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Online to Offline—The Great Technology Migration

A few years back, when we last wrote extensively about the significant developments undergone by Asia's technology industries over the previous decade, the focus was on the region's transformation into an innovator of new emerging technologies and the world's largest manufacturer and exporter of information and communication technology products. Not only has the region earned its place as a major importer and consumer of its own products, it has also increasingly become a trendsetter in new emerging technologies. Key to this has been the Asia's ability to leapfrog certain technological developments, making much quicker transitions to new technologies than Western countries: jumping from fixed line to wireless communications and moving away from desktop devices to mobile devices. Now, the latest interesting instance of technology leapfrogging that is happening in Asia is dubbed "Online-to-Offline," commerce, or O2O—an e-commerce model that combines offline opportunities with online platforms. Asia's Internet companies that have already conquered the online space in their domestic arenas are now aggressively moving into more traditionally offline business models and services. And this is happening at a faster pace than Western counterparts.

NextGen

Online gaming and Internet portal companies in Asia have long set global trends and were among the region's first generation of online firms. Online gaming companies first started to boom in South Korea as a result of government-led infrastructure spending—Korea was a pioneer in putting in place solid Internet infrastructure in the late 1990s and early 2000s, which was crucial to the development of its gaming industry. The industry then spread to China and the rest of Asia. Portal companies provided basic services, such as news, weather and email, and by and large, Internet companies were providing very niche services and products to Asia's consumers.

Now, there's an entirely new generation of Internet companies: e-commerce, social networking and location-based service (LBS) companies, which involve location data to control features in the way that ride-sharing apps like Uber do. The new wave of Internet companies has become much more ingrained in the everyday lives of consumers, and is occupying a much bigger share of their time. In Asia, the reach and impact of e-commerce has been much larger in China than anywhere else.

South Korea and Japan had relatively well-developed, well-organized and modern retail industries when e-commerce industries were first started. But in China, e-commerce companies quickly gained ground and won market share faster and more easily than did their counterparts in South Korea and Japan. In China, e-commerce companies command a much bigger market capitalization than all offline companies combined; whereas in South Korea and Japan, offline retail companies still command higher market capitalization. Many consumers in China, especially in smaller cities, have grown up with the availability of online shopping. In fact, shopping online was really the only option they had given the lack of physical retail stores in those cities. To many Chinese consumers, these e-commerce companies became everyday household brands. Now, the e-commerce sector is beginning to emerge in India. Given the even smaller footprint of organized retailing in India, compared to China, Indian e-commerce companies are poised to grab an even bigger share of retailing than their counterparts in China have.

O2O: China Leading the Way

In recent years, we have been following the exciting shift among Internet companies in leading another trend: online-to-offline commerce. This trend is more evident in China than anywhere else in the world, and is made possible there by the dominant status and brand power of its Internet giants. Some companies are moving from purely online businesses to those that incorporate full service models. Chinese Internet companies are making much larger inroads into the everyday lives of consumers.

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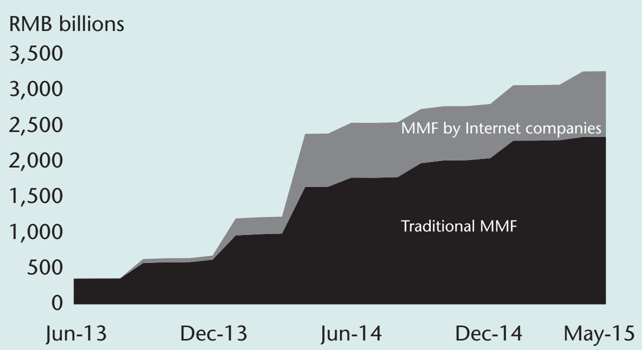
China's brick and mortar infrastructure still lags that of more developed countries—in terms of breadth and level of services offered. For example, China still doesn't have national logistics companies, equivalents of UPS and FedEx, to provide one-stop nationwide delivery services. Instead, e-commerce companies are building out their own nationwide logistics footprint, in order to create a full-service experience for customers.

China's brick and mortar financial institutions, mostly state-owned-enterprises, have a relatively short history of offering modern banking services and are not as sophisticated as their Western counterparts. Again, Internet companies are seizing this opportunity to penetrate the banking industry. For example, they began offering money market funds in 2013 and have quickly grown to manage a large segment of the market. Internet companies are gearing up to offer basic banking services online too—arguably the first, true private banks in China. Peer-to-peer Internet lending has also taken off in China. Can you imagine banking with Amazon or Google instead of Bank of America or Chase? Perhaps in the future, yes, but this is already happening in China.

Internet companies in China are penetrating deeper into the everyday lives of Chinese consumers in almost every respect. Internet companies have touched upon just about every major life purchase—from cars to homes to insurance products. Mobile Internet penetration in China is among the highest in the world, and China is often leading the innovation, creating new markets and services in the mobile Internet space. There are even apps made by LBS companies for everything from finding parking spaces in busy downtown areas to getting your next meal delivered.

