

2017 Japan Luxury report

Changing channels landscape to satisfy Japanese luxury consumers' appetite for novelty

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Foreword

With most attention focused on China and its consumers' massive appetite for luxury goods, or to a lower extent on South Korea as the new trendsetter for fashion and beauty, Japan has been less looked after.

The perceived morose economic situation of the Japanese economy, its aging and declining population, or its historical deflation had much to do with it. Yet with 3.6 trillion yen (approximately 28 billion euros) spent each year in luxury goods, Japan is the second largest luxury market in the world – behind the United States, but still ahead of Mainland China.

For many luxury brands, Japan is often contemplated as their first market in terms of sales and more importantly in terms of profits: over half of local luxury executives report that Japan is seen by their headquarters as a growth engine and a profit generator.¹ Indeed Japan accounts for up to 30-40% of some global luxury brands' profitability. And while the general perception may be that the Japanese luxury market is stable and unchangeable, there are, on the contrary, several forces at work that are likely to reshape it.

¹ Live survey conducted with 53 luxury brands' executives in Japan during our May 2017 Japan luxury CEOs roundtable

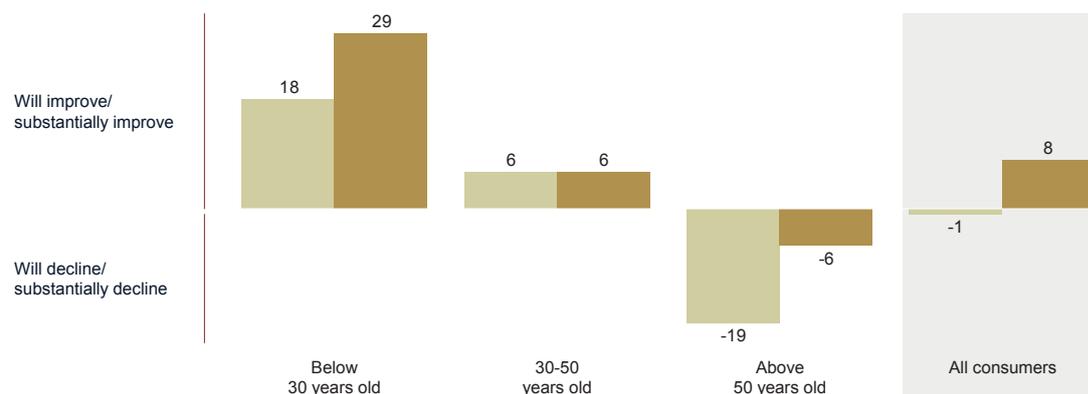
The Japanese luxury market is in recovery, with a positive momentum ahead

Between 2007 and 2012 the Japanese luxury market experienced a major downturn, dropping 6% per annum. With the context of the global economic crisis, followed by the Fukushima catastrophe, Japan luxury spending shrank by over 1 trillion yen (9 billion euros) and reached a floor level in 2012. In 2013, the market started to recover in what we called at the time a “Godzilla effect.” Since then we have observed a dynamic growth momentum at 8% per annum between 2012 and 2016, allowing the Japanese luxury market to recover all of the spending lost in the prior period. This robust recovery can be attributed in some part to the improvements observed in the Japanese macro-economic environment that arose with the Abenomics policies. With a cheaper yen, positive inflation trend and an increase in household spending, Abenomics seem to have translated into a stronger confidence, up 19% since the 2014 tax hike. This trend is also confirmed by our latest consumer research that we conducted with over 500 Japanese luxury consumers in March-April 2017²: their perspective on their own economic situation improved by +9 points vs last year – with the Millennials (i.e. consumers below 30 years old) being the most optimistic (Exhibit 1).

