McKinsey iConsumer China 2016 survey

How savvy, social shoppers are transforming e-commerce

McKinsey Digital April 2016

Kevin Wei Wang
Alan Lau
Fang Gong

April 2016

How savvy, social shoppers are transforming e-commerce

Kevin Wei Wang
Alan Lau
Fang Gong

INTRODUCTION

With the most Internet users of any country, China is the world's largest and fastest-growing e-commerce market. Capitalizing on opportunities, however, is becoming harder for consumer-facing companies as e-commerce penetration rates plateau in high-tier cities and as digital attackers, especially in the online-to-offline space, cut into incumbents' margins.

According to McKinsey's latest survey of China's Internet users, promising sources of e-commerce growth are emerging. The research points to areas with major growth potential: the uptake of online shopping among consumers in low-tier cities, e-commerce penetration beyond first-mover product categories such as apparel, purchases initiated from social media platforms, and the use of cross-border shopping to supplement domestic channels.

Our research also revealed positive trends in multichannel services, known in China as online-to-offline (O2O) services. Some observers have speculated that O2O services have used investment capital to cut their prices and thereby win customers. While this is true for some categories, our survey suggests customers appreciate the convenience and quality of O2O services—particularly travel, dining, and transportation, on which they increase their total spending after they start to use O2O options.

This year's survey, conducted online during January 2016, engaged more than 3,100 people across a wide range of income levels and household locations. Their responses confirmed our view that the e-commerce and O2O-services markets still hold enormous potential. In this report, we describe changes in Chinese e-commerce and consider the growth prospects associated with trends in low-tier cities, social media, and cross-border shopping. We then turn to the dynamics of the O2O sector and take a closer look at opportunities in travel, dining, and mobility services.
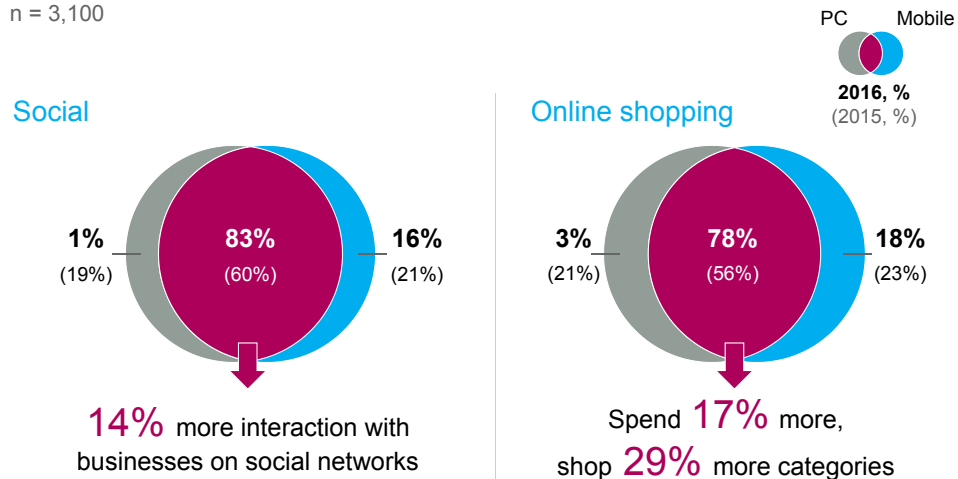
THE EVOLVING PROFILE OF E-COMMERCE IN CHINA

At approximately $630 billion of sales in 2015, China's online retail market is the world's largest, nearly 80 percent bigger than the United States's, which it overtook some two years ago. E-commerce in China accounts for 13.5 percent of all retail spending, a higher share than that of all large economies but the United Kingdom. Although Chinese e-commerce is forecast to grow strongly in the near term, our survey shows that companies need to prepare for new customer segments, product categories, and sales channels to emerge as dominant sources of future growth.

Catering to users across devices has become essential for consumer-facing businesses. This year's survey confirms that China's digital consumers still overwhelmingly use mobile devices to access the Internet, as they have for years. While mobile-first marketing strategies are important, PC-based offerings should not be neglected. We found that multidevice owners (those who use two or three connected devices, such as smartphones, tablets, and computers) are more intense digital consumers. They spend 17 percent more on e-commerce than their mobile-only peers. They also shop online in 29 percent more categories and interact 14 percent more with businesses through social networks, using such interfaces as brands' public WeChat accounts (Exhibit 1).

