission by sharing Paipai Weidian merchandise links in a group chat or on their Weixin Moments. They will receive a commission based on the sales generated by the shared links, with different commission rates depending on the product category.

We think the market might be overly pessimistic on JD's mobile performance. We remain positive on the strategic importance of the Tencent partnership, both in the form of the level-one access and Weidian. It should help raise JD's profile, particularly in the lower-tier cities where its presence is less developed.

- **Vipshop**

**Vipshop takes the lead in mobile GMV contributions (66% in Q414), aided by a flash sales model**

In Q414, the GMV for mobile accounted for 66% of Vipshop's total GMV, compared to 57% a quarter ago, exceeding the company's target of 50% contribution by end-2014. Vipshop leads Alibaba and JD in terms of mobile GMV contributions. In our view, the different shopping experience on online flash sales platforms, the higher likelihood of impulse purchases, and the limited time for discount sales events encourage consumption on mobile devices.

According to Vipshop, the average basket size on its mobile platform is fairly similar to that on the PC platform, while shopping frequency on mobile is 7-8% higher. Vipshop has also introduced special promotions to drive mobile GMV growth, such as waiving shipping fees, and mobile-only events and SKUs[3]. We expect the migration from PC to mobile to help Vipshop extend its addressable customer base.

## III. O2O

**eCommerce companies use O2O services to expand their consumption scenarios**

Online-to-offline (O2O) services entail a cooperation among third-party payment companies, eCommerce companies, social network platforms, and merchants, to integrate online and offline services. O2O has been a focus of eCommerce companies as an effective way to expand consumption scenarios, while mobile payment is an essential part of the closed loop for their O2O strategies.

[3] SKU = stock keeping unit

- **Alibaba's selected O2O initiatives**

**Alibaba's selected O2O initiatives—cooperation with Intime Retail, group-buying and taxi-hailing**

Alibaba is aggressive in its push of O2O services. Specific to Intime Retail, the company's inventory is now available on Tmall, with pick-up available in stores. Group-buying is another early form of the O2O model, where consumers make the payment for services online at discounted prices, and then realise the fulfilment at physical stores such as restaurants, cinemas, and KTV lounges. With regard to Alibaba's efforts in the taxi-hailing service (via its investment in Kuaidi Dache, a major mobile taxi app in China), we believe a key goal is to encourage the adoption of its mobile payment app, Alipay, which in turn, could help both its O2O services and eCommerce businesses.

- **JD's selected O2O initiatives**

**JD is active in O2O services—cooperation with local offline retail chain, O2O in rural China, online food deliveries, healthcare and medical segment**

Since 2013, JD has cooperated with a local offline retail chain in Taiyuan, Tangjiu of Taiyuan City, to provide delivery services (primarily for groceries). We think the cooperation is a win-win. It allows JD to offer a "within one hour" delivery service by utilising offline Tangjiu stores, extending its presence without a substantial investment. Meanwhile, Tangjiu's online store on JD can benefit from JD's substantial traffic flow and SKUs.

JD has also launched a number of new initiatives to drive O2O opportunities over the past months.

**a. O2O in rural areas**

JD is actively tapping opportunities in O2O in the lower-tier cities and rural areas. JD and China Post announced their partnership on eCommerce and O2O in the Tier 3 and lower cities to expand JD's consumer reach by leveraging China Post's local branches. JD has also launched "Jingdongbang" service outlets in rural areas to serve local consumers. These O2O initiatives should help JD effectively expand its presence into the lower-tier cities and rural areas as they integrate online consumption with one-stop offline services.

**b. Online food deliveries**

In late September 2014, JD launched a new online community for O2O services, JD Kuaidian, and introduced their public accounts on Weixin. JD offers guaranteed two-hour deliveries if the order is placed between 9:00am and 8:30pm. The goods are mainly sourced from surrounding supermarkets and include milk, fresh vegetables and fruits, snacks, and beverages—they are delivered by JD and third-party courier companies. During the same period, JD also made a second investment in Daojia.com, an online food delivery service provider.

