



Smart Operations

*How digitalisation is transforming
China's retail operations*

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Executive summary

Experimental digital technologies such as automated checkouts, price promotions and stock ordering are already emerging in China's retail sector, making it a forerunner in the digital retail arena. As these technologies continue to be tested, a winning formula for digitalisation will be discovered soon. For the time being, there are only a few traditional offline retailers with ambitious digitalisation agendas in China to compete with the giant online players like Alibaba and Tencent.

We believe digitalisation will soon change retail operating models, impacting customer purchase experience and service level at the front office. This is most relevant for premium and lifestyle retailers. Even more than that, digitalisation will improve retailers' competitive cost position at the back office, which is particularly important for discounters and mid-market retailers. Therefore, digitalisation can be a source of competitive advantage for the most innovative Chinese retailers. In the long-term, it will become a must for all retailers to stay in the game, withstand squeezed margins and survive the upcoming wave of industry consolidation.

This article sheds light on selected applications of digital technologies along the retail operating model in China. Based on project experience, it provides an overview of the applications, benefits, implementation needs and typical financial impact of digitalisation. We also outline important guidelines for decision makers to invest in digital technologies and manage digital transformations.





Introduction

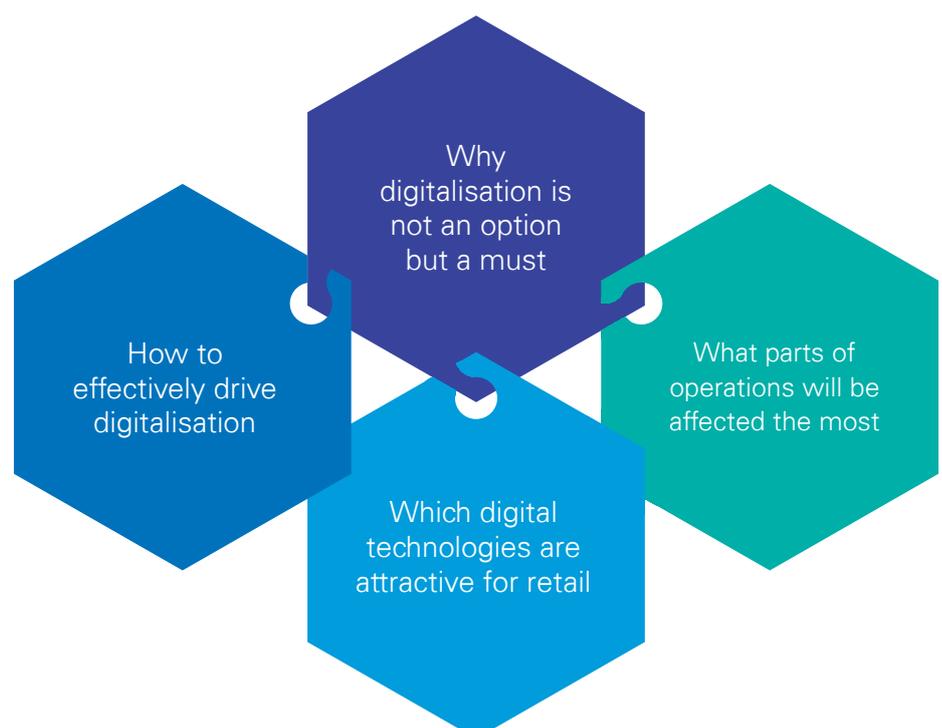


Twenty years ago, China was just an apprentice in retail, with a marketplace characterised by traditional wet markets while eagerly copying western big box hypermarket formats. In a blink of an eye, the country's retailers diversified into a multitude of formats with more than a dozen international retailers in the game. More importantly, online supermarkets, third party online platforms like Alibaba and social media-based retailers like Tencent opened up a new battleground, with China moving in as the world's leading online retail market. In addition, online and offline channels are converging while offline retailers digitalise their businesses and new experimental formats like checkout-free stores are being launched. All of this has moved China from an apprentice into a master, as Chinese retail has become the digital forerunner. Now, the whole world is seeking a winning formula for digitalised retail, and this concept will likely be invented in China.

Some retailers are frenetically working towards their digitalisation, either in response to cost pressure or for enhancing customer experience and exploring new sales channels. However, many of these efforts fail. This is not so much caused by immature technologies or large investments but mostly due to insufficient planning and preparation, gaps in digital competencies, poor implementation and a lack of acceptance in the organisation.

At the same time, many retailers have not developed a digital strategy. They do not hire sufficient digital talent, or they postpone digital investments into a distant future, thereby risking their operating models to become obsolete soon.

This article takes a closer look at the impact of digitalisation on retail operations in China. In particular, we will discuss:





Why digitalisation is not an option but a must



'Digitalisation' is the enhancement of business processes via information technology. Although the phrase 'digitalisation' was coined and has been tossed around within C-suites since the early 2000s, it has only recently become truly relevant for traditional retailers. Why is that?

The past few years have been a period of rapid 'datafication'. We have witnessed an explosion of data across three perspectives:

- **Reach:** Through improved mobile device penetration and affordable Internet, today's retailers have access to customers and their information. Individual customers and their behaviours can now be better tracked.
- **Coverage:** With improved interconnectivity between e-commerce and social media platforms, businesses are able to obtain access to more areas of customers' daily lives, gaining a fuller picture of consumer lifestyles.
- **Standardisation and computation:** Gradual maturity of data classification tools (e.g., hashtags, location recognition) as well as the availability of more powerful yet affordable computing capacity vastly simplifies data analysis.

Digitalisation enables retailers to capture value by enhancing operational efficiencies via automation. For example, automated ordering and meticulous real-time inventory management across a network of warehouses can shorten delivery times, reduce inventory mark-downs and avoid out-of-stock situations. In this way, digitalisation gives retailers a head start in cost competition and creates a cost disadvantage if it is ignored in the long run.

On the consumer-facing side, algorithm-driven pricing can improve top-line and margins while client-facing digital assistants can improve customer experience and may even convert physical products into a subscription service. Aside from sales and profitability, digitalisation also has the potential to foster loyalty. This moves market share in favour of those retailers who digitalise earlier and more thoroughly than their peers.

Finally, digitalisation greatly improves transparency across all areas of retail operations, thereby facilitating insight on consumers, staff, supply chain, cost and safety.