Exhibit 1

China is a mobile-first market, but multiscreen users on average spend 17 percent more than their mobile-only peers

Device adoption among digital consumers, %
n = 3,100

Social

1% (19%) 83% (60%) 16% (21%)

14% more interaction with businesses on social networks

PC   Mobile

2016, % (2015, %)

Online shopping

3% (21%) 78% (56%) 18% (23%)

Spend **17%** more, shop **29%** more categories

SOURCE: McKinsey iConsumer China 2016 survey

Among China's digital consumers, certain product categories have caught on more than others (Exhibit 2). Consumer electronics and small appliances are two well-established online categories, with e-commerce reaching around 30 percent of total retail sales. Apparel has historically led other categories in online adoption; our survey found that nearly 60 percent of consumers bought apparel online at least once in the past three months. For the apparel sector to increase its online-value-share percentage above its current level in the low 20s, all elements of the e-commerce experience—including merchandise selection, style advice, and returns and exchanges—need to become as appealing as shopping in physical stores.

Food (including packaged and fresh food), a category that faces more challenges in building sustainable online business models, has also reached a high level of adoption, with nearly 50 percent of consumers making some purchases online, according to our survey. But those online purchases account for only 5 percent of consumers' total food spending. The small size of the average online food basket, at less than $15, suggests that consumers are not yet going online to make food purchases as large as those they make at supermarkets. Companies that can entice consumers to do routine grocery shopping online stand to capture a lot of business.

Exhibit 2   Product categories exhibit a wide range of e-commerce adoption rates and sales volumes

E-commerce value penetration, %

Online shopping adoption,[1]
% of digital consumers, n = 2,616
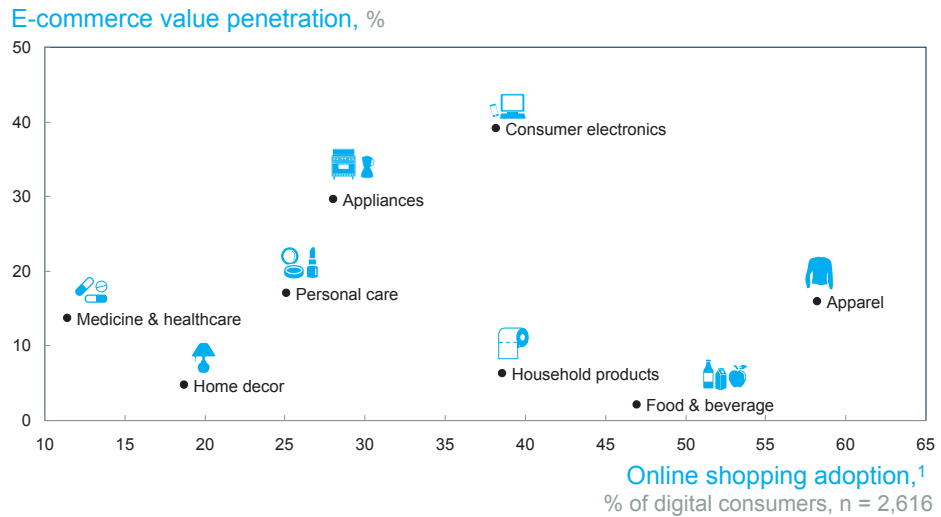
1 In the past 12 months for consumer electronics and appliances; in the past 3 months for all other categories.

SOURCE: Euromonitor; McKinsey iConsumer China 2016 survey

Within this large and active e-commerce market, we see three trends that have important implications for how consumer-facing businesses can continue pursuing revenue and profit growth in China.
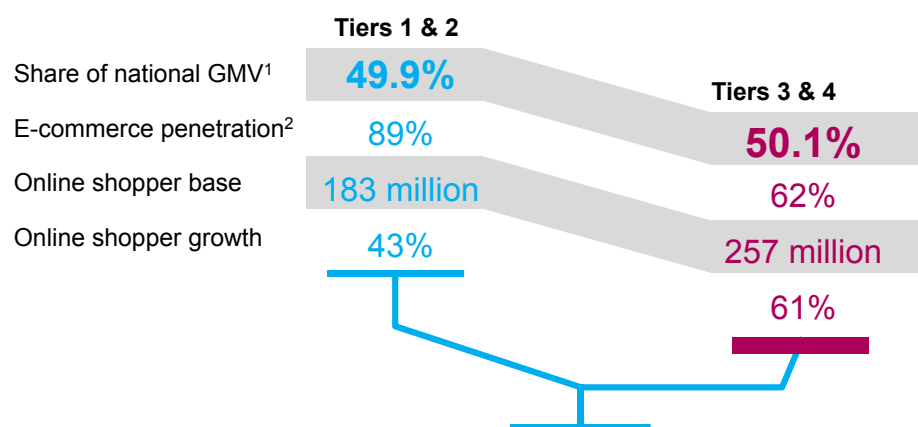
Consumers in low-tier cities are outspending those in high-tier cities online—and the gap is likely to get wider