EXHIBIT 1 Perception of luxury consumers' own economic situation

How do you see your own economic situation evolving toward 2020?
Percent delta¹

■ 2016
■ 2017



¹ Percent delta between respondents who answered “will improve” or “substantially improve” and “will decline” or “significantly decline” Source: McKinsey Japan luxury consumer survey in 2016 (n = 531) and in 2017 (n = 554)

² McKinsey proprietary research conducted in March-April 2017 on 554 Japanese luxury consumers

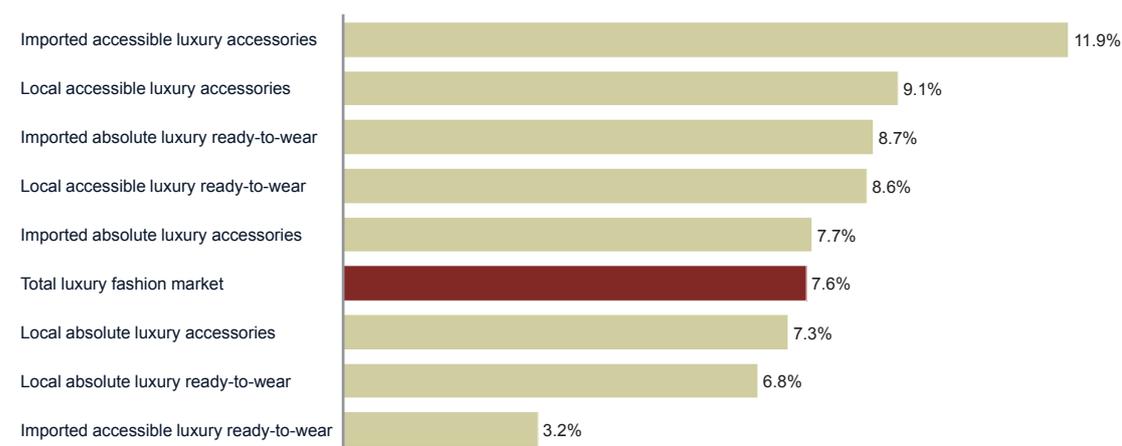
However, the Japanese luxury market recovery has not benefited all market segments to the same magnitude. On the one hand, imported accessories (primarily leather goods) and local affordable luxury fashion labels overperformed total market growth, with growth rates of 12% and 9%, respectively, between 2012 and 2016. On the other, imported affordable fashion brands and local absolute luxury brands underperformed, with growth rates in the low single digits (Exhibit 2). This contrasted situation underlines the different faces of the Japanese luxury market:

- Preference for local brands' offering, Japanese-specific fashion styles and shapes that stand out from Western brands' offering – especially in the affordable luxury segment
- Local absolute luxury brands losing part of their relevancy, with many of them being associated with the 1980s and 1990s fashion trends, and facing difficulties in competing against global and preeminent luxury brands that eye Japan as their private garden
- Affordable luxury accessories, driven by international giants, offering an entry access point for Western luxury consumption by many Japanese consumers

