McKinsey&Company

Apparel, Fashion & Luxury Group

The age of digital Darwinism

Enhance the customer experience and transform your business to survive and prosper in the luxury digital era

Introduction

The trajectory of digital in luxury has come into sharper focus. Digital is a critical source of growth and a powerful way to increase brand equity by creating brand advocacy and a compelling story. Digital also enables companies to reimagine key enterprise processes, both front-end and back-of-house. A "Luxury 4.0" operating model is emerging, in which brands and retailers use data to build customer intimacy, capture emerging customer preferences, and streamline the process of turning ideas into new products. Brands can enhance the customer relationship and restore the authentic personal experiences that defined luxury when it was confined to a small elite. Finally, the trajectory of digital will likely bring further disruption, for which players in the luxury market should prepare.

In this paper, we look at the impact of digital in luxury from three perspectives:

1. Customer experience
2. Changes to the enterprise
3. Future disruption.

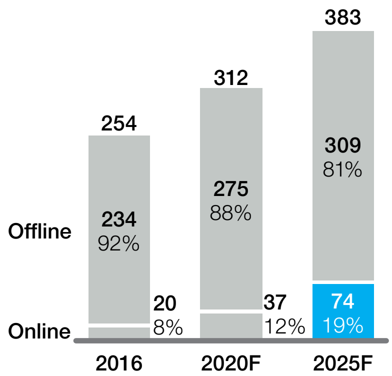
We believe that investors, brands, and retailers can benefit from these perspectives as they build the systems, competencies, and organizational muscles needed to take full advantage of the digital opportunity.

Experience: the dynamics of the digital luxury journey

Online sales of personal luxury goods — apparel, footwear, accessories, jewellery and watches, leather goods, and beauty and perfume — account for 8 percent of the €254 billion global luxury market, or about €20 billion. That is up five-fold from 2009 and we expect online luxury sales to more than triple by 2025, to about €74 billion (Exhibit 1). This means that nearly one-fifth of personal luxury sales will take place online.

Exhibit 1

By 2025, 1/5 of luxury sales will be online
Sales of personal luxury goods[1], € billions

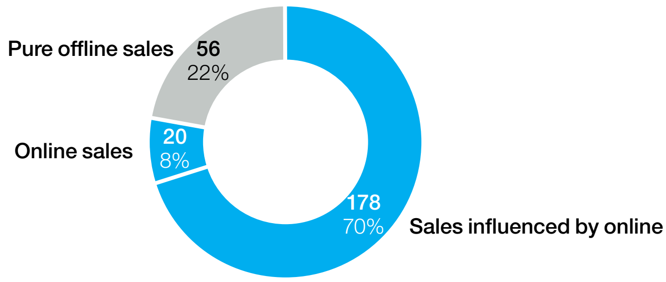


SOURCE: Euromonitor; Forrester

Digital is having an even greater impact on how luxury shoppers choose brands and goods. Nearly 80 percent of luxury sales today are "digitally influenced", meaning that, in their luxury shopping journeys, consumers hit one or more digital touch points. The typical luxury shopper now follows a mixed online/offline journey, seeking the advice of peers on social media or looking for suggestions from trusted bloggers before entering a store, then often posting about their purchases afterwards. The luxury shopper who begins and ends the customer journey offline is a vanishing breed — representing just 22 percent of all luxury shoppers (Exhibit 2).

Exhibit 2

80% of sales are influenced by online
Sales of personal luxury goods[1], € billions



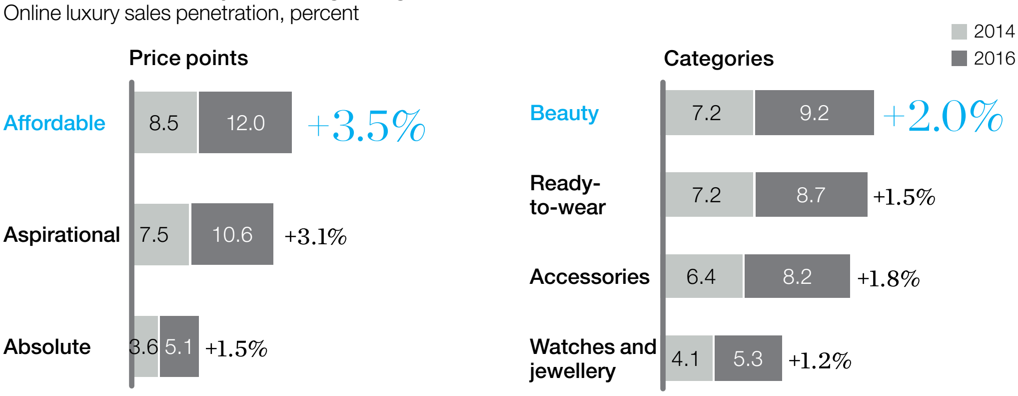
SOURCE: Euromonitor; Forrester; companies' Annual Reports; McKinsey