By several measures in our survey, the e-commerce activity of low-tier cities (Tier 3 and below) now rivals or surpasses that of high-tier cities (Tiers 1 and 2). Low-tier cities' total spending on e-commerce caught up with that of high-tier cities for the first time in 2015 (Exhibit 3). And low-tier cities are now home to 74 million more online shoppers than high-tier cities.

Even with these gains, low-tier cities still have tremendous potential for e-commerce growth. Some 160 million people in low-tier cities who use online services have yet to begin shopping online. That's nearly as many people as the number of online shoppers in high-tier cities today. Major e-commerce platforms are investing heavily to acquire customers and build logistics networks in low-tier cities. Brands that have historically focused on high-tier cities may benefit from revisiting their geographic strategies and making adjustments to take advantage of opportunities in low-tier cities, where physical retail needs time to mature.

In high-tier cities, by contrast, our survey shows limited potential for e-commerce growth driven by user penetration. Nearly everyone living in high-tier cities is online: 83 percent of people 13 and older. Among those Internet users, 89 percent already shop online. Further e-commerce growth in high-tier cities may therefore need to come from increased shopping frequency, expansion of online shopping categories, and larger purchases. To increase e-commerce sales to existing shoppers, companies will need to use data analytics to better understand the needs of different customer segments and engage them with tailored upselling and cross-selling efforts.

Exhibit 3
Low-tier cities spend more on e-commerce than high-tier cities

	Tiers 1 & 2	**Tiers 3 & 4**
Share of national GMV[1]	**49.9%**	**50.1%**
E-commerce penetration[2]	89%	62%
Online shopper base	183 million	257 million
Online shopper growth	43%	61%

1 Gross merchandise value.
2 Of digital consumers age 13+.
SOURCE: McKinsey iConsumer China 2016 survey

Social media has become a powerful channel for initiating online purchases
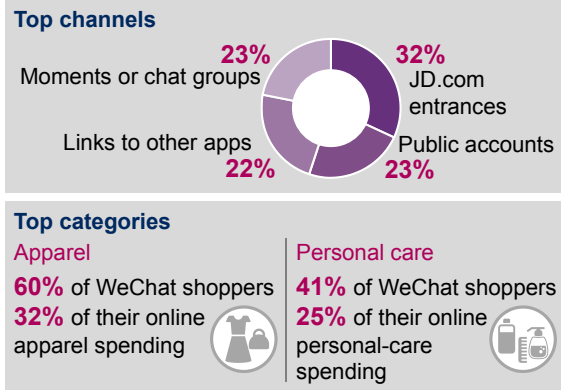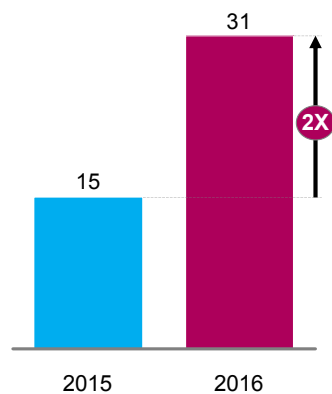
Half of the digital consumers we surveyed use social media to do product research or get recommendations. More recently, consumers have used social media as a significant channel not just for deciding what to buy, but also for acting on those decisions. Of the WeChat users we surveyed, 31 percent initiated purchases on the platform—double the proportion of the previous year. These purchases begin in a range of places on the social platform, from official channels (such as JD.com entrances and brands' public accounts) to user-generated content (such as Moments and chat groups) to links to other apps.

Impulse-driven categories like apparel and personal care are most popular among the WeChat shoppers we surveyed, with WeChat-initiated purchases accounting for about 25 to 30 percent of online spending in those categories (Exhibit 4). We see considerable opportunity for brands and retailers to reach customers on social platforms, using tactics like contextual targeting to display information about products at moments when consumers are reading about them.