EXHIBIT 2

Japanese luxury fashion market recent evolution by segment

2012-2016 market growth
Compound annual growth rate

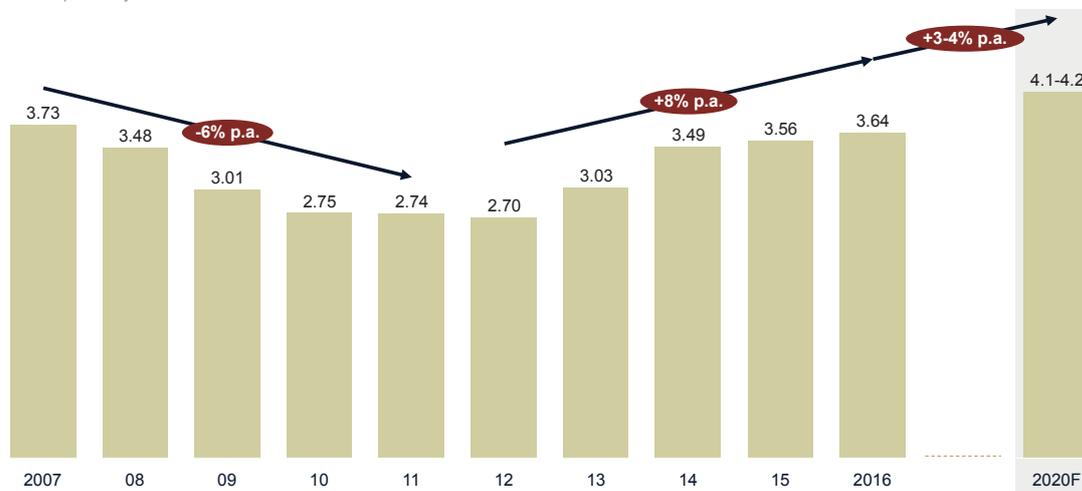


Source: Yano Research Institute, companies' information, McKinsey analysis

In the short term, we expect the Japanese luxury market to maintain its positive momentum: 82% of luxury executives surveyed state that their sales outlook for 2017 is better or significantly better than 2016. Looking ahead to 2020, we anticipate the market to grow at a more moderate rate of 3-4% per annum (Exhibit 3), with affordable luxury price points and the accessories category leading the way. This is confirmed by luxury brand local executives, with 86% of them being optimistic or somewhat optimistic on the development of the Japanese luxury market in the next 3-4 years.

This momentum is likely to be fueled by the reinforced role of the Millennial generation, who are taking over part of the population. We observe that Millennials are less likely to trade down, more optimistic about their luxury spending, and less reluctant to show off than the other age groups. Inbound tourists are also contributing to this positive outlook. Since 2015, we have observed a major boom from Chinese tourists visiting Japan, i.e. tripling in less than 2 years, impacting positively on the Tokyo and Osaka luxury markets in particular. With the upcoming 2020 Tokyo Olympics, tourists will continue to positively weigh on the market – especially if the government takes key measures to improve the country’s attractiveness to tourists.³

EXHIBIT 3
Japan luxury goods market evolution
Trillion Japanese yen



Source: McKinsey luxury scope

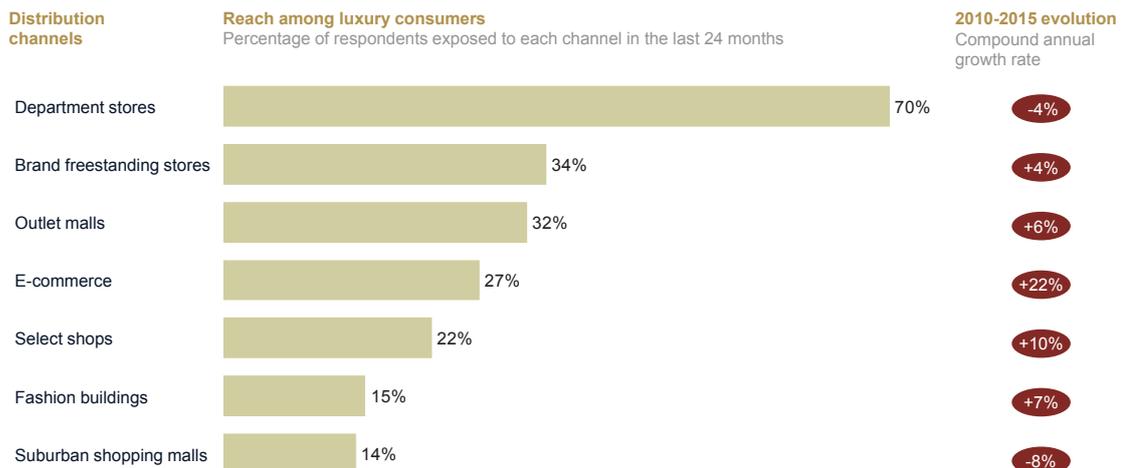
³ See the McKinsey report “Can inbound tourism fuel Japan’s economic growth?”