In late January 2015, JD announced a strategic investment in an online food delivery service platform, Ele.me, together with CITIC Private Equity, Tencent, Dianping, and Sequoia Capital. According to management, Ele.me is the largest online food delivery platform in China, with a 60% market share and 20m users.

**c. Healthcare and medical**

In December 2014, China's State Food and Drug Administration issued "Grade A Online Drug Sales Platform" certification to JD, making it the third eCommerce platform to receive the certification after Tmall and Yihaodian. "Grade A" certification allows JD to work with approved drug manufacturers, drug distributors and medical institutions. JD had previously only offered healthcare products that did not require a license. The new certification will help expand its

business to online drug sales, and likely provide O2O opportunities in the healthcare and medical sector in the future.

## Surprises on the upside and downside

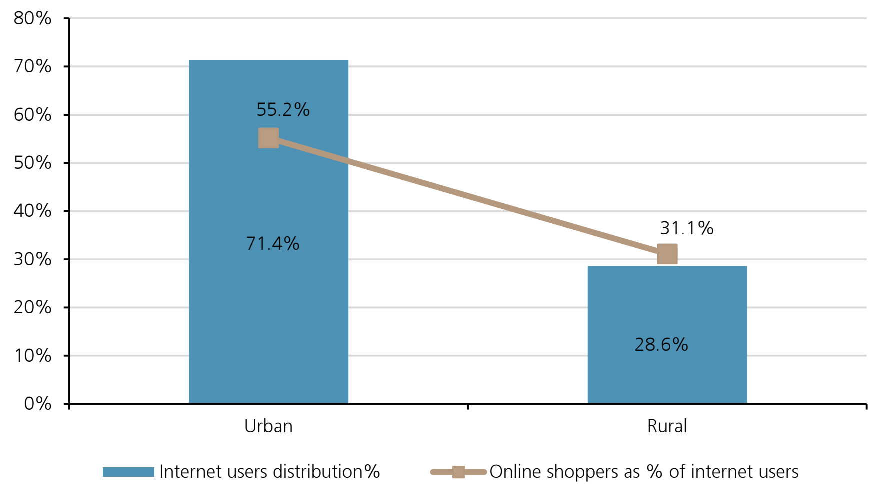
### Upsides

**Upsides: faster mobile take-up, monetisation and rural area expansion; better execution on category expansion**

- Faster-than-expected growth in mobile take-up and mobile monetisation
- Faster expansion in the lower-tier cities and rural areas
- Better execution on category expansion, especially categories tied to spending by the head of the household (food and CPG [consumer packaged goods], including baby products).

The potential upside to our estimates could come from the very low penetration in rural areas. In 2013, 28.6% of Chinese Internet users lived in rural areas, and online shoppers only accounted for 31.1% of total Internet users in rural areas, compared to a 55.2% penetration rate in the urban areas. Rural Internet users represent untapped potential for continued high growth in China's eCommerce market, in our view.

**Figure 30: Online shopping penetration in urban versus rural areas (2013)**




Source: CNNIC

### Downsides

**Downsides: a worsening competitive landscape, margin deterioration, macro consumption environment, regulatory risks, and volatility in Alibaba's PC take rate**

- We think the key downside for China's eCommerce market is changes to the competitive landscape.
- Worse-than-expected margin deterioration due to competition and heavy investments in the industry.
- Changes in the macro consumption environment.
- Government crackdowns on pricing transparency and the quality of goods.
- Volatility in PC take rate from advertising changes at Alibaba.

The eCommerce market in China is generally led by the following three dominant operators in different segments: 1) Alibaba in the C2C and B2C marketplace; 2) JD

in B2C direct sales; 3) and Vipshop in online discount flash sales. There has been some consolidation in the market over the previous years, particularly in the B2C segment. However, market competition should continue, given our view that efforts by the smaller companies in aggregate will result in their ability to take some share in the Chinese eCommerce market. Specifically, we expect continued pressure from existing competitors (such as Dangdang, Suning, Yihaodia, and Gome), investments by foreign companies (Amazon and eBay), incremental investments by traditional offline retailers (expansion into the marketplace and O2O efforts), and an aggressive push by the vertical eCommerce operators.