In summary, digitalisation clearly brings numerous benefits that retailers cannot afford to ignore. However, they will also need to stay vigilant in the face of a more vulnerable digitalised environment. This is because digitalisation exposes businesses to new risks such as data privacy violations and cyber-attacks. It also massively increases the impact of IT system failures, data losses and break-downs of Internet connectivity. Ensuring smooth operations of a retailer's digital infrastructure is therefore vital to the business and its consumers. It requires careful planning and proper risk management.



What parts of operations will be affected the most



A simplified view categorises retail operations into a 'customer-facing' front office and a 'cost-burdened' back office¹. Digitalisation affects both dimensions in a distinct way.

Front office digitalisation

The front office comprises a retailer's customer journey including all touch points such as advertising, website content, purchase experience in physical stores, online shops, payment and the delivery of products to consumers' homes.

Front office operations impact customer experience and service level which can be enhanced via digitalisation. Front office digitalisation brings dramatic changes to operating models. It requires significant adjustments and careful communication, given that it changes the way a retailer interacts with its customers. Examples of front office digitalisation are

- Consumer intelligence via mobile apps and loyalty cards
- Automated personalisation of mass offerings to customers
- Conversion of products into a subscription services via assistants
- Convenience in payment, ordering, home delivery or pick-up
- Information and entertainment related to products and lifestyle

Front office digitalisation adds value for the customer, increasing their loyalty and willingness to accept higher prices while also driving cost. It is most suitable for retailers with a premium positioning (e.g., premium supermarkets, branded cosmetics, lifestyle furniture).

Online players such as Amazon and Alibaba have sophisticated models for digitalising consumers and monetising their data. Injecting these capabilities into traditional retailers creates a game-changing offering. A recent example is Alibaba's HeMa (盒马鲜生) - an innovative supermarket format in Shanghai. Once in the store, HeMa staff digitalises retail customers by helping them to install a home delivery app on their smartphones. Customers can then conveniently order food and have it delivered in a 3km perimeter within 30 minutes. HeMa gains access to valuable customer data when consumers order via the app or visit the store. Such apps enable the analysis of basket composition, purchase frequency, movement profiles, demographics, etc. They also support better loyalty programs, tailored advertising and price promotions.

Brick-and-mortar retailers like Auchan, Metro and Yonghui are also experimenting with similar approaches but most retailers are less inclined to push for front office digitalisation. Nevertheless, its potential for customer differentiation and loyalty, market share gains, additional sales and improved margins is significant.

¹ Back office comprises both middle office and back office operations as in KPMG's Connected Enterprise approach.

Picture A: Unmanned store in front of an Auchan hypermarket



Picture B: 'Yonghui Shenghuo' home delivery app (永辉生活)



Back office digitalisation

The back office comprises retailers' buying function, warehousing and logistics, store operations, infrastructure, people and administration. It drives operational effectiveness in terms of speed of delivery, product safety, suitable locations, and efficient use of space and people. Most importantly, it bears the retailer's cost, determines operating margin and the feasibility of price points for customers.

Back office digitalisation is essentially automation which improves a retailer's cost position by significantly reducing variable costs. On the other hand, it adds fixed costs for investment and maintenance of the necessary infrastructure. Similar to the front office, back office digitalisation improves effectiveness, speed and transparency which is critical to handle increasingly complex and volatile O2O (online-to-offline) supply chains. Examples of back office digitalisation include:

- Real-time inventory tracking along the supply chain
- Automated price promotions and checkouts in stores
- Automated stock ordering from warehouse and from suppliers
- Automated support for site selection and store layout design
- Inbound and outbound delivery via self-driving vehicles
- Real-time tracking of employee hours and activities

Back office digitalisation is critical to a competitive cost position making it a priority for cost-driven formats such as discounters. These measures are most effective in an environment with high rents and wages, as they make the use of space and labour more efficient.

Chinese retailers suffer from high rent, which is expected to increase a further 4-6% p.a. over the next few years. Despite being a traditional low labour cost country, wages have increased massively over the last 10 years and continue to rise at a rate of about 6-8% p.a. However, retail prices are expected to rise by only 2-4% p.a. and competitive intensity is increasing with higher store density. This disparity is creating enormous pressure on Chinese retailers' margins and same-store-sales, which have been decreasing for some time. It will also accelerate the process of market consolidation over the next five to ten years with more retailers going out of business.

Back office digitalisation is one of the primary counter measures against the above-mentioned cost pressure and could make the difference for many players to preserve their margins and survive the upcoming wave of market exits.

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Which digital technologies are attractive for retail



Digitalisation is enabled by a series of technologies. Before diving into selected ones with high relevance for retailers, some general facts should be mentioned:

- **Maturity:** Some of these technologies are already available while others are still immature and may become available in the future. Digitalisation strategies should focus on mature technologies, given the risks involved in immature options.
- **Impact:** Most technologies drive incremental changes for retailers' operating models and are associated with limited risks and investment (e.g., most back office digitalisation). These can serve as quick wins for mass retailers. Other technologies require fundamental adjustments that will generate higher returns in the long run, with a higher chance of contributing to real competitive advantage. Of course, such initiatives require higher effort and investment and imply higher risk (e.g., most front office digitalisation).
- **Feasibility:** Developing digital technology in-house requires a thorough risk and feasibility assessment as well as proofs of concept in a small ring-fenced setup (e.g., test in three stores).
- **Data:** All digitalisation technologies are connected to data. They either focus on data collection (e.g., sensors), data processing (e.g., algorithms) or data output (e.g., digital assistants). Data itself is the 'lifeblood' of digitalisation and requires a proper backbone (e.g., IT systems, Internet connectivity, data backup and security).
- **Multiple uses:** Technologies can support one or more operational functions. Machine learning algorithms, for example, are applicable to all operating functions while beacon technology is used in store operations only.
- **Make or buy:** Technology investments can be limited to buy proven off-the-shelf software, hardware and implementation advice which is the safest option. However, most digitalisation technologies are new and either have to be developed in-house or jointly explored with external partners. This is particularly the case for the most advanced technologies with the highest potential for differentiation (e.g., automated checkouts, O2O inventory management systems).

