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Rosefinch Research | Cross-Border e-commerce and Brand Export: Historical opportunity for Chinese Sub-Manufacturer

There are several industries that blossomed during the global pandemic. Besides pharmaceuticals and virtual meeting software, there was also the cross-border e-commerce.

There was a saying amongst e-commerce insiders: during 2020 June and September, you can achieve immediate financial independence as long as you can sell your product to the US! The e-commerce volume indeed grew tremendously. As of April 2020, the penetration rate of US e-commerce is 27% vs 11% at the beginning of the year. In other words, US e-commerce penetration in the short 8 weeks exceeded its total growth in the previous 10 years.

Chinese online merchants had significant contributions in this round of explosive growth. In 2020, Chinese online merchants accounted for 70% of new merchants on the US e-commerce platforms. Independent websites that market cross-border clothing saw their volume growing from under 20 billion to almost 50 billion RMB during the pandemic. This sent shockwaves as more and more people started to talk about the exports of Chinese brands. Why are Chinese brands going abroad? Why now? What do they have to compete with global brands? What are the opportunities and risks of Chinese brands going abroad? We will attempt to address these questions using the following perspectives:

1. Supply Chain Advantage: core capability of exported Chinese brands
2. Rise of North American e-commerce: time to seize the opportunity
3. Distribution revolution: David vs Goliath
4. Battle of brand export models: platforms vs independents
5. Here comes the swarm: the risk and opportunity of brand export

Part 1
Supply Chain Advantage: core capability of exported Chinese brands

After the reaffirmation of economic reform policies in 1992, foreign capital moved into China strongly, forming the 4th major global transfer of manufacturing base. As the foreign capital started factories, many Chinese private small and medium enterprises rose to provide relevant parts. Zhejiang province, for example, was known for their screws and bearings. These factory owners, much like the coal miner owners of Shanxi, became representatives of private entrepreneurs of that age. And once China joined WTO in 2001, the foreign trade grew quickly and China replaced Japan as the factory of the world and became the leading global Sub-Manufacturer.

Sub-manufacturing has two models, one is Original Equipment Manufacturer (OEM), the other is Original Design Manufacturer (ODM.) The current Chinese sub-manufacturers are no longer pure OEM which is just manufacturing. ODM model is also very common now, where the local manufacturer does the entire chain from design to production. China's Guangdong province has become the world's biggest manufacturing base for consumer electronics, which evolved from the initial local parts manufacturing, to assembly, to now design and development.

During the last twenty years of manufacturing base shifting to China, besides the consumer electronics in Guangdong, there's also the shoe-manufacturing in Fujian Putian, machinery in Jiangsu and Zhejiang, etc. The different regions of China formed different industrial bases with top notch

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supply chain capabilities. Only in China can you have fast turnaround to product requests and complete the entire production within a single city or somtimes a single industrial park. With about 20-30% of the global manufacturing capabilities, China is a manufacturing force to be reckoned with.

Being a global factory means global orders, increase in employment, higher GDP, but also low profit, low barrier to entry, and lowest part of the Smile Curve. The Smile Curve represents the value-adds of three phases of production: origination via intellectual property, manufacturing, and distribution. When seen from value-adding perspective, the manufacturing portion is the lowest while both IP and distribution have higher value-add, thus creating the "Smile." To increase profitability, we must move away from the lowest part of the smile curve towards either distribution or brand.

On the brand side, there were some attempts such as high-imitation or white-brand. The manufacturer would get some brand samples and replicate them. Those that's sold without a label but with reasonable quality are called "white-brand". But these are not very scalable. Those who try to use high-imitation to free-ride on brand value run high legal risk: a shoe manufacturer in Fujian Putian was fined 10 million RMB.

Sub-manufacturers don't need to pursue high-imitation or white-brand strategies. In order to increase profitability, the safest and most robust approach is to build brand. During the OEM stage, the product design is still barrier to enter the brand business. But at the ODM stage, design or development is no longer the bottleneck. Branding is the barrier that stands between 10% and 70% profit margin.