Exhibit 4   Purchases initiated from WeChat doubled in a year

% of WeChat users who have shopped from WeChat[1]
n = 525

Top channels

23% Moments or chat groups

32% JD.com entrances

22% Links to other apps

23% Public accounts

Top categories

Apparel

60% of WeChat shoppers

32% of their online apparel spending

Personal care

41% of WeChat shoppers

25% of their online personal-care spending

1 Referring to those who have ever made purchases through WeChat's JD.com entrance, public accounts, Moments, group chats, or links to other apps.

SOURCE: McKinsey iConsumer China 2016 survey

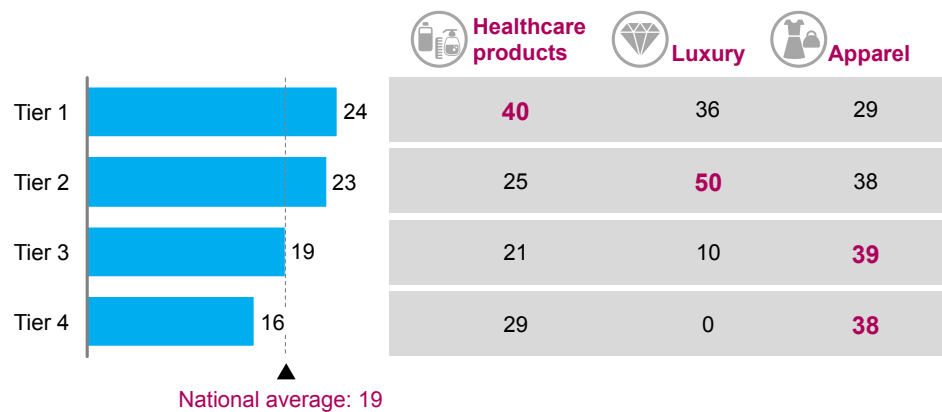# Consumers are buying goods from cross-border vendors to supplement what they buy domestically

E-commerce has given China's digital consumers access to products from overseas, and a notable share of consumers appears to be taking advantage. Nearly one-fifth of the digital consumers we surveyed now buy some goods from vendors outside China (Exhibit 5). We also found that cross-border shoppers prefer items that are either too expensive or too scarce at domestic vendors. For example, shoppers in Tier 1 cities use overseas sellers most often for premium healthcare products (for example, dietary supplements, medicines, and medical instruments) that supplement the offerings of local retailers. For consumers in Tier 2 cities, luxury goods account for the highest proportion of purchases from foreign vendors.

Chinese authorities recently announced the formalization of import and value-added taxes on cross-border commerce. As these changes take effect, we believe China's consumers will increasingly use foreign e-commerce vendors to buy products that domestic sources do not offer, rather than to get better prices on goods that are available from domestic vendors. For foreign brands that have limited reach but proven appeal in China, e-commerce offers a way to serve Chinese consumers without adding local distribution capabilities.

Exhibit 5

Nearly one-fifth of digital consumers buy from e-commerce vendors outside China

Online shoppers who buy from vendors outside China, %
n = 1,018

Spending on cross-border purchases as a share of total spending, %

	Healthcare products	Luxury	Apparel
Tier 1 — 24	**40**	36	29
Tier 2 — 23	25	**50**	38
Tier 3 — 19	21	10	**39**
Tier 4 — 16	29	0	**38**

National average: 19

SOURCE: McKinsey iConsumer China 2016 survey

NEW DYNAMICS IN O2O SERVICES

O2O services companies have attracted huge streams of capital from investors who see the category as the next big thing in digital China. Some observers believe O2O businesses have used investors' money to lure customers with prices that are too low to generate profits—and they predict that O2O companies will eventually go out of business or burn through their capital reserves and raise prices enough to send consumers back to offline-only vendors. O2O services have put considerable pricing pressure on traditional vendors in sectors such as travel but less in sectors such as dining and mobility. In all these sectors, quality and convenience matter just as much as price, if not more.

Among the consumers we surveyed, 77 percent reported that their total spending on travel increased after they began buying from O2O vendors (Exhibit 6). Similarly, using O2O services led 65 percent of consumers to increase their total spending on dining and 42 percent to spend more on mobility. This suggests that O2O services offering a unique value proposition could power additional growth in China's online market over the years to come.