We believe the most important advantage for eCommerce operators is their pricing gap with offline retailers—thus, fierce price competition from offline retailers would likely exert pricing and margin pressure on eCommerce operators.

## Key catalysts in 2015

We think the key potential catalysts this year are:

- mobile monetisation progress
- M&As that enrich mobile offerings in the eCommerce sector

**2015 key catalysts—mobile monetisation progress; M&As that enrich eCommerce mobile offerings**

Over the past 12 months, there have been frequent M&A transactions in the eCommerce space. Internet giants Alibaba, Baidu and Tencent (BAT) have actively invested in verticals across the sectors, such as group buying, logistics suppliers, mobile social platforms, and navigation/maps, to extend their addressable user bases, improve supply chain efficiency, gain diversified access points on mobile Internet, and pursue opportunities in O2O.

1) Any announcements by eCommerce companies that could help enrich mobile offerings and the O2O business could be a positive catalyst for eCommerce stocks and the industry.

2) Announcements by the above-mentioned Internet giants (which were absent in the eCommerce segment during the PC era) to enter or expand their presence in the mobile eCommerce space could indicate intensifying competition—this would be negative for eCommerce stocks.

**Figure 31: M&A activities have become more frequent**

| Date | Event |
|---|---|
| 15-Jan | Tencent and JD.com acquired a 25% and 3.3% stake in Bitauto, respectively |
| 15-Jan | Tencent invested US$30m in Line0, a food ordering company |
| 15-Jan | Alibaba invested in Kuaidi Dache, a taxi booking app |
| 15-Jan | Ctrip acquired a majority stake in Travelfusion, an online travel company |
| 14-Dec | Baidu invested US$600m in Uber |
| 14-Dec | Tencent invested in Dididache, a taxi booking app |
| 14-Oct | Baidu invested in Peixe Urbano, an online discount company |
| 14-Sep | Tencent acquired a 10% stake in Koudai Gouwu, an mobile shopping app |
| 14-Sep | Tencent acquired an 11.55% stake in China South City, a logistics company |
| 14-Sep | Tencent invested in Woqu, an online travel company |
| 14-Sep | JD.com invested in Daojia, a food ordering platform |
| 14-Jul | Tencent invested US$3.2m in eDaixi, a mobile laundry app |
| 14-Jun | Alibaba announced an acquisition of the remaining 34% stake in UCWeb |
| 14-May | Tencent acquired a 5% stake concurrent with JD.com's IPO |
| 14-May | Alibaba announced an acquisition of a 10.35% stake in SingPost, a provider of mail and logistics services in Singapore and the Asia Pacific region |
| 14-May | Tencent announced an acquisition of an 11.28% stake in NavInfo, a navigation/map service provider in China |
| 14-Mar | Alibaba announced an acquisition of no less than a 25% stake (stock + convertible bonds) in Intime department store |
| 14-Mar | Tencent announced an acquisition of a 15% stake in Leju, an online real-estate services provider in China |
| 14-Mar | Tencent acquired a 15% stake in JD.com |
| 14-Feb | Tencent acquired about a 20% stake in Dianping.com, a restaurant review website |
| 14-Feb | Vipshop acquired a 75% stake in Lefeng.com, an online beauty and fashion retailer |
| 14-Feb | Yihaodian and Dangdang confirmed a strategic alliance to share the second-level domain of "dangdang.yhd.com" |
| 14-Feb | Alibaba announced its acquisition of Autonavi, China's top smartphone map app |
| 14-Jan | Baidu announced it will acquire the remaining 41% stake in Nuomi |
| 14-Jan | JD.com acquired Hotelvp, a last-minute hotel booking app |
| 14-Jan | Suning acquired a group-buying site "Manzuo" for its local O2O strategy |
| 14-Jan | Alibaba acquired a 54% stake in CITIC 21CN, a pharmaceutical data firm |
| 13-Dec | Alibaba invested in Haier Electronics to form a logistics joint venture |
| 13-Dec | Tencent invested in Dididache, a taxi booking app |
| 13-Dec | Ctrip acquired a 20% stake in eHi AutoServices, a car rental company |
| 13-Aug | Baidu invested US$160m in Nuomi (59% stake), a group-buying website |
| 13-Apr | Alibaba acquired an 18% stake in Sina Weibo |
| 13-Apr | Alibaba invested in Kuaididache, a taxi booking app |

