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Japan's luxury shoppers move on

The Japanese consumer's seemingly insatiable appetite for luxury goods has declined, so companies in this sector must rethink the way they compete.

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When it comes to luxury goods, Japan's consumers are among the world's biggest spenders. The country's luxury market, worth $15 billion to $20 billion, is second in size only to that of the United States. Yet the "mass luxury"[1] market is feeling unprecedented pressure. Sales are down sharply, luxury-goods companies have warned that they won't meet their current growth and earnings targets, and dire headlines proclaim the market's decline.

These challenges are hardly unique to Japan—the economic crisis has sapped consumer confidence globally and sparked a backlash against conspicuous consumption. Yet Japan *is* different: the current crisis has not only reduced the discretionary spending of consumers but also accelerated fundamental shifts in their attitudes and behavior. These changes are not temporary, and luxury players must adjust their strategies to succeed in a market that, despite the current slowdown, will remain very large and attractive.

To help luxury companies better understand both the near- and longer-term outlook for Japan's market, McKinsey surveyed more than 1,500 Japanese luxury consumers in March and April 2009.[2] We also interviewed CEOs, presidents, and other senior officers at more than 20 luxury-goods and premium-brand companies, as well as the CEOs of three of Japan's largest department store chains and a number of luxury hotels.

We found significant, long-lasting shifts in attitudes and behavior among Japanese luxury consumers. Luxury companies can no longer rely on a "brand as badge" mentality. They will have to fight harder (and against more and different competitors) for a share of consumers' wallets. They will have to woo even loyal buyers in more personalized ways. Reliance on the traditional luxury-goods channels—department stores and company-owned stores—has worked well in the past but will almost certainly damage the long-term health of luxury manufacturers.

Some luxury players understand these changes and are adjusting to them, but many still believe that everything will return to normal, whatever that means, once the downturn has passed. Those companies may be in for a surprise.

An appetite for luxury

Although the hypothesis is difficult to prove empirically, there is a consensus that Japan's passion for luxury goods began in the 1970s, with a widely held belief among the country's consumers that European products were of higher quality and more durable than local ones. This idea later evolved into an emotional and social attachment to luxury brands. Owning expensive European-made products became a badge of economic success and social acceptance.

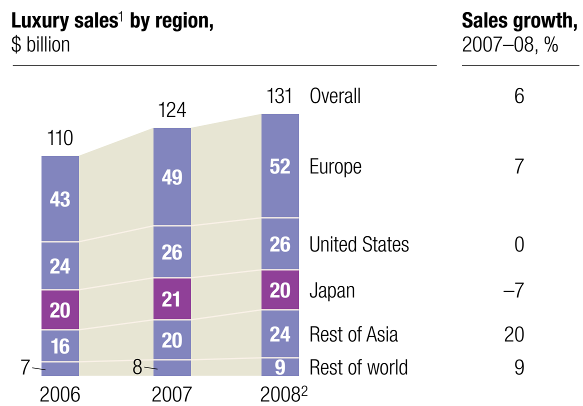
[1] "Mass luxury" is the idea that luxury brands can succeed in the mass market while retaining an image of exclusivity.

[2] Consumers who purchased luxury items from a list of specific brands during the past 12 months.

In Japan, unlike many markets, luxury goods have typically signified a middle- rather than upper-class lifestyle. The most influential Japanese fashion magazines and department stores, which dictated the fashion sense of most members of Japan's large middle class, touted luxury brands. Middle-class consumers skimped on other expenses, forgoing travel or expensive meals so they could buy designer handbags and apparel. As a result, the market for luxury goods boomed in the 1980s and continued to grow despite the economic ups and downs of the 1990s. A handful of the most popular brands benefited enormously. Today, Japan represents 10 to 20 percent of global luxury-goods sales, depending on how the market is defined (Exhibit 1).[3] If Japan's global travelers are included, the country has the world's largest luxury-goods consumer base.[4]

Exhibit 1

A world of luxury



[1]Luxury sales by region, including watches; jewelry; leather goods, footwear, accessories; ready-to-wear; and cosmetics, fragrances, skin care.
[2]Estimated.