Japanese luxury consumers continue to have high expectations, with novelty gaining in importance

Digital touchpoints are starting to play a major role within Japanese luxury consumers' journeys. Brand websites are now part of the top 5 touchpoints, with 1 out of 3 consumers experiencing it – still far below the reach of department stores (70% of consumers) (Exhibit 4). In addition to brand websites, brand-curated social media like Instagram, Facebook or Snapchat are progressing robustly versus last year. The reinforced role of digital highlights the generation shift previously described as well as changes in habits propelled by mass-market pure players like Rakuten, Amazon or Zozotown. Yet with only 7% penetration, online luxury sales are less developed than in many other markets, reflecting a lack of digital savviness for luxury goods purchases, the absence of Japanese language from some luxury brands' e-shops, and the limited online presence of key local players like department stores.

EXHIBIT 4

Channels dynamics



Source: McKinsey Japan luxury consumer survey 2017 (n = 554); Yano Research Institute; luxury import brand market 2016; McKinsey analysis

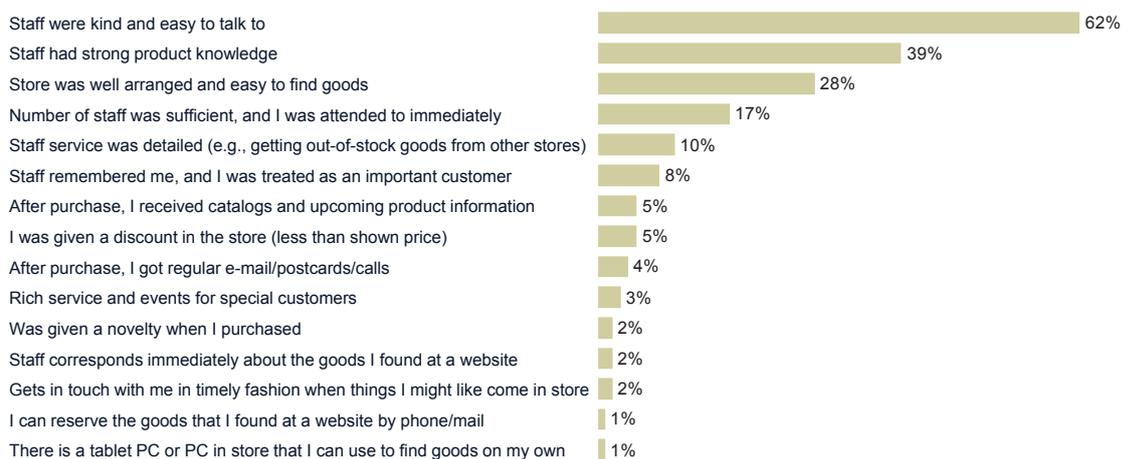
The role of the point of sale remains paramount, whether it is a department store, a brand store or another format. This role regards both information gathering and purchase, and is associated with high expectations from Japanese luxury consumers. These expectations focus particularly on sales excellence. Indeed “kind and easy to talk to” and “strong product knowledge” stand out as the top two factors in customer experience satisfaction. In addition, Japanese shoppers appreciate receiving a personal and exclusive treatment in the store. With tourist flows invading some stores in Ginza or Omotesando, this treatment has raised in importance and proved critical to building loyalty among high-demanding local customers. It is a particularly important issue for local luxury executives, for which retaining qualified staff and building customers' loyalty are the two most pressing operational issues.

However, sales staff kindness and service quality are no longer sufficient to satisfy Japanese luxury consumers and capture their spending at home. While price disparities versus overseas have always been a major concern, novelty has become a major driver of dissatisfaction (Exhibit 5). More than 75% of Japanese consumers perceive that their local luxury stores are not offering enough new products lineup and have a rather narrower assortment than what they can find overseas. This appeal for novelties also impacts brand preferences – as illustrated by the high brand rotation observed across department stores, select shops and freestanding store retail spaces, with consumers’ brand loyalty being at a historical low.

