How Can Department Stores Resist Homogenization?

Inflation pushes the industry to a turning point

Japanese society is undergoing a major structural shift from deflation to inflation. Wages are steadily rising, driven by aggressive wage increases at major companies. On the other hand, due to the complex interplay of various factors such as exchange rates, geopolitical risks, and climate change, the prices of raw materials and supplies have risen, which have led to price increases exceeding wage growth. As a result, real wages have not stabilized at a positive level. In particular, we believe that the recent rise in food prices is having a negative impact on consumer sentiment, especially among the middle class.

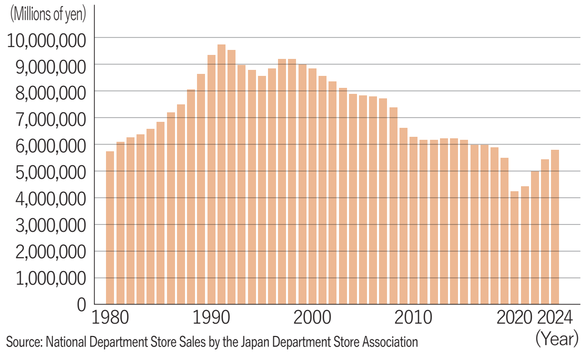
Amid this situation, department stores, as a business model resistant to inflation, showed sustained strength in domestic consumption, centered on favorable trends in luxury goods, jewelry, watches, and other high-priced items, due to the continuing wealth effect and the rise and growth of a new wealthy class. Additionally, with the number of inbound foreign tourists exceeding 36.87 million in 2024, duty-free sales at department stores nationwide also surged, particularly in general merchandise such as luxury goods and watches, reaching 648.7 billion yen, nearly double the pre-COVID-19 level. However, this rapid growth in duty-free sales is largely due to the price difference between domestic and overseas markets caused by the extremely weak yen, and sales are currently slowing down sharply in the first half of 2025 as brands raise prices and the exchange rate enters a period of adjustment.

When viewed over long-term trends, national department store sales have been on a downward trend since peaking at 9.7 trillion yen in 1991. And it is said that the COVID-19 pandemic triggered a decade's worth of changes all at once, with sales disappearing by 1.2 trillion yen a year in 2020. The shrinkage of the department store market is due in part to external macro factors such as a declining population and the collapse of the middle class due to increasing polarization, as well as intensifying competition across industries, including the rapid expansion of e-commerce, but the essential issue is the obsolescence of business models that cannot respond to changes in customers and rapid changes in the environment.

Amid this situation, After the COVID-19 pandemic, the quality of consumption has changed dramatically. One is a shift in the target of consumption to higher-value-added goods and services, and the other is the expansion of the customer base of department stores to younger and wealthier customers. We believe that domestic consumption among the wealthy will remain sustainable due to factors such as the state of financial assets and changes in the quality of consumption. As for trends among the middle class, we believe there is room for department stores to capture them, due to more discerning consumption. This change can be viewed as positive for department stores.

On the other hand, it cannot be denied that sales to inbound tourists is extremely volatile due to factors such as institutional reforms, exchange rate trends, and geopolitical risks, and it must be said that excessive dependence on them carries risks. However, the view that it is a growth market in the medium to long term remains unchanged. The essence of the matter is whether or not we can respond flexibly to changes in order to enhance the value we provide to our customers.

National department store sales



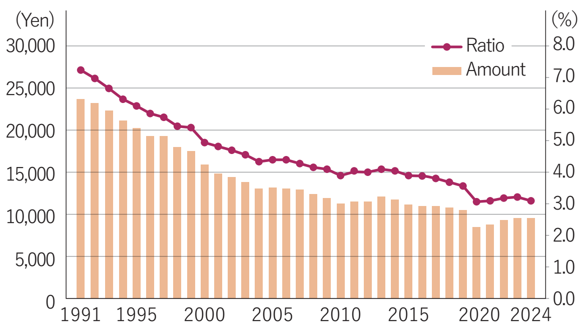
Source: National Department Store Sales by the Japan Department Store Association

History is made by adapting to change

The department store business model was born more than 100 years ago. Large stores were opened and they expanded their product categories as they developed and prospered, from men's and women's clothing to kimono, children's clothing and toys, furniture, home appliances, and food. In terms of business structure, department stores mainly purchased products on a no return basis and took inventory risk, which is called *kaitori* in Japanese. But in the 1980s, a new form of transaction without inventory called *shoka shiire* expanded to around 80%. In *shoka shiire*, purchase is recorded when the product is sold to a customer and the product is not recorded as department store inventory. And the focus of the business shifted from merchandising to marketing or brand assortment. At the same time, department stores overly depended on clothing, particularly women's clothing, against the backdrop of the DC brand boom, instead of carrying a full line of products, which is the origin of the Japanese word *hyakkaten* (literally, a store selling hundreds of products) for a department store. It was then that department store sales peaked.

On the other hand, according to the Family Income and Expenditure Survey by the Ministry of Internal Affairs and Communication, the percentage of expenditure on clothing and footwear, which was 7.3% in 1991, dropped to the 3% range in 2016 and continues to be less than half of its peak in recent years. Department stores could hardly get out of past successes that they grew with apparel and continued to allot too much space to women's clothing, which widened the gap with customers' tastes and buying behavior. Amid the diverse changes in consumption quality, the challenge of homogenization remains persistent, with companies still seeking fundamental transformations including business model overhauls.