Source: 2007 luxury-market size and sales split based upon compilation of reported revenues and geographic splits of 18 major luxury groups plus 13 other companies, which we compiled from annual reports, analyst reports, and estimates from private companies; 2006 and 2008 further extrapolated using regional growth rates provided by Afrifocus Securities in its 2009 report, *Luxury goods: 2008 was reasonable, 2009 . . .* that tracks sales performance of 9 major luxury groups: Bulgari, Coach, Hermès, L'Oréal, LVMH, PPR, Richemont, Swatch, and Tiffany & Co.; 2007 data are from 2007 annual reports or public financial data for 30 luxury companies (representing approximately 65% of market)

Who are typical Japanese luxury consumers? Disproportionately, women over the age of 35, because of the luxury-goods categories we included in our research: fashion apparel, leather goods, watches, jewelry, skin care, and cosmetics. The Japanese luxury-consumer base includes two large segments reflecting a demographic split: the traditional 45-years-or-older segment (still responsible for a significant portion of luxury spending on many

[3]Japan is "the world's most concentrated source of revenue for luxury brands," according an article of the same name by the Japan External Trade Organization, May 2006 (www.jetro.org/content/361).

[4]*Luxury Uncovered*, JP Morgan European Equity Research, December 16, 2008.

brands) and the generally trendier under-45 segment (with a number of subsegments based on factors such as income levels, sources of income, and job status). One important consumer segment for many luxury brands consists of single women aged 20 to 35 who hold full-time jobs but live with their parents and therefore have a substantial discretionary income.

The two primary sales channels for luxury goods in Japan are department stores (where luxury manufacturers typically have “shops in shops”) and stand-alone company-owned or -operated stores. Today, department stores generate about 55 to 60 percent of luxury-goods sales,[5] and many major luxury players in Japan control virtually every aspect of their presence—not only owning the merchandise, but also using their own employees as salespeople.

The bubble bursts

Obviously, luxury-goods sales suffer during difficult economic times, but the global recession only partially explains the steep decline in Japan’s luxury market. After modest growth from 2001 to 2006, it contracted in mid-2006, recovered modestly in late 2007, and fell sharply in 2008 (Exhibit 2). Most of the expansion early in the decade apparently resulted from price increases rather than volume growth. Recent data show that retail sales of imported brands, including luxury ones, fell by 4.6 percent, to 846 billion yen ($8.8 billion) in 2007 and by an additional 4.9 percent in 2008, to 804 billion yen.[6]

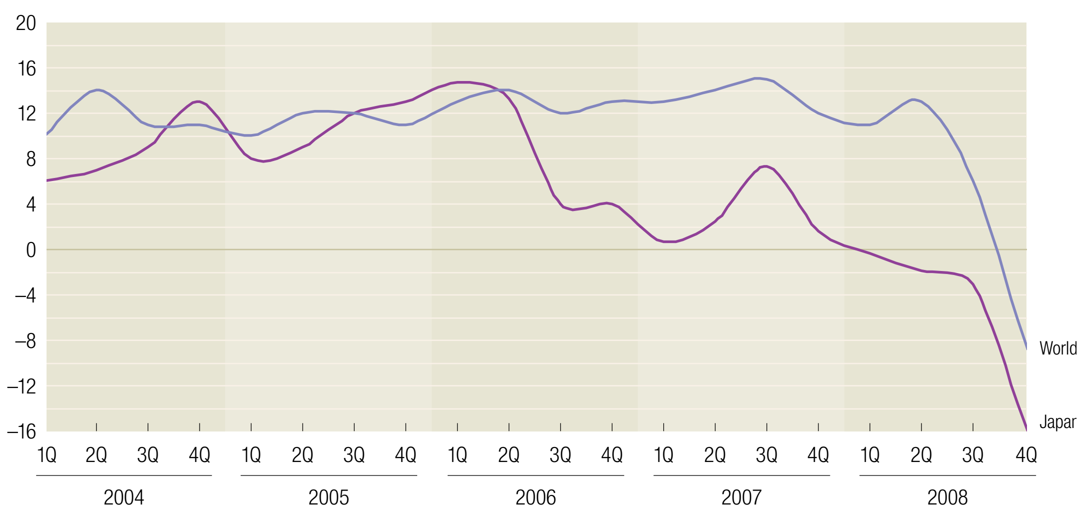
[5] *Luxury Import Brand Market in Japan*, Yano Research Institute, November 2007.

[6] *Luxury Import Accessories Market in Japan 2009*, Yano Research Institute, April 2009. Figures based on August 31, 2009, exchange rates.