GROWTH OF CHINA'S MONEY MARKET FUNDS

In 2013, Chinese Internet companies began offering money market funds



Source: Wind Info

Innovations Emerging

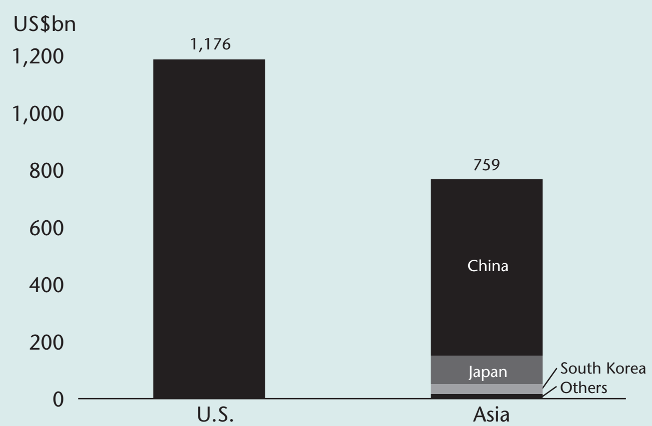
But why are we seeing such innovation happening more in China than anywhere else in Asia? A few things are necessary for major innovations to occur. First, you need to have a sizable market to sell your products or services, and the ability to recoup heavy R&D investments when you are successful. Major innovations are very expensive. In the U.S., a typical process for new drug discovery can cost more than US$2.5 billion. The market needs to be big enough to sustain heavy R&D investment that goes into developing new products and services. Second, you need consumers who are willing to pay for new services and products, and companies that are keen on improving productivity. Third, you need an active group of entrepreneurs. Lastly, you need venture capitalists and private equity investors who are willing to risk their capital to fund these entrepreneurs. The modern day concept of venture capitalists was invented in the U.S. and it continues to play a critical role in driving Silicon Valley's growth. For many decades, there was no other single market that could challenge the U.S. in all these aspects. All major innovation of the past few decades seemed to take place in the U.S. Now, China is emerging.

China has already overtaken the U.S. as the biggest new automobile market; in 2014, it sold more than 18 million new cars compared to 16 million new cars in the U.S. This year, China also surpassed the U.S. as Apple's biggest iPhone market. Every year, China's education system produces a few million highly educated workers, and among them are many ambitious entrepreneurs. China is also boosting its R&D. The number of patents filed in China surpassed the U.S. in 2011, and the gap is widening. With its massive market, consumers and entrepreneurs, the last piece of the puzzle is venture capitalists.

Fortunately, venture capitalists have no boundaries and the same venture capitalists that backed many Silicon Valley companies are flocking to China, recognizing its market potential. During the first quarter of this year, total venture capital investments grew by 170% compared with the first quarter of last year and the number of deals increased to 215, up more than 50% from the same period last year. China is also developing its own venture capital ecosystem. The Chinese government announced that it will set up a venture capital fund worth 40 billion renminbi (approximately US$6.5 billion), nurturing an environment ripe for innovation.

“In certain Internet industries—especially in online-to-offline migration, mobile Internet penetration and financial technology—we are beginning to see Asian companies leading innovation.”

MARKET CAPITALIZATION OF INTERNET COMPANIES



	U.S.	Asia
Population (millions)	316	3,747
Internet penetration 2014	87%	32%

*Internet companies include those offering online software/services, retail and other consumer services. “Others” includes India, Taiwan, the Philippines and Malaysia. Indonesia, Thailand and Vietnam have no publicly traded Internet/e-commerce companies. Market Cap data as of 7/7/2015

Source: FactSet

India and Southeast Asia: the Next Frontier

Elsewhere in the Asia region, India and Indonesia also hold vast market potential. Both countries have the market size and vibrant consumer culture needed. Indian Internet companies are still quite small in scale and market cap. However, we are seeing very rapid development of e-commerce companies now, and venture capital funding is also very active in India.

In fact, India has the second biggest venture capital investment in Asia, behind China. Given its even smaller footprint of organized brick and mortar retail outlets, compared to China, the potential for Indian e-commerce companies could be even greater than what we have witnessed in China. It is possible that e-commerce companies might command greater market share in India and other Southeast Asian countries than China or Korea.

To be sure, there are still risks in the future development of Asia’s Internet industry. Government support sometimes plays a key role to an industry’s success as seen by the early success of Korea’s gaming sector, but it can also pose threats. The biggest risk is the regulatory environment. Especially online, financial technology will have to deal with the same kind of regulatory scrutiny faced by traditional financial institutions and overregulation can impair entrepreneurial activity. A single misstep by the government, either over-regulating or de-regulating, can adversely impact business. Spending on infrastructure, such as that for high-speed Internet and faster mobile networks, needs to be expedited, especially in India and the Southeast Asian region. Southeast Asia still lacks a widespread 4G LTE network and high-speed broadband network—essential for Internet industry to boom.

The current environment does appear promising, however. Governments are beginning to recognize the importance of these issues. The Chinese government is taking a more proactive stance; it granted Asia’s first Internet banking licensing in 2014. And we are seeing political leaders in India and Southeast Asia pledge to step up infrastructure spending to aid the rapid development of new emerging industries. We are seeing very strong entrepreneurship activities across in Asia, most notably in Indonesia and Thailand.

The e-commerce industry is still at a nascent stage in most Southeast Asian countries and there are no publicly listed e-commerce companies listed in Thailand, Vietnam or Indonesia. But with private e-commerce companies possibly gearing up to go public soon, attractive investment opportunities may be emerging in this market.

Currently, U.S. companies are still the dominant innovation leaders in the world and U.S. Internet companies still command more market cap than all Asian Internet companies combined. However, in certain Internet industries, especially in the online-to-offline migration, mobile Internet penetration and financial technology, we are beginning to see Asian companies leading innovation. Given the much larger potential market and lower Internet penetration, it doesn’t seem far-fetched to imagine the combined market cap of Asian Internet companies surpassing that of U.S. companies in the near future.

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