Exhibit 6

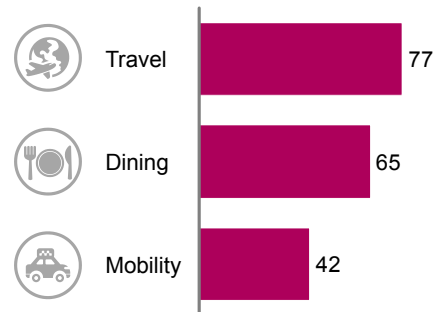## Despite creating high expectations for discounts, O2O services strongly stimulate total spending

Consumers who expect O2O services to cost less than offline-only services, %
n = 520

Travel	Dining	Mobility
59	39	35
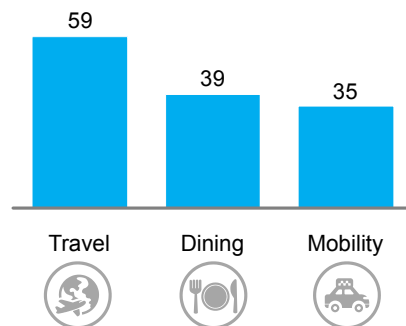
Consumers indicating that total spending increased when O2O services were used,[1] %
n = 520

Travel	77
Dining	65
Mobility	42

1 Including those who answered "start doing," "total spend increases a lot (>50%)," and "total spend increases a bit (20–50%)."

SOURCE: McKinsey iConsumer China 2016 survey

Chinese consumers are embracing O2O travel services

Nearly 80 percent of the digital consumers we surveyed have traveled in the past 12 months. These consumers are relying more and more on O2O travel services. According to our survey, travel is one of the most popular O2O categories, used by 36 percent of O2O consumers nationwide and 56 percent in Tier 1 cities (Exhibit 7).

Travel also demonstrates the pricing and spending dynamics of O2O services. Nearly 60 percent of the people we surveyed expect to pay O2O travel providers less than they would pay traditional providers. The survey also showed that online channels stimulate significant travel spend: 77 percent of O2O travel users indicate that their total travel spend increased after they began using O2O travel services. Many hotels and airlines are strengthening their own e-channels to avoid pricing pressure from O2O services.

To capture opportunities in O2O travel, businesses also need to address consumers' stated concerns, which include ticket guarantees and doubts about product and service quality.

Exhibit 7

Many consumers use O2O travel services, and those who do will pay more for value-added features
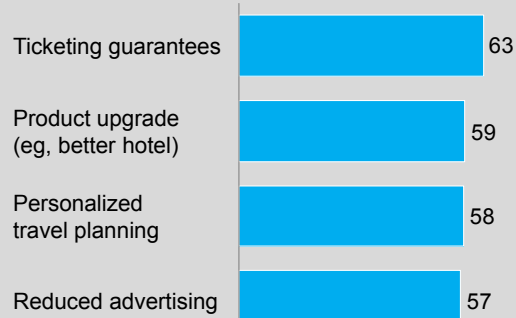
Consumers using O2O travel services, %
n = 520

Tier 1	56
Tier 2	41
Tier 3	36
Tier 4	26
Rural	21
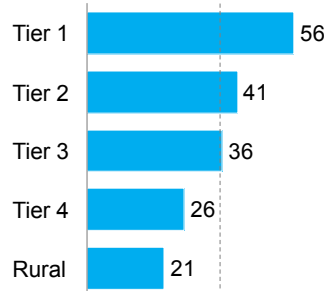
National average: 36

O2O travel users who are willing to pay a premium for value-added services,[1] %
n = 188

Ticketing guarantees	63
Product upgrade (eg, better hotel)	59
Personalized travel planning	58
Reduced advertising	57