Exhibit 2

The fall

Constant currency growth by region



Source: *Luxury goods: 2008 was reasonable, 2009. . .* Afrifocus Securities, February 2009; this report tracks sales performance of 9 major luxury groups: Bulgari, Coach, Hermès, L’Oréal, LVMH, PPR, Richemont, Swatch, and Tiffany & Co.

Our interviews indicate that year-to-date sales of fashion apparel and accessories are down by as much as 20 percent—and even more for some companies and categories, including high-end women's apparel. Luxury-goods executives say the decline reflects falling foot traffic, as well as significantly lower average-transaction levels and percentages of browsers who actually buy something.

Three factors are responsible for this shift. Clearly, the financial crisis is the most recent and palpable. Earlier this year, consumer confidence in Japan fell to its lowest level since it was first tracked, in 1982. Japanese luxury buyers—younger consumers, in particular—say that they have significantly reduced their spending on luxury products over the past year. Luxury buyers with the lowest confidence levels cut spending on them by an average of 11 percent, and even the most optimistic spent slightly less on them after the recession began, in November 2008, than before it. Category by category, our survey results were generally consistent with market trends: watches and jewelry were hardest hit, followed by fashion apparel and leather goods. Skin care and cosmetics fell only modestly.

Confidence is slowly improving, and about 65 percent of the consumers surveyed expect to resume their luxury-spending patterns once the economic crisis has passed. Yet one-third of consumers in our survey declared they would "never spend the same way on luxury items."

The second factor in the decline of luxury sales—the 2004–07 luxury-brand bubble—was fueled by newly rich bankers, traders, real-estate agents, and entrepreneurs, who poured their money into these goods, sparking a massive store expansion by companies that sold them. For a country with less than half the population of the United States, the number of luxury-goods stores in Japan is staggering: the British group Burberry has 75 stores in Japan and only 32 in the United States; France's Hermès, 64 and 30; Italy's Prada, 35 and 15; and the Italian jeweler Bulgari, 31 and 17, respectively.[7] As the Japan CEO of a luxury-apparel manufacturer told us, "Over the past five or six years, we kept getting the push from headquarters to open more and more stores, irrespective of performance. Now our mandate is to close a significant percentage of those stores."

Finally, and most important from a long-term perspective, Japan's channel trends, consumer attitudes, and behavior shifted during the past six to eight years. The financial crisis has accelerated this transformation, exposing four important changes that are contributing to the luxury-market downturn and will probably persist.

Greater individuality

Until recently, women in Japan gained much of their status and confidence from external badges, in the form of branded apparel, handbags, jewelry, and other accoutrements.

[7] These totals, derived from corporate Web sites, span the entire brand (for instance, Burberry includes its Japan-only Blue Label stores), with outlets and duty-free locations.

Conformity trumped individual expression. Today, Japanese women are much more confident about creating their own personal style. Luxury consumers, once predictable in their preferred brands, patterns, and browsing and shopping channels, are now beginning to mix the expensive with the cheap and to shop in a broader range of channels. In a December 2008 Nikkei survey, 86 percent of Japanese women agreed with the statement, "I mix and match my clothes according to my own tastes."

A broader definition of luxury

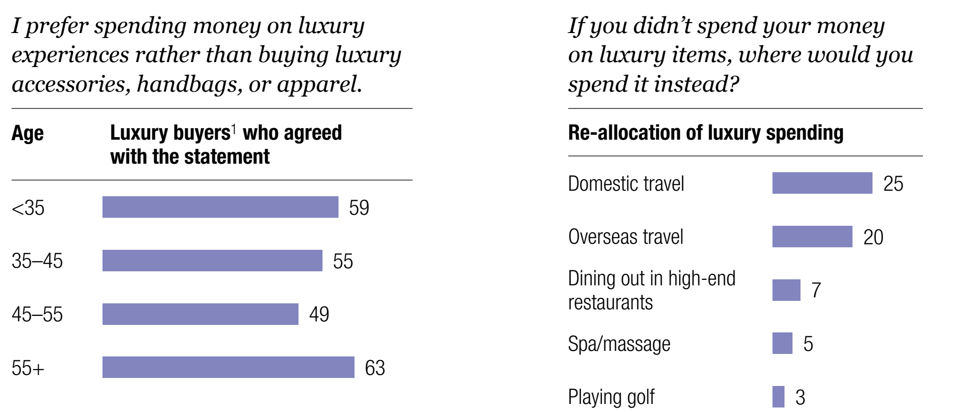
Japanese luxury consumers today weigh the purchase of luxury goods against luxury experiences, such as a vacation, a meal at an expensive restaurant, or a day at a spa. Across demographic groups, almost half of the survey respondents said that they would rather spend money on such experiences than on luxury handbags, accessories, or apparel (Exhibit 3). The manager of a leading luxury hotel in Tokyo told us that the vast majority of his guests are Japanese, including many Tokyo residents: "A large part of our customer base is 35- to 55-year-old ladies with money, so we are going after the same wallets as the luxury manufacturers are."