Since domestic market has limited capacity, the branding push must go abroad to enter the global market. However, evolving from sub-manufacturer to brand export has a new challenge: how to build a brand from 0 to 1 or even to 100? How to compete against existing brands? How does a corporation with no brand or customer base compete with established brands who's been active for decades in China and abroad? These challenges seem impossible, but another industry revolution is creating historical opportunities for Chinese sub-manufacturers.

Part 2
Time to seize the opportunity

The dramatic changes to distribution channels are creating unprecedented opportunity for Chinese brand to go abroad. The Western brands had historically built extensive global off-line distribution network over decades. It's extremely difficult for Chinese brands to squeeze into these established channels. In addition, the traditional international distribution chain is very long and inefficient, requiring mark-ups of 700%. Cross-border B2C online merchants however can reduce mark-up to 225%. The rise of e-commerce therefore gives Chinese brand a new opportunity to participate from the same starting line and even a chance to be a step ahead.

The rise of online merchants is similar to another episode: the rise of Chinese e-comm platform in 2003. US had e-comm platform before 2000, while Chinese e-comm platform only started in 2003. But the pace of development in China is much faster than US. In 2019, Chinese e-comm penetration rate is over 30% vs US's 11% and Europe's 10%.

Online and offline distribution all depend on customer traffic, but from very different sources. Offline distribution's customers are spread across different regions, stores, etc. Online distribution's customers are highly concentrated mostly on the main retail-distribution e-platforms. There is also further fundamental difference in consumer types. The online consumers are generally younger, with

weaker brand recognition and lower brand loyalty. In this channel, both new and established brands are at the same starting point. Because Chinese merchants have already honed their supply chain management and operational skills, they are the favorites in this race.

In the years of dramatic e-comm development, the Chinese merchants have far outpaced their Western counterparts. These Chinese merchants survived the brutal competition in domestic market and are generating explosive growth in the global markets. Last year, about 70% of all new online merchants on major e-comm platforms are Chinese. As e-comm penetration rate increases, there are new opportunities for Chinese brands to go abroad. The operating models have shifted from "Copy TO China" to "Copy FROM China."

There are three key factors in consumer space: product, channel, brand. The product comes from supply chain; the channel is cross-border e-commerce; so the missing link for Chinese sub-manufacturers is brand. While the supply chain and e-comm channel build the foundation, to truly touch the consumer and develop brand awareness, we will still need distribution. And indeed, a distribution revolution is happening right now.

Part 3
Distribution revolution: David vs Goliath

When retail sales embraced online, distribution did the same. Social media's emergence was the catalyst for the new brand's David to defeat the traditional Goliath. The traditional brand marketing focused on physical billboard advertisements in subway, railway stations, airports or central buildings. These are expensive, takes long time to setup and difficult to get consumer feedback. Only market leaders or cash-flush unicorns have the resources to engage this type of advertisement.

After 2010, digital marketing began its ascend. The internet was a very favorable medium for advertising then: operating cost is much lower than offline advertisement and there's immediate direct feedback on each consumer interaction. Many Chinese online merchants made their first pot of gold through online advertisements. During this phase, the consumers are more aware of online merchants or online super-markets than individual brands.

It is during the second phase when the brand power really came through: influencer marketing. In 2010, we start to see influencers sharing photos of their outfit, travel, or exercise activities on social media. Compared to the first phase of writing-based social media, the photos have bigger impact and contain more information. At that time, the influencer business-model is still in incubation phase and influencers can be contracted relatively cheaply. Some Chinese brand merchants seized the opportunity and signed many influencers at low rates, thus realizing rapid brand recognition as these influencers grew in popularity. In 2010, it costed as low as 30 USD to sign on an influencer. By 2016, it's already 50,000 USD.

In 2016, short video platforms came online in the US. Compared to picture sharing, short video is more advanced as it's more dynamic and realistic. This medium is perfect for e-comm, much like the previous "shopping channels". The era of short video is even better than that of TV across many areas: purchase channel, payment method, logistics, customer service, client acquisition, etc.