EXHIBIT 5

Drivers of luxury customer experience satisfaction

Top drivers of customer satisfaction
Percentage of respondents



Source: McKinsey Japan luxury consumer survey 2017 (n = 554)

Unprecedented channels reconfiguration driven by the evolution of consumer behaviors and generational shifts

As acknowledged above, department stores are the primary touchpoint and place of purchase for Japanese luxury consumers, still representing over half of the luxury market value. Nevertheless, Japanese department stores have been struggling for the past decade, experiencing 4% per annum sales decline between 2010 and 2016. And this trend is likely to be reinforced in 2017, as our research uncovered an 8% drop in department store frequentation from our survey's respondents. While shoes still seem to rely strongly on them, leather goods and watch and jewelry categories have observed the biggest decline. This negative slope appears to be anchored in a series of challenges that department stores have not yet fully addressed:

- Aging core consumer base, representing a major share of their revenues, still valorizing a traditional model and acting as conservative agents
- Formats and floor layouts becoming old fashioned and unappealing to younger customers
- Significant drop in foot traffic in suburban areas where catchment areas are no longer attractive enough to support one or more department stores
- Difficulties in embracing the digital and omnichannel opportunities

In parallel, younger-oriented formats – namely select shops and fashion buildings – are booming (Exhibit 6). Between 2012 and 2015, these two formats grew at double-digit rates thanks to new openings and share gains. Their success results from capturing Millennial consumers' attention thanks to renewed and more affordable offerings. Fashion buildings, i.e. multistory shopping centers located within or close to train/subway stations, are home to the latest affordable luxury brands (mainly local), with a rather high tenant turnover that guarantees consumers find the trendiest look and products. Similarly select shops, i.e. multi-brand retailer chains, offer a

EXHIBIT 6

Preferred channels by age groups

Exposure by channel
Percentage

	Total	Difference to total		
		Below 30 years old	30-50 years old	Above 50 years old
Department store	59	0	2	-2
High-end shopping mall	19	3	1	-3
Fashion building	37	8	4	-9
Suburban shopping mall	39	7	-2	-4
Outlet mall	12	2	-1	-1
Underground fashion streets	20	4	0	-3
Stand-alone brand boutique	19	4	1	-4
Multi-brand select shops	20	8	0	-6
Commercial area near terminal station	34	0	4	-3
Commercial area near residential area	26	4	0	-2

Source: McKinsey Japan luxury consumer survey 2017 (n = 554)

fast-moving assortment of local and international brands that they curate on a model inspired by Colette and 10 Corso Como. Less exclusive than these internationally renowned concept stores, select shops are now well-established retailers with hundreds of stores for the largest ones.

Select shops and fashion buildings have also embraced another trend that is shaping the Japanese luxury market: experiential shopping. Indeed, we observe more and more of these formats including cafés, restaurants, hair salons or even flower shops within their walls as a way to become a destination for those in their 20s and 30s. Recently opened shopping malls like Ginza Six in Tokyo or Doton in Osaka, and booming freestanding stores, fashion districts like Aoyama and Daikanyama in Tokyo, are also becoming experiential places. Interestingly we have seen consumers stating that their primary motive for visiting these places is to go out with family or friends rather than to shop (Exhibit7).

EXHIBIT 7

Purpose for visiting recently opened shopping centers

Purpose for visiting new establishments when they open

Percentage of luxury purchasers who are interested in going to new shopping centers



	Shopping alone	Shopping with friends or family	Going out with friends or family	Having lunch/dinner with friends or family	Seeking something special	Killing time
Ginza Six (Tokyo)	7%	8%	42%	10%	13%	11%
Nagoya JR Gate Tower	7%	11%	34%	25%	11%	11%
Geino Namba (Osaka)	7%	14%	43%	14%	9%	8%
Doton Plaza (Osaka)	7%	16%	43%	7%	7%	11%
LECT Hiroshima	9%	20%	40%	8%	6%	12%

Source: McKinsey Japan luxury consumer survey 2017 (n = 554)

New shopping malls and booming street fashion districts are also at the center of luxury brands' attention. As 44% of luxury brand executives see the Japanese luxury retail landscape increasing in complexity, with new channels and new locations gaining in importance, hunting for new prime spaces is the game of the moment.