Meanwhile, luxury goods are losing their luster. Across demographic groups, one-third of all consumers—and as many as 43 percent of those 55 or older—agreed that "owning luxury goods is not as special as it used to be." Only 32 percent of the respondents said they were "very" or "somewhat" interested in luxury products, compared with 51 percent in the same survey in 2004.

Exhibit 3

Trading off luxury

% of luxury buyers who strongly agreed, agreed, or moderately agreed, n = 1,492



[1]Consumers who bought at least one luxury item in past 12 months.

Source: 2009 McKinsey survey of luxury consumers

More and cheaper options

The proliferation of luxury and imported fashion brands in Japan has greatly intensified competition for the luxury consumer's pocketbook. A walk through Tokyo's trend-setting streets, such as Ginza or Omotesandō, proves the point: steps from the stores of Sweden's H&M and Spain's Zara (both offering trendy but relatively inexpensive fashions), Italy's Diesel (enjoying significant growth in sales of $200 to $300 handbags), and Japan's Uniqlo, you find more traditional luxury stores with merchandise at prices 10 to 20 times higher. Even sportswear makers now offer fashion-inspired higher-end apparel lines.

In short, while the number of Japanese consumers and their total spending on apparel and accessories have remained relatively flat for the past decade, that spending is now spread across many more brands and products. The mix includes some surprises. As the Japan CEO of a well-known luxury-apparel and -accessory company told us, "We even think of Apple, with its iPod and all of its accessories, as taking from the luxury wallet."

Shrinking department store sales

As recently as a decade ago, Japan's department stores not only monopolized the luxury-goods and fashion apparel market but also were the primary source for the latest fashion trends. In the past five to seven years, company-owned stores, factory outlets, and other formats have enjoyed strong growth. They now account for more than half of total sales for a number of major luxury brands.

Sales in department stores fell by about 3 percent annually from 2000 to 2006. From 2007 to 2009, their share of fashion apparel and accessory sales plunged by more than 15 percent, and the first three months of 2009 paint a similarly dismal picture. It isn't clear if sales in department stores are a leading or lagging indicator for the luxury-goods sector. What is clear is that Japanese consumers aren't flocking to department stores as they once did. This development presents a secondary threat to luxury manufacturers: department stores are looking further afield to stimulate sales. Uniqlo, for instance, recently agreed to open in department stores, expanding into the domain luxury-goods companies once dominated.

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In this uncertain environment, what are luxury brands to do? We believe that the business model many of them rely on almost exclusively today—strong brand equity and continued patronage from a mix of wealthy consumers and mass-luxury buyers aspiring to wealth—isn't sustainable. Luxury-goods companies must recognize that they cater to specific consumers and should emphasize the notion of scarcity and exclusivity, perhaps by promoting their heritage and history, as well as the provenance and workmanship of their products.

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Sales tactics can also foster consumer loyalty—crucial in an industry where the best customers account for 20 to 45 percent of sales. Supply can be reduced, for example, to generate a sense that consumers must act immediately or risk missing out on what's available. Private sales, limited-time offers, and invitation-only events can nurture an air of exclusivity. At the same time, however, companies must attend to the basics by focusing on the cost of goods sold. That might mean using the downturn as an opportunity to renegotiate contracts with suppliers and partners and to streamline labor costs, a significantly higher percentage of sales for luxury than for nonluxury companies.

One thing is fairly certain: recent structural changes in Japan's luxury market don't represent the end state. Companies must anticipate and respond to changes in consumer attitudes and behavior, as well as the evolution of channels and competitors. The flexibility to adjust brand positioning, product offerings, and distribution strategies will be essential.

Despite the current turmoil, Japan will certainly remain a large and important luxury-goods market. But it will also become a more contested one, with winners distinguished from losers by the ability to build loyalty among existing customers, to connect with and capture the next generation, and to operate efficiently and profitably.

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