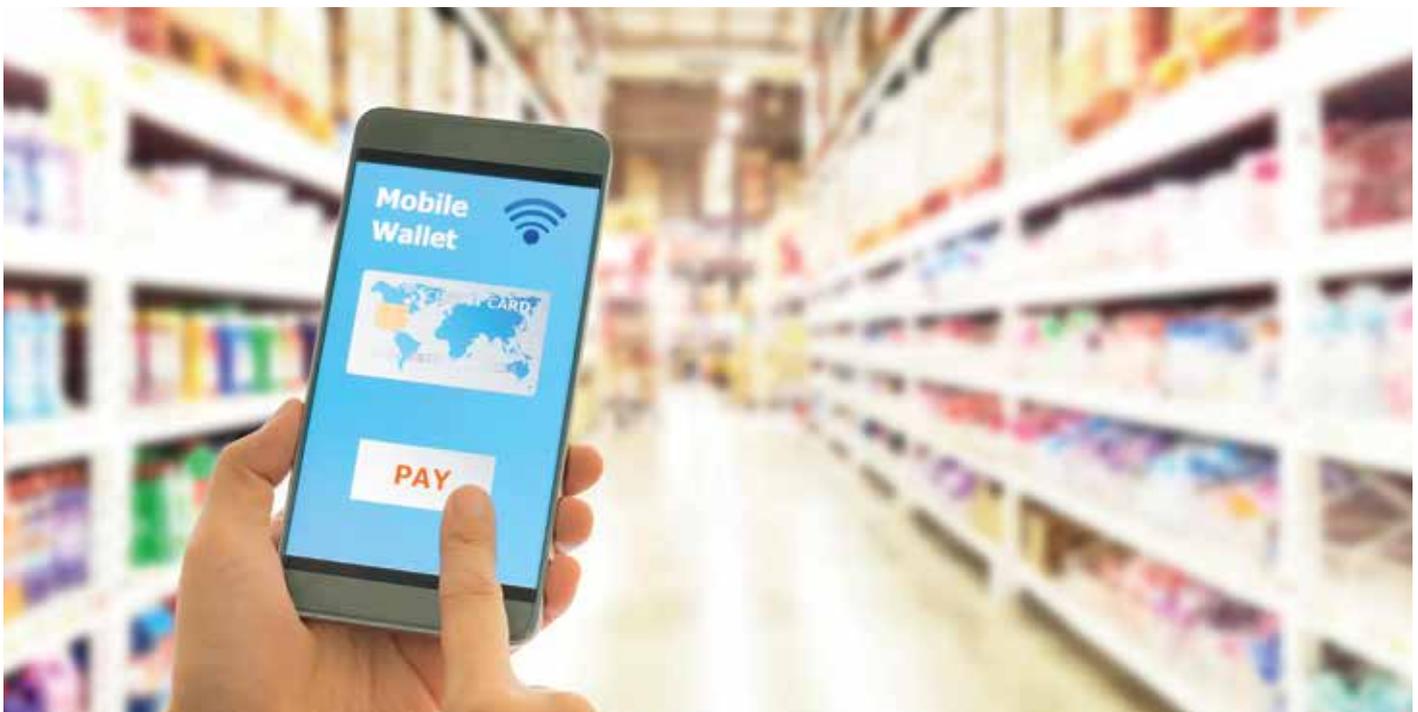
The graph below summarises technologies along selected front- & back office applications.

Exhibit A: 6 technologies along retail front office and back office

		Technology						Implication
		IoT	A.I.	Robotics	RPA	Chatbot	AR/VR	
Front office	1 Personalised promotion							Increase basket size and improve loyalty
	2 Automated interactions							Enhance customer service and reduce service costs
	3 Immersive experience							Increase sales and reduce operating costs
Back office	4 Automated supply chain							Improve supply speed, reduce costs and working capital
	5 Real time inventory mgmt.							Maximise sales and reduce inventory mark-downs
	6 Automated administration							Improve failure rate and reduce labour costs

Source: KPMG analysis

On the following pages, we take a closer look at these technologies, their applications, benefits to retail operations, implementation needs and typical financial impact. This is based on KPMG analysis, project experience and the assumption of mature FMCG retail operations of 500-1,000m² stores in Chinese tier-1 cities.

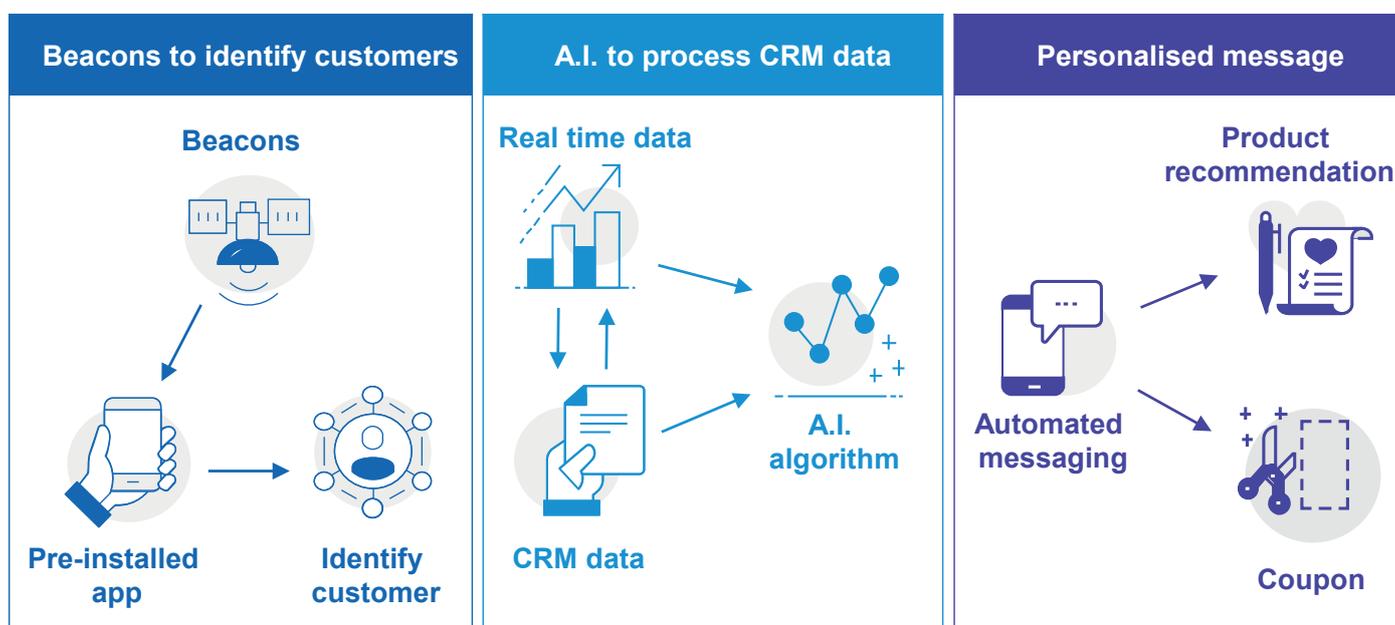


Front office applications

- **Personalised promotion via IOT (beacons) and A.I.**

- **Application:** Beacons are devices that emit Bluetooth signals so that as customers enter the store, the beacons connect to their smart phones and thereby recognise customers if they have the retailer's app installed. They facilitate real-time data collection, record customers' location, time passed in-store, movement profiles and shopping route. By using collected data and matching it with the CRM (Customer relationship management systems) database, retailers can send tailored messages to customers' devices such as coupons and product recommendations. Other products and installations with Internet connectivity (Internet of Things) are additional data sources with similar effects.