1 Respondents who said they are "willing" or "very willing" to pay more for value-added services.
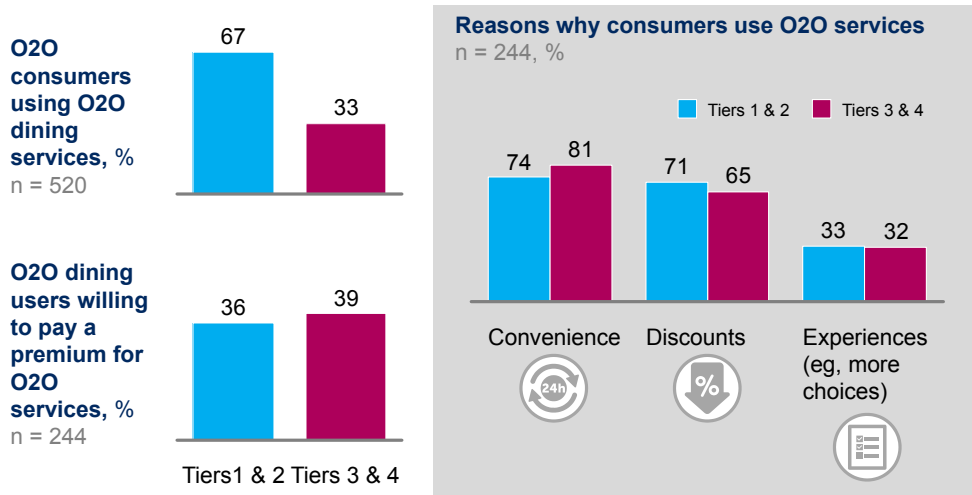
SOURCE: McKinsey iConsumer China 2016 survey

O2O dining services are growing rapidly thanks to price stimulation, but consumers' expectations for quality and experience are rising

Our survey results suggest that O2O dining services are poised for strong growth. Convenience and discounts stand out as the most important reasons why consumers choose to use O2O dining services. Diners in high-tier cities are leading the way: 67 percent of O2O consumers in Tier 1 and 2 cities are using O2O dining services, compared with 33 percent of O2O consumers in cities at Tier 3 and below (Exhibit 8). As O2O dining services continue expanding their city coverage, we expect adoption rates in low-tier cities to catch up to rates in high-tier cities.

Although consumers expect O2O travel services to cost less, many express a willingness to pay a premium for O2O dining services: 36 percent for Tier 1 and 2 cities, 39 percent for cities in Tier 3 or lower. Notably, though, significant numbers of O2O dining users say they are willing to pay for value-added services such as food-quality control (68 percent of those surveyed), faster delivery (52 percent), and better packaging (49 percent). Those who do not use O2O dining services indicate that food safety is their top concern, followed by a preference for restaurant dining.

Exhibit 8

Diners rely increasingly on O2O services, and low price is not always the main reason

O2O consumers using O2O dining services, %
n = 520

67 / 33

O2O dining users willing to pay a premium for O2O services, %
n = 244

36 / 39

Tiers1 & 2   Tiers 3 & 4

Reasons why consumers use O2O services
n = 244, %

■ Tiers 1 & 2   ■ Tiers 3 & 4

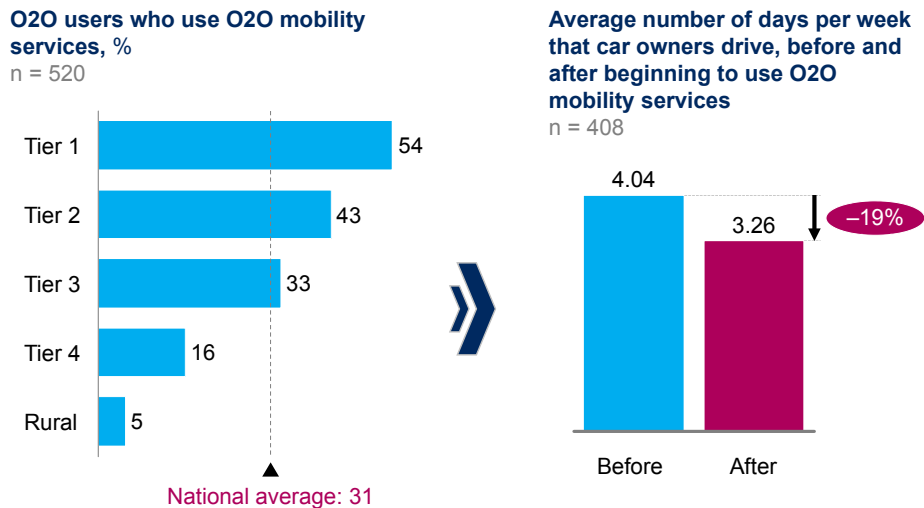|	Convenience	Discounts	Experiences (eg, more choices)
Tiers 1 & 2	74	71	33
Tiers 3 & 4	81	65	32

SOURCE: McKinsey iConsumer China 2016 survey

As people use O2O mobility services like Uber and Didi more, they drive less

Didi, Uber, and other O2O mobility services have caught on with 31 percent of digital consumers (Exhibit 9). These services are especially popular in high-tier cities, with 54 percent penetration in Tier 1 cities and 43 percent penetration in Tier 2 cities.