Market outlook: Fierce competition requiring faster adaptation from both local and international players

With the Japan luxury market growing again and remaining a major profit driver for many established luxury players, we have observed a renewed interest in Japan in the past year or so. Brands with no presence in the archipelago, or that exited it, are contemplating market entry – often as part of their Asian strategy. Newly entered brands and challengers investigate how to crack the Japanese “codes” (see sidebar, “The 6 codes of Japanese fashion and luxury”) – which highly benefit more established brands. In the meantime, local Japanese luxury brands that remain highly dependent on their home market – given their rather limited international presence – continue to struggle as they face challenges from consumers and department stores. This situation is likely to translate into fiercer competition over the coming years, with clear winners and losers across both international and local players.

As the market experiences a profound channels reconfiguration, along with changing consumer habits, we believe that players that adapt best to this new environment are likely to outperform those that continue to rely on traditional models. Shifting the paradigm and meeting the high expectations of Japanese luxury consumers would require luxury brands to:

- Reconfigure their channels presence to embrace emerging consumer needs in terms of service and experience, starting with launching new store formats inspired by successful concept stores and innovative points of sale
- Explore new locations – across different channels – in some cases taking bets on future upcoming fashion districts, requiring luxury brands to put further emphasis on retail development
- Bring a continuous newness to their stores, be it a high frequency of product introductions or a perceived change with fast-rotating visual merchandising
- Animate customer relationships, building on store staff excellence to create deeper intimacy with their customers, using private events and personalized services to achieve this objective

Facing this new world, international players and local brands will have to overcome distinct challenges. On the one hand, international brands are confronted with difficulties in understanding the Japanese market codes, which often run counterintuitive to Western minds, leading to potential errors in decoding Japanese consumers’ expectations and needs. On the other hand, local players that have been centered towards Japan and its codes can sometimes encounter challenges in changing the way they operate and champion new ideas. And as a Japanese proverb states, “haya-oki to sanmon no toku,” luxury brands that adapt first are likely to benefit the most from the world’s second-largest luxury market.

“THE SIX CODES OF JAPANESE FASHION AND LUXURY”

- **Code #1: Places are a much better brand:** Except for the most preeminent global brands, Japanese consumers tend to favor the location where they shop over the brand they may ultimately purchase. In their consumer decision journey, the place of purchase plays a major role, being a vector of identity, style and reassurance. On the contrary, brands have a limited role – with the products themselves coming just after location.
- **Code #2: Cosmopolitanism is a Japanese value:** Japanese luxury brands often use an English, French or Italian brand name, even though they are 100% Japanese. Their communication often features Western models. In many aspects, it is very difficult to identify them as “local” brands. The objective of such positioning is not to copy what international brands are doing or to avoid being viewed as a Japanese brand; local players’ intent is to appeal to consumers’ interest for cosmopolitanism, which is often associated with success.
- **Code #3: Unique styles that appeal to multifaceted consumers:** Japanese styles are numerous, like the preppy Kawai, the loose shapes of casual wear, the extravagant colors or the edgy cuts of fashion-forward designers, to name a few. This profusion of styles satisfies Japanese consumers’ need to express their belonging to a community or a social class in a clear manner.
- **Code #4: Labels proliferation to cover for multiple needs:** Japanese brands often rely on multiple labels or lines – up to a dozen for some large players. Such proliferation results from local brands’ approach of having a label or line dedicated to a specific market opportunity. While in Europe or in the US a brand would try to cover the largest market (even across different segments), Japanese brands are more focused and segmented. This multiplication of brands may have contributed to diminishing the role of brands in Japanese consumers’ decision journey.
- **Code #5: Seasonality actually follows the seasons and the weather:** With four real seasons where temperature and humidity vary, and interseasons that last for a few weeks, Japanese consumers are cautiously adapting their wardrobe to natural conditions. This results in Japanese players introducing at least six or eight collections per year; this frequent dispatch of new products sets an expectation for a highly dynamic store appearance.
- **Code #6: Quality is table stakes and differentiation is hard to achieve:** Japanese consumers value product quality highly. When they shop, the perceived quality of the fabric of the product they want to buy, its finishing or its packaging is often critical. But in a country where consumers can pay up to \$100 or \$200 for a top-quality watermelon, standing out for product quality is very difficult.

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