Exhibit B: Personalised promotion



Source: KPMG analysis

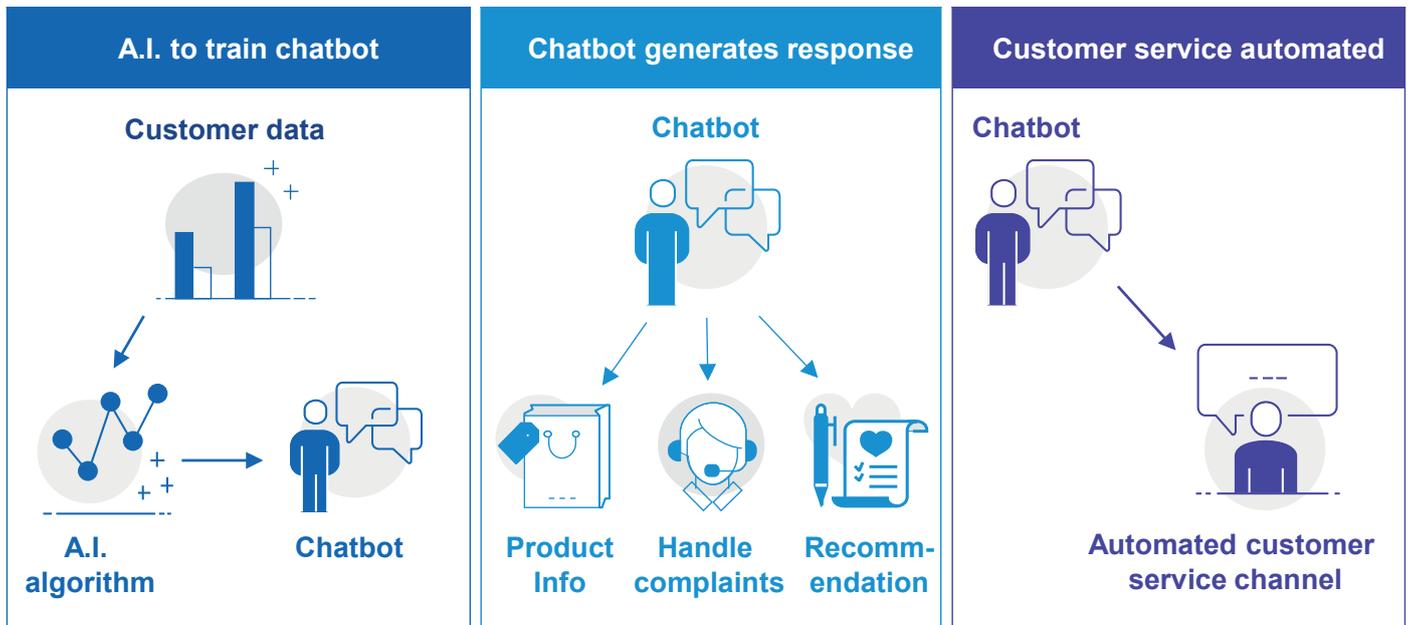
- **Benefits:** Via beacons, retailers gain access to individual customer data and can create a great deal of intelligence on their personal preferences. They enable personalised sales promotions to increase basket size as well as to sell specials and end-of-shelf life products. Finally, they facilitate new product introductions and cross-selling, all of which can increase sales.
- **Implementation needs:** Retailers will need to install beacons in their stores, develop their own apps and distribute them to customers. For these models to be successful, they will also need to develop predictive A.I. models and proper customer relationship management systems. The technology is mature and readily available but the implementation effort is high.
- **Financial impact²:** Personalised promotion increases basket size and improves loyalty. In most cases, sales increases by 0.5-2.0% with EBIT improvement of 2-8%.

² KPMG retail cost model.

• **Automated interactions via chatbots and A.I.**

- **Application:** Chatbots are automated customer interaction algorithms which replace customer service staff. They provide around-the-clock live pre-sales and after-sales support. Simple chatbots provide information to customers, such as product descriptions, pricing and availability. They also receive feedback and complaints that trigger appropriate action or escalate when needed. More advanced chatbots are also able to generate recommendations tailored to customers’ needs. Chatbots are based on A.I. algorithms, which require access to customer data and have to be trained-up on the most common requests. They only pass on requests to customer service staff when they go beyond standard situations. In that sense, chatbots are similar to standard call centre menu options.