Information dissemination and distribution are inseparable. Behind every new channel of information dissemination is a structural shift in consumer base, which in turn brings deep change in distribution channel. Those who capture the online opportunity can enjoy the first-mover advantage and

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capture consumer consciousness at very low operating costs. As information dissemination move from words to photo to video, Chinese brands saw the opportunity for independent websites.

Part 4
Battle of brand export models: platforms vs independents

There are two main models for brand exports: one is to open shop via e-comm platform, the other is to create independent website. The platform model requires very little initial investment and no technical staff. Even just one person can handle the relevant purchase, operation, and report requirements. The shortcoming is also clear: it's beholden to the platform. As the platform matures and volume goes up, the running cost will increase accordingly. There's also a challenge in forming strong brand recognition – consumers to sticky to the platform, but not necessarily to the individual merchant.

The goal of brand recognition is to form the shortest and most effective path in the consumer's mind. If the consumer is searching a key word in the platform and get the list of "best sellers", it's actually reinforcing the platform's brand. The merchant brand becomes a secondary brand since it came after the platform in the process. To improve brand recognition, the independent approach may be better. The independent website can form its own brand effect, not limited to platform's channeling of consumer interests, and allow higher growth potential.

As early as 2014, there were a lot of independent websites in China with various product areas. Most disappeared with only a handful of survivors who are trying to gather more strategic investment to fund future growth. As time goes by, it gets harder and harder for Chinese independents. This is related to the shopping habits of Chinese online consumers. The presumption of consumer choosing your product is that the consumer can see you first. With China well into the internet era, consumers normally just directly open their familiar shopping applications. It's very hard for the new shopping app to break this habit. Most of the online shopping flows are controlled by a few giants, who usually support their own online merchants. In China's e-comm business, you must commit to one of the giants from the startup stage of your online business, otherwise you won't even get a shot at growing.

US situation is different: US consumers still like to Google. The habit gives a growth opportunity for US independents. Of course, the independent approach carries a high start up cost. Thankfully, the maturing enterprise software solves this problem. Around 2017, the e-commerce Saas saw tremendous growth. By using Saas, a merchant needs only a few days to start its own independent website and vastly reduces the startup cost. This removed the biggest obstacle to the independent website approach. And now, the players are ready to engage both platform and independent paths to brand exports.

Part 5
Here comes the swarm: danger and opportunity of brand export

Amongst the private equity investors in the Chinese consumer sector, it's often said that every single Chinese consumer product is worth a brand do-over. Product, channel and brand are coming together as China moves from sub-manufacturing phase towards brand phase.

To successfully compete against global online brands, Chinese export brands must leverage China's advantages in its supply chain and e-comm operation, especially in areas of 3C (Computer, Communication, and Consumer Electronics), clothing, and furniture.

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Danger and opportunity co-exist in the push for Chinese brand exports. We can see some potential opportunities below:

1. 3C, clothing, furniture

   Not all products can successfully export via online. To survive the global competition, they must have two characteristics: first it must have strong supply chain in China, second the product must have low online penetration rates in global markets, such as 3C, clothing and furniture.

2. Cross-border Service Provider

   There are three main types of cross-border e-comm service providers: logistics, Saas and agent operator.
   a. Logistics: FBA, dedicated channel or foreign warehouse. Localized logistics companies are well established, but cross-border logistics lack companies that can effectively link these together.
   b. Saas: Saas provider can support brands to create independent global websites and control startup costs.
   c. Agent Operator: handling high volume operation requires certain expertise. In China, such operators are called TP or Taobao Partner, named after the first such operators in the popular Taobao platform. By outsourcing operation aspects, the brand can focus on supply chain management.

There are also risks associated with brand exports:

1. Post-pandemic demand contraction

   The brand export wave started after the pandemic. With so many Chinese sellers rushing into US market, there may be an oversupply once the US's own supply chain recovers.

2. Major platform's attack on independents

   The rise of Saas service does made it easier to start independent websites. But independents have no clear advantage vs the platforms. Independents don't have the capability to adapt the multi-products on their own, so must embrace the platform strategy if they want to expand product types. Competing on platform structure is a different dimension from competing on single product, thus representing large uncertainties for the single merchants.

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