Ratio and amount of clothing and footwear expenditures per household



Source: The Family Income and Expenditure Survey by the Ministry of Internal Affairs and Communication

Business models becoming increasingly diverse

We have developed multiple options for the department store business model.

One is a choice "not to operate as a department store." That is to say, we converted some stores to a 100% real estate rental business without adopting department store's traditional transaction formats of *kaitori* and *shoka shiire*. Its typical example is GINZA SIX, a luxury mall which was created in 2017 by developing the two blocks including the former site of the Matsuzakaya Ginza store as one.

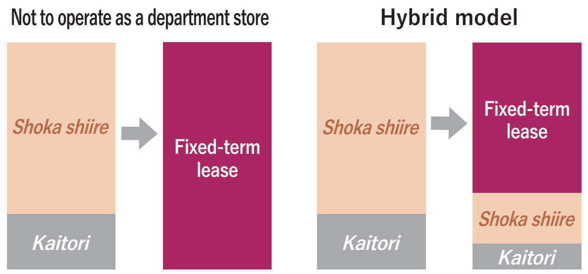
The other is to build a "hybrid model" that combines real estate rental with *kaitori* and *shoka shiire* under the "department store brand." Its typical example of a large-scale core store is the main building of the Daimaru Shinsaibashi store, which opened in 2019. Also for small and medium-sized stores, we develop optimal business models by analyzing local customers and the surrounding environment, such as the Daimaru Suma store, which was renovated in 2020 to include a library.

Our strength lies in our ability to offer options that are best suited to each area as a department store business model.

The advantage of fixed-term lease is that it not only generates stable revenues and reduces operating costs, but also freshens up the store's appearance by increasing the variety of tenants to better cater to service consumption and experience-based consumption. This model can also be said to be deflation-proof, as it ensures stable earnings. It is common for rent structures to differ for each contract, including the proportion of fixed and variable rent.

On the other hand, the advantage of *shoka shiire* is that we can seek greater return through sales growth. As the economy is about to shift from a deflationary phase to an inflationary phase, we believe that we have the potential to further demonstrate our strengths in terms of profitability, and that it is necessary to take a strategic approach, including from the perspective of ROIC.

The department store market varies greatly depending on the area. We will pursue the optimal business model for each store while keeping it variable.



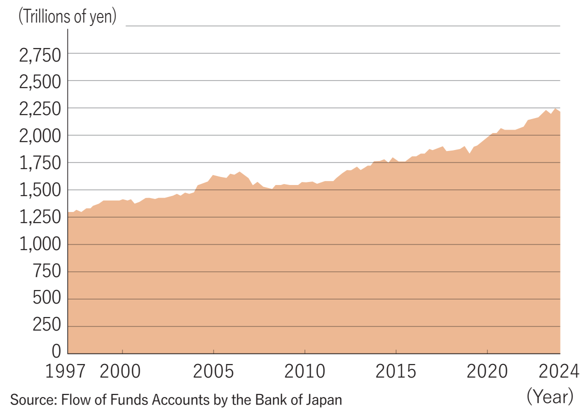
Strength in high-value-added products and services

Even during the COVID-19 pandemic, luxury goods sales continued to grow steadily, and have since grown rapidly. Daimaru Matsuzakaya Department Stores' sales of luxury goods in fiscal 2024 showed a high growth of 97.0%, almost doubling the fiscal 2019 level. Over the past few years, we have strategically focused investments on expanding the luxury offerings at our core stores, capturing changes in both domestic and inbound tourist consumption, and achieving significant results.

On the other hand, sales of mass-produced and widely distributed women's clothing have not returned to pre-COVID levels. To address this issue, the Matsuzakaya Nagoya store underwent a major renovation across eight floors, including reducing existing apparel space by 60%, to tap into new markets including younger demographics.

In addition, sales of our gaisho, which has organized wealthy customers, have already exceeded 200.0 billion yen, a double-digit increase from before COVID-19. It is also worth noting that Japanese household financial assets have increased by more than 200 trillion yen compared to 2019, before the COVID-19 pandemic. The core of the gaisho business is "people" to "people," but the COVID-19 pandemic has triggered the digitalization of the gaisho business as well. Specifically, in addition to the rapid spread of app, the use of the closed website "connaissligne" has led to major changes in the way business is conducted, and the shift to online sign-up procedures has also helped to attract younger affluent consumers.

Household financial assets



Source: Flow of Funds Accounts by the Bank of Japan

The essence of physical stores lies in the value of experience

The COVID-19 pandemic has accelerated society's digital transformation at an unprecedented pace, with online shopping making rapid progress. We have come to realize that digital technology transcends the constraints of time and place in a variety of situations, both on and off the job. On the other hand, as its antithesis, it has also provided an opportunity to reaffirm how irreplaceable and precious the value of real experiences gained through the five senses is.

The importance of store space can be reaffirmed by the overwhelming atmosphere created by the newly renovated Matsuzakaya Nagoya store. This is a luxurious, comfortable, and exclusive customer experience that can only be achieved in a physical store. In addition, the lounge spaces provided in each store are also popular as high-value-added services.

Our main task is to amplify the value we provide through real communication between people, and that is where our strength lies. We will expand human power using digital technology. Its starting point is in physical stores. From now on, it will be important for department stores to make use of their networks, including with creators, artists, and suppliers, to differentiate themselves through the co-creation of unique content.

By creating a sense of the world based on content and curation capabilities, we will further refine our physical stores and integrate digital technology into them. We believe that these are the basis of the department store business model in the present age.