Exhibit C: Automated interactions



Source: KPMG analysis

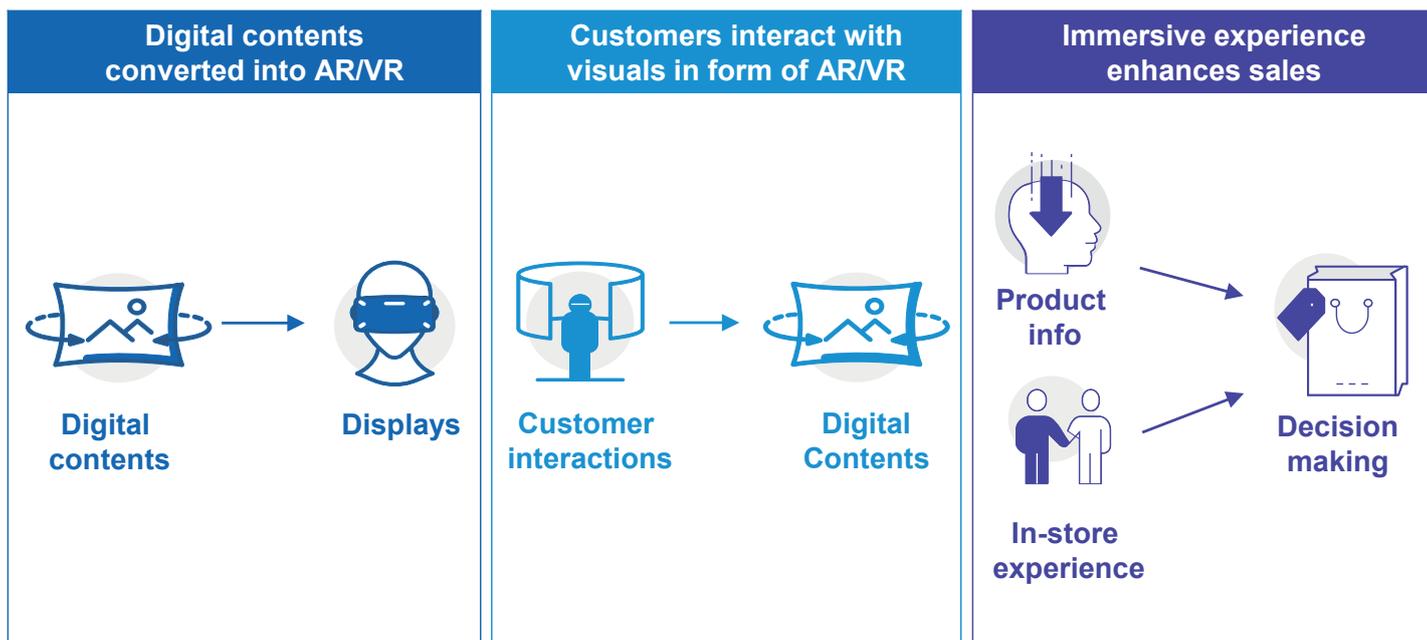
- **Benefits:** For simple customer interactions, chatbots are very effective. This enables trained customer service staff to focus on more advanced and value-adding tasks, thereby increasing service level and customer loyalty. However, in most cases the focus is on reducing customer service costs to save on wages, training and administration.
- **Implementation needs:** Retailers have to analyse typical customer interaction situations that are routinely handled by customer service staff and train A.I. algorithms to process these. There is little implementation effort, given that chatbots are readily available software.
- **Financial impact²:** The use of chatbots facilitates a reduction of customer service costs by 60-80% and reduces related corporate labour costs of Chinese offline retailers by 5-10%. Besides, online orders can be pushed slightly which increases sales somewhat. Overall, this translates into an EBIT improvement of 1-4%.

² KPMG retail cost model.

• **Immersive experience via augmented and virtual reality (AR/VR)**

- **Application:** Augmented reality/ virtual reality are visualisation tools that can be used in stores or at customers’ homes. They enrich the purchase experience by allowing customers to visualise how products such as furniture or clothing would look. This enables tailoring of products and serves as an additional sales channel, complementing or replacing physical stores. Augmented reality is the use of mobile phones or glasses to add a layer of digital information on the reality that users can see, while virtual reality is a completely artificial environment. Consumers can manoeuvre across AR/VR using their movements (i.e., hands, head and eyes). AR/VR technology creates an immersive environment for customers to see, feel and experience products that they otherwise would have to imagine or come to a store to physically experience. It also conveys additional content on the products.

Exhibit D: Immersive experience



Source: KPMG analysis

- **Benefits:** AR/VR increase sales, customers' convenience and loyalty. They may also reduce operating costs when replacing physical stores.
- **Implementation needs:** Implementing AR/VR technology uses visualisation hardware in stores or requires consumers to possess such devices at home. Existing solutions are still expensive and functionality is limited. However, maturity will rapidly increase over the next few years. Significant investment and in-house media competency such as specialised staff and entire content-creating departments are required to feed the virtual world with products and related content which is tailored to consumers' lifestyles. It also needs close cooperation with the buying, marketing and IT departments as well as product suppliers, which are a main source of content.
- **Financial impact²:** Immersive experience can improve sales by 5-15% when added to physical stores. This compensates for the additional costs and could even result in a double-digit impact on EBIT ranging 20-50%, if physical stores are replaced.

Back office applications

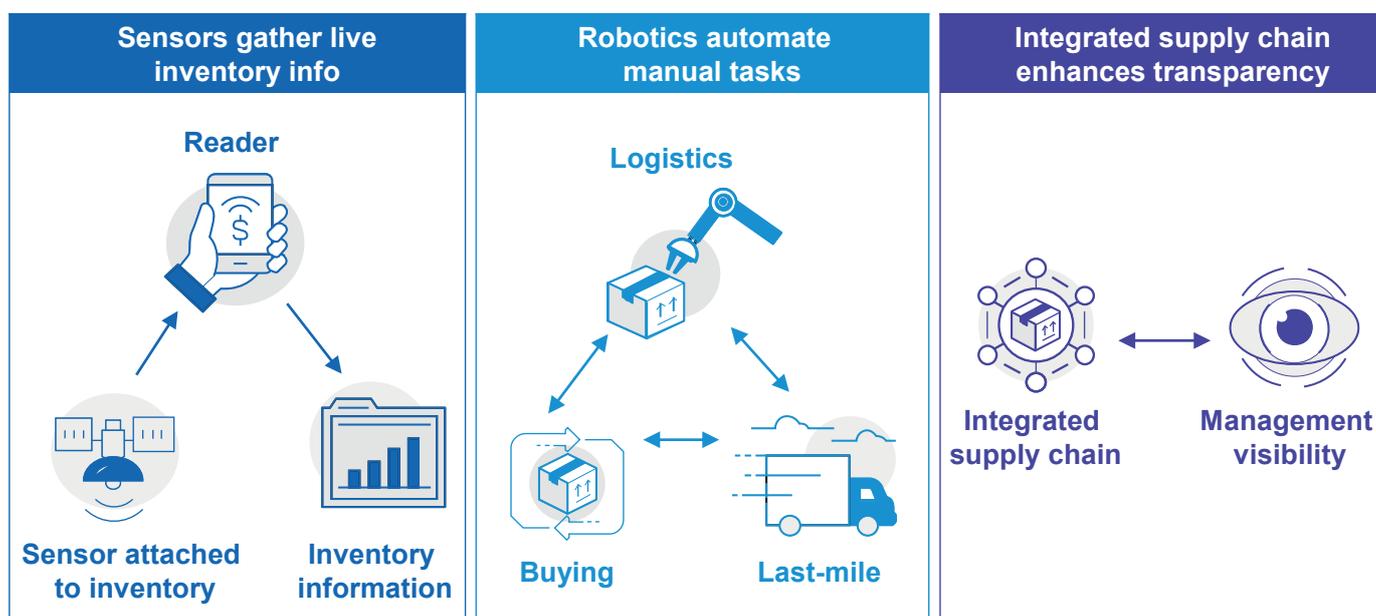
- **Automated supply chain via Internet-of-things & robotics**

- **Application:** Supply chains extend from agriculture and raw materials via production, wholesale and retail to home delivery. Product tracking, quality checks and inventory management require high effort while transparency is limited. The Internet-of-Things digitalises products, which allows their tracking via sensors across the supply chain through warehouses, during transportation and in stores. Products identify themselves and tell the sensors which product it is, where it is located, its remaining shelf life and how it has been treated (e.g., damages, temperature). This increases transparency and reduces manual tasks such as inventory taking. When combined with blockchain technology, IoT enables complete product tracking, maximising safety and minimising counterfeiting as well as food safety risks. All of which are of significant concern in China.