Source: Company data

### Statement of Risk

We believe the key risks for China's eCommerce sector include: 1) an evolving competitive landscape and intensifying competition; 2) continued investments required for expanding fulfilment; 3) adverse changes in economic growth and consumer sentiment; 4) execution risk and an inability to manage growth; and 5) regulatory and credit risks.

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|---|---|---|---|
| **Buy** | FSR is > 6% above the MRA. | 47% | 37% |
| **Neutral** | FSR is between -6% and 6% of the MRA. | 42% | 32% |
| **Sell** | FSR is > 6% below the MRA. | 11% | 21% |
| **Short-Term Rating** | **Definition** | **Coverage**[3] | **IB Services**[4] |
| **Buy** | Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event. | less than 1% | less than 1% |
| **Sell** | Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event. | less than 1% | less than 1% |

Source: UBS. Rating allocations are as of 31 December 2014.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category. 4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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**UBS AG Hong Kong Branch:** Erica Poon Werkun, CFA; Angela Xu, CFA. **UBS Securities LLC:** Eric J. Sheridan; Timothy E. Chiodo, CFA.

### Company Disclosures

| Company Name | Reuters | 12-month rating | Short-term rating | Price | Price date |
|---|---|---|---|---|---|
| **Alibaba Group Holding Limited**[16] | BABA.N | Buy | N/A | US$85.12 | 27 Feb 2015 |
| **JD.com**[2, 4, 5, 6, 16] | JD.O | Neutral | N/A | US$27.67 | 27 Feb 2015 |
| **Vipshop Holdings Limited**[16] | VIPS.N | Neutral | N/A | US$24.45 | 27 Feb 2015 |