Consumers seem to be less sensitive to the price of O2O mobility services than to the price of other O2O services. Just 35 percent of O2O users in our survey said they expect lower prices from O2O mobility services (compared with 59 percent who expect lower prices from O2O travel services), and 42 percent of users said their total spending on mobility services increased after they began using O2O options.

The use of O2O mobility services is also changing consumers' driving behavior. Survey respondents reported that the average number of days they drive per week dropped by nearly one full day, from 4.04 days per week to 3.26 days, after they began using O2O mobility services. Carmakers and dealers may need to look for ways to adjust their offerings as consumers shift to using O2O mobility services. Given the possibility that some consumers will buy fewer cars as they rely more on mobility services, automakers should explore new opportunities to market vehicles through mobility services, such as targeting their drivers as frequent car buyers or using them to showcase new car models to the public.

Exhibit 9

After starting to use O2O mobility services, consumers drive fewer days each week

O2O users who use O2O mobility services, %
n = 520

Tier 1 — 54
Tier 2 — 43
Tier 3 — 33
Tier 4 — 16
Rural — 5

National average: 31

Average number of days per week that car owners drive, before and after beginning to use O2O mobility services
n = 408

Before: 4.04
After: 3.26
−19%

SOURCE: McKinsey iConsumer China 2016 survey

In an e-commerce market as large and fast-growing as China's, retailers and consumer-facing businesses will have no shortage of opportunities: in low-tier cities where online and e-commerce penetration remain relatively low, and in categories of goods and services that have yet to become major e-commerce propositions. Even in high-tier cities and

in categories such as apparel and food with high e-commerce adoption rates, there is significant room for online spending to make up a bigger share of consumers' overall spending, as consumer-facing companies improve their offerings and user experiences, and leverage social channels to influence consumers' decisions.

O2O services have shown that convenience and experience (in addition to low prices) can win consumers and even convince them to spend more than they might otherwise. For businesses in the O2O market, overcoming shoppers' concerns and offering new levels of value may be the keys to achieving mass-market acceptance and establishing business models that will thrive over the long term.

Our survey of China's digital consumers indicates that growth in e-commerce and O2O is shifting to new areas. Succeeding in this market is a matter of keeping pace with changes that are playing out across geographies, product categories, and channels. Consumer-facing companies must look closely within these parts of the market to uncover opportunities and move quickly to take advantage of them before their competitors do.

About the McKinsey iConsumer China 2016 survey

This report is based on an extensive survey of China's Internet users.

- The survey was conducted online in January 2016. It is part of a series of annual surveys of China's Internet users conducted by McKinsey since 2012.

- The survey sample consisted of 3,120 respondents, divided evenly between men and women and among five geographic categories (Tier 1 cities, Tier 2 cities, Tier 3 cities, Tier 4 cities, and rural areas). The respondents also represent a wide range of incomes and Internet-use levels.

- The survey included a deep dive into the devices that consumers use to go online, the use of social media, cross-border e-commerce, and three categories of O2O services: travel, dining, and mobility.

About McKinsey & Company

McKinsey & Company is a global management consulting firm, deeply committed to helping institutions in the private, public and social sectors achieve lasting success. For over eight decades, our primary objective has been to serve as our clients' most trusted external advisor. With consultants in 109 locations in over 60 countries, across industries and functions, we bring unparalleled expertise to clients anywhere in the world. We work closely with teams at all levels of an organization to shape winning strategies, mobilize for change, build capabilities and drive successful execution. Within McKinsey Digital, our deep sector and functional expertise allows us to help clients generate maximum value from digital at every level of their organization. We work closely with clients to accelerate the pace of change to deliver rapid returns, and put in place the foundations needed to sustain growth over time.

Authors

Kevin Wei Wang

Partner
Hong Kong
Kevin_Wei_Wang@mckinsey.com

Alan Lau

Senior Partner
Hong Kong
Alan_Lau@mckinsey.com

Fang Gong

Partner
Shanghai
Fang_Gong@mckinsey.com