Robotics, on the other hand, automates manual tasks such as goods-in process and commissioning at warehouses. The use of robotics is greatly facilitated by IoT technology, because products interact with robots, telling them where they should be stored in a warehouse and for which store or consumer they have to be commissioned.

² KPMG retail cost model.

Exhibit E: Automated supply chain



Source: KPMG analysis

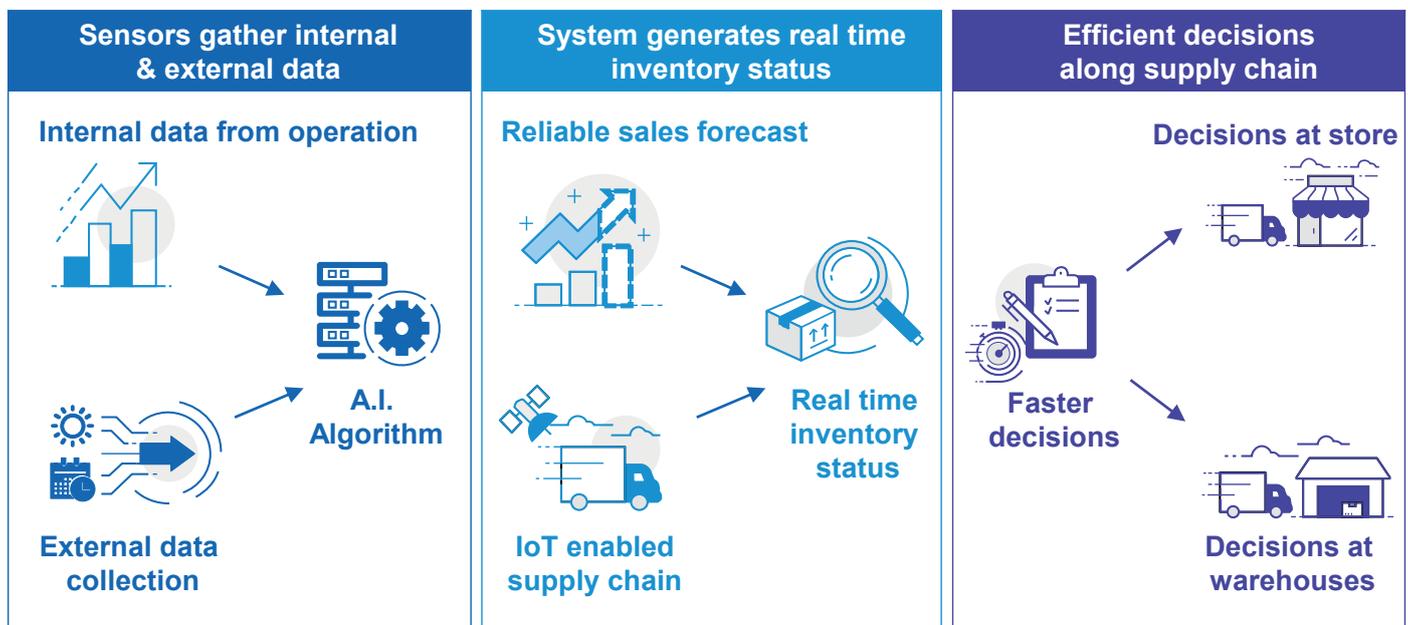
- **Benefits:** Supply chain automation increases transparency and speed across the supply chain while reducing labour cost, errors and risks. It also enables more informed management decisions and facilitates rapid reaction to changes of demand or bottlenecks in supply. Most of these effects reduce costs and working capital while having a minor impact on sales.
- **Implementation needs:** Supply chain automation requires the installation of a seamless chain of sensors and communication devices to interact with the products (e.g., in warehouses, stores, floor moving vehicles, lorries). Secondly, suppliers need to upgrade products with IoT capabilities. These can be simple RFID tags or more complex alternatives. Thirdly, robotics need to be installed in central warehouses and in some cases in store warehouses. Going forward, transport vehicles will also become automated. The technology is mostly available but still expensive. As an example, RFID chips are not yet an economic solution for FMCG such as food but are easily affordable for more expensive slow-movers like jewellery. Also, IT infrastructure, Internet connectivity, inhouse data management capabilities and robotics equipment are needed. The investment for such infrastructure is very high.
- **Financial impact²:** Fully automated supply chains reduce warehousing and logistics costs by 5-10%, inventory mark-downs by 10-20% and working capital by 10-20%, while heavily increasing CAPEX. EBIT impact ranges 4-12%.

² KPMG retail cost model.

- **Real time inventory management via IoT and A.I.**

- **Application:** Real-time inventory management enables better and faster decisions when ordering at stores from warehouses and at warehouses from suppliers. The ordering is done via artificial intelligence algorithms based on real-time sales data from stores or online shops, external data sources with an impact on sales (e.g., seasonality, weather, holidays, consumer sentiment) and information on remaining shelf life, supplier and transportation lead times, scheduled retail price promotions and supplier pricing schemes (e.g., volume discounts). Effective real-time inventory management requires reliable sales forecasts and IoT-enabled supply chains. At least, this comprises digitalised pallets on which products are stocked during shipping but ideally also includes the products themselves.