Source: UBS. All prices as of local market close.
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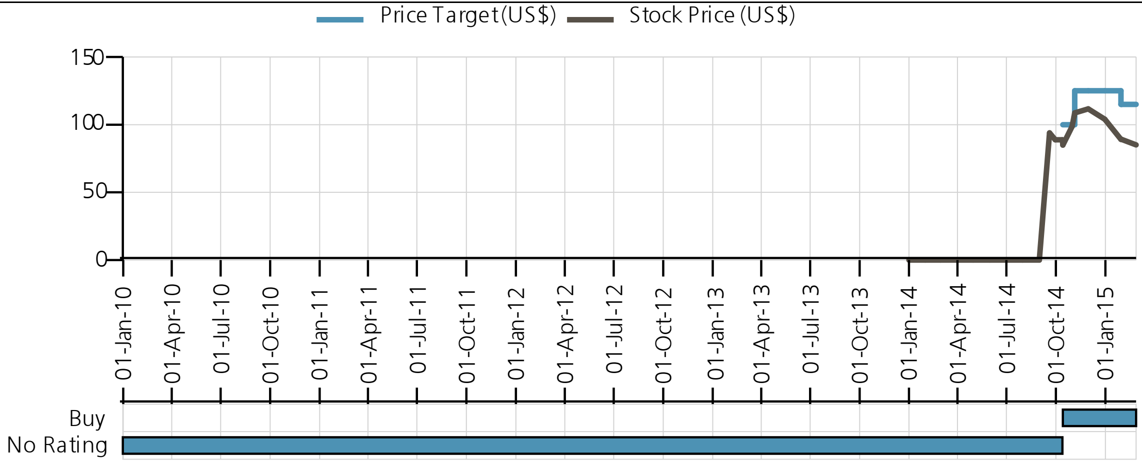
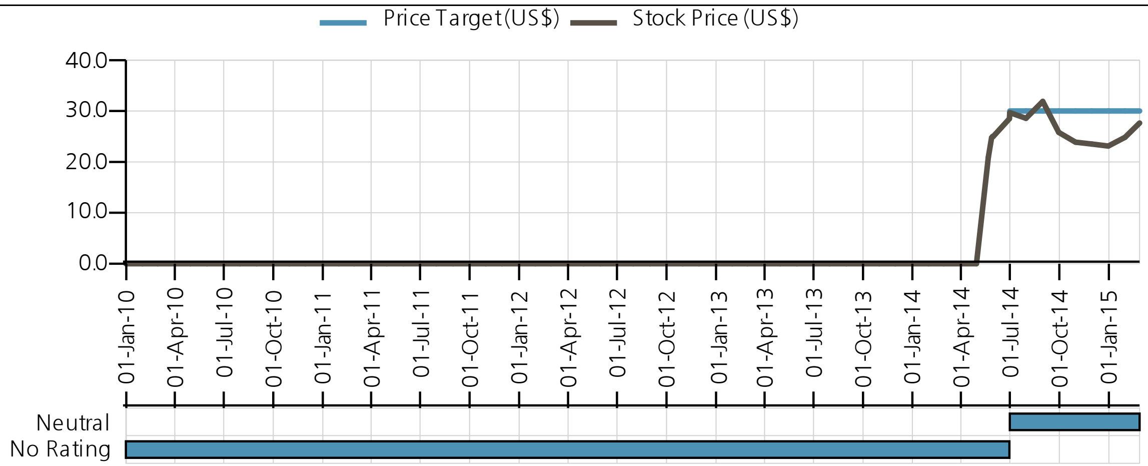


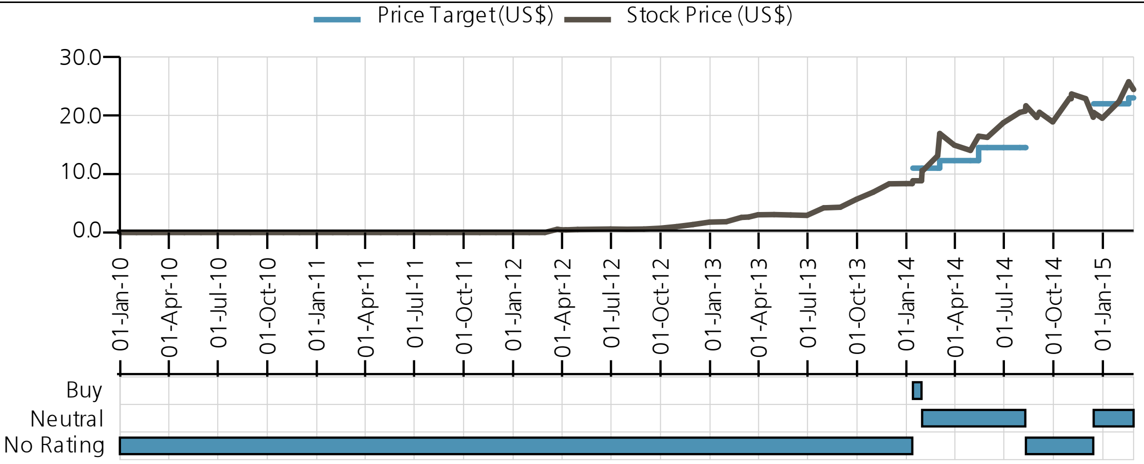

Source: UBS; as of 27 Feb 2015

**JD.com (US$)**




Source: UBS; as of 27 Feb 2015

**Vipshop Holdings Limited (US$)**




Source: UBS; as of 27 Feb 2015

Additional Prices: Baidu, Inc., US$203.75 (27 Feb 2015); Tencent Holdings, HK$135.90 (27 Feb 2015); Source: UBS. All prices as of local market close.

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