Exhibit F: Real time inventory management

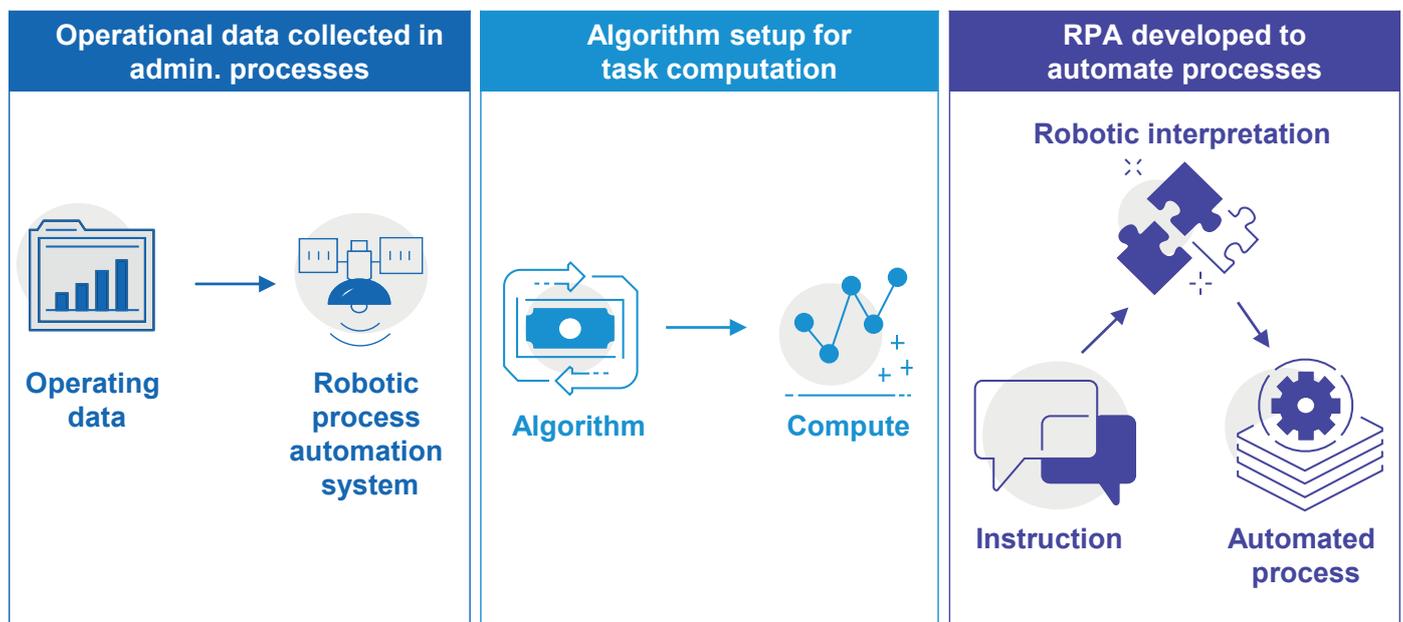


Source: KPMG analysis

- **Benefits:** Real-time inventory management reduces out-of-stock situations and thereby maximises sales. It also minimises inventory mark-downs because less products have to be discarded and reduces working capital as well as warehousing costs due to lower stock levels. All of this impacts the bottom line.
- **Implementation needs:** Retailers who implement real-time inventory management have to put A.I. algorithms in charge of ordering. Both, installing A.I. software and training the algorithms via machine learning require limited effort. However, there is an array of prerequisites like the front office data sources for proper demand forecasting, the IoT enablement of the supply chain (e.g., RFID) and a solid IT backbone which require significant investments of time and resources. There is also a need for inhouse capabilities in A.I. such as data scientists to run this infrastructure. The maturity of real-time inventory management technology is high.

- **Financial impact²:** Real time inventory management will reduce inventory mark-downs by 5-10%, reduce warehousing costs and lead to a more effective use of supplier conditions (e.g., volume discounts). This improves EBIT by 3-8%.
- **Automated administration via robotic process automation**
 - **Application:** Robotic process automation (RPA) is a technology that automates administrative processes performed by human workers. It directly learns from observing human users' interaction with the graphical user interface of software tools, email, etc. This includes manipulating data and handling data between different applications. It affects all routine back office workflows of a retailer such as accounting and finance, human resources, logistics and IT.

Exhibit G: Automated administration



Source: KPMG analysis

- **Benefits:** The use of these so-called 'software robots' reduces labour costs and human error. They also enable human workers to focus on tasks that are more value-adding and satisfying.
- **Implementation needs:** Automated administration requires investment in software tools, training the software to perform tasks, train staff so that they learn how to work with it and do software maintenance. The implementation effort for this mature technology is limited. Retailers would need to build and institutionalise RPA capabilities in their organisations to ensure user acceptance.
- **Financial impact²:** Administrative automation reduces SG&A costs, lowering them by 1-3% for quick wins. The long tail has potential of additional 2-3%, although with a lower likelihood of success. EBIT impact ranges 1-4%.

² KPMG retail cost model.

The table below summarises business implications of the selected digitalisation use cases.

Exhibit H: Business implication of selected digitalisation use cases

		Technology			
		Technology maturity	Implementation effort	EBIT improvement	Focus
Front office	1 Personalised promotion			2-8%	Top-line
	2 Automated interactions			1-4%	Bottom-line
	3 Immersive experience			20-50%	Top-line
Back office	4 Automated supply chain			4-12%	Bottom-line
	5 Real time inventory mgmt.			3-8%	Bottom-line
	6 Automated administration			1-4%	Bottom-line

Source: KPMG analysis



5

How to effectively drive digitalisation



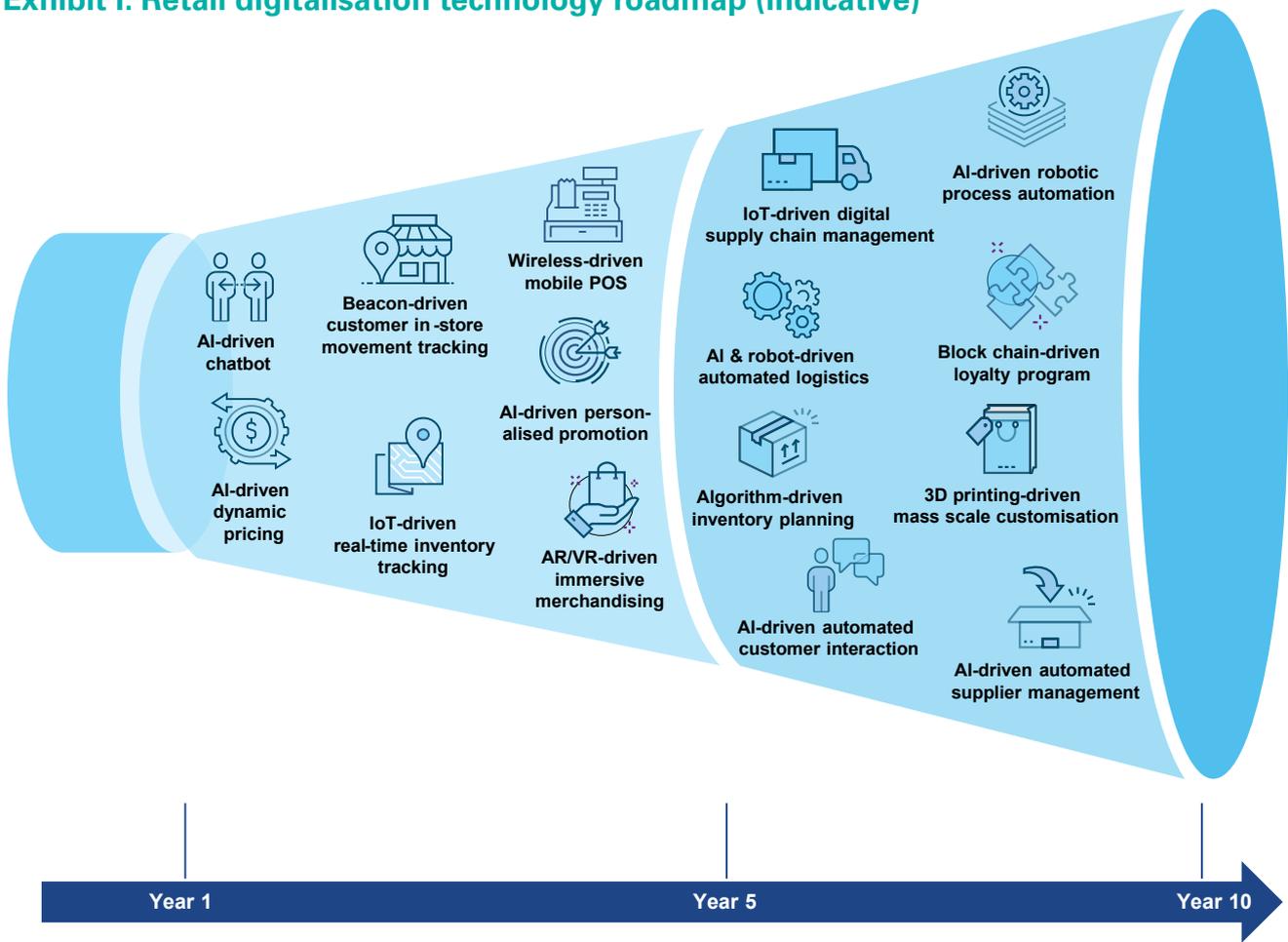
Digitalisation implies significant changes to retail operations and sizeable investments of financial resources as well as the deployment of dedicated people. It also impacts existing operations to some degree and implies risk. This therefore requires thorough planning, informed decision making and effectively orchestrated implementation – a journey that starts with a ‘digitalisation strategy’ and includes a ‘digital transformation’ to achieve the ‘digital ambition.’

KPMG analysis on leading Chinese retailers shows that more than half of digitalisation initiatives fail. The main reasons for this failure are insufficient planning and preparation, gaps in digital competencies, poor implementation and lack of acceptance in the organisation. The size of the investment and immature technologies play a subordinate role.

The following list summarises learnings from recent digitalisation projects in Chinese retail which have proven to be vital for success:

- **X-ray:** Transparency is needed to understand options for digitalisation. In particular, available technologies, their applications along the value chain, impact on operations and financials, competitors’ digitalisation approaches and consumer expectations need to be understood first.
- **Ambition:** The starting point of digitalisation is a clear idea of what should be achieved. This can be a defined improvement in customer retention, EBIT margin or working capital. It can also go as far as building a new digitalised line of business. In any case, clarity is needed on a limited set of quantified objectives.
- **Short-listing:** Digitalisation technologies and operating model applications should be identified and filtered by impact, ease of implementation and technological maturity to weed out those technologies that do not fit business and operating model needs.
- **Quick wins:** Some technologies are readily available, yield quick returns and require little effort. Those should be prioritised for rapid investment and implementation. Early success stories help the organisation accept new initiatives and move projects forward.
- **Roadmap:** Some technologies are mature or will become available over the next three to five years while others will become relevant in the more distant future. In addition, the implementation of some technologies can be precursors to enabling a higher level of digitalisation. Therefore, a long-term vision should be developed that maps out short-listed technologies along a digitalisation roadmap over 10 years. This shows development stages along technologies for digitalised operations. The following graph shows a simplified example for the retail sector as a whole.

Exhibit I: Retail digitalisation technology roadmap (indicative)



Source: KPMG analysis



- **Business case:** Each technology application is an investment case that has to be feasible and profitable, considering operational improvements, ramp-up timelines, one-off costs, financing needs and risks. The digitalisation journey as a whole should be reflected in a business case with an array of clearly defined milestones. This ensures conscious and informed investment decisions and an element of 'control', i.e., built-in options to stop initiatives that have become out of budget or unfeasible.
- **Proof of concept:** Assessing feasibility is a key challenge when investing in technology. This is most critical for less mature technologies, in-house developments and external technology partnerships. Feasibility analysis has to apply the proper expertise and should be quickly substantiated by prototypes and small-scale tests like a roll-out in three stores. From a management perspective, this requires a strict timeline with milestones for deliverables, decisions and implied next-round investments.
- **Organisation:** Digitalisation is a long-term task and should be properly institutionalised in a retail organisation. Options range from a light-touch task force, supported by external experts building isolated 'digital flagships', to a digital 'centre of excellence', building separate digital business units all the way down to a truly digitalised organisation across functions and business units. The best solution differs by business, ambition and the chosen roadmap. In any case, the new organisation's role and interaction with the existing core business are to be defined, planned and communicated early-on to allow for a smooth acceptance by the existing organisation.
- **Conducting the orchestra:** Digitalisation is initially a strategic decision that requires subsequent implementation by a number of contributors and stakeholders. This includes staff in front office and back office functions as well as IT and accounting experts, data scientists, technology providers and advisors. All of these parties have to work together and need to be centrally-managed along the 'critical path' of implementation ensuring delivery on time, at quality and within budget.

KPMG works with retailers and consumer goods companies shaping digitalisation agendas and driving their implementation journeys from 'Strategy-to-Results'. This is facilitated by KPMG's 'Connected Enterprise' framework and '9 Levers of Value' approach.

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