[1] Apparel, footwear, accessories, jewellery and watches, leather goods, beauty and perfumes

The impact of digital on consumer behavior and luxury purchases varies by product category and price point. The biggest luxury categories for online sales are beauty products, apparel (ready-to-wear), and accessories (handbags, small leather goods, etc.). Watches and jewellery trail these categories in terms of purely online sales because of their higher price points. Consumers shopping for affordable luxury are more inclined to buy online than "absolute" luxury shoppers. Overall, consumers in the affordable luxury segment are younger, with the millennial segment being over-indexed, and hence more willing to experiment. In between are "aspirational" luxury consumers (Exhibit 3).

Exhibit 3

The affordable segment and beauty products are driving online luxury sales, where affordable luxury sales are growing fastest online
Online luxury sales penetration, percent

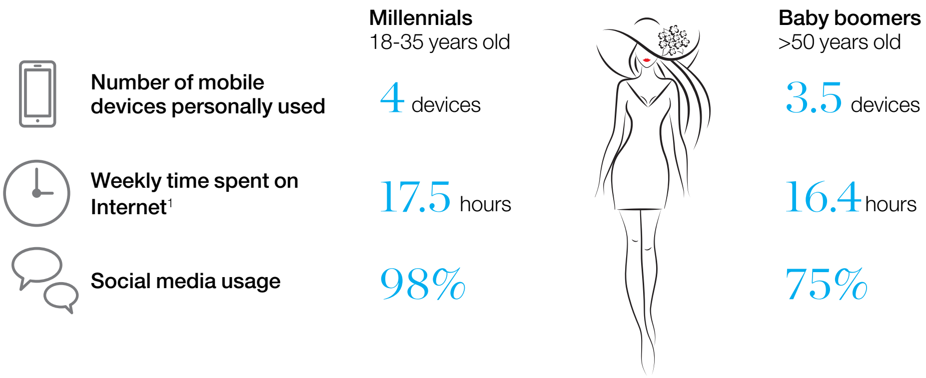


SOURCE: Euromonitor; Forrester; McKinsey

Luxury shoppers have enthusiastically embraced the digital lifestyle. Nearly all (98 percent) have smartphones, compared with 65 percent of the general population. Furthermore, enthusiasm for the online lifestyle spans age groups among luxury consumers — it is not just a phenomenon linked to millennials (Exhibit 4). For example, baby boomers (aged 50 and over) use an average of 3.5 mobile devices compared with 4 for millennials. Boomers spend 16.4 hours per week on the Internet, not much less than the 17.5 logged by millennials. About 75 percent of boomers use social media, compared with 98 percent of millennials. When

Exhibit 4

All luxury shoppers are going digital — not just millennials



[1] Excluding professional usage

98%

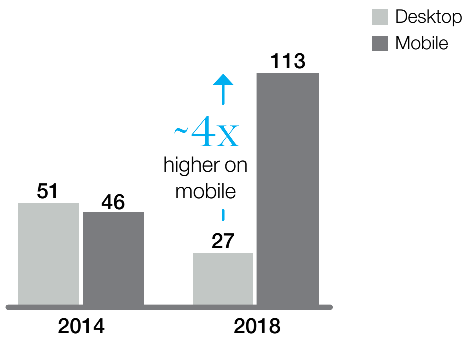
of luxury consumers are smartphone equipped vs. an average of 65%[1]

it comes to digital, millennials lead the way and are teaching the older generations new behaviours as well as setting expectations for the quality of digital interaction with brands.

Mobile is becoming the new desktop. Consumers now spend nearly four times as many hours on mobile devices as they do on desktop computers. Mobile has become the main source of information and, increasingly, the way luxury goods are purchased (Exhibit 5). Luxury buyers are moving decisively to mobile for Internet access.

Exhibit 5

By 2018, time spent by consumers on mobile will be 4x higher than on desktops
Global Internet consumption, minutes



SOURCE: Zenith, "Digital inside: get wired for the ultimate luxury experience" (8 countries surveyed: US, China, Italy, Japan, Brazil, UK, France, South Korea)

77%

of luxury consumers own multiple devices vs. an average of 35%[1]

This poses additional challenges for brands: how do you convey your dream and translate the magic of your story-telling to a 10 cm by 6 cm screen? How do you show the breadth of your collection and the richness of its details to a consumer who is in an elevator or on a noisy city street? How do you complement the information the shop assistant will provide to a consumer who remains connected to an additional source of information on the brand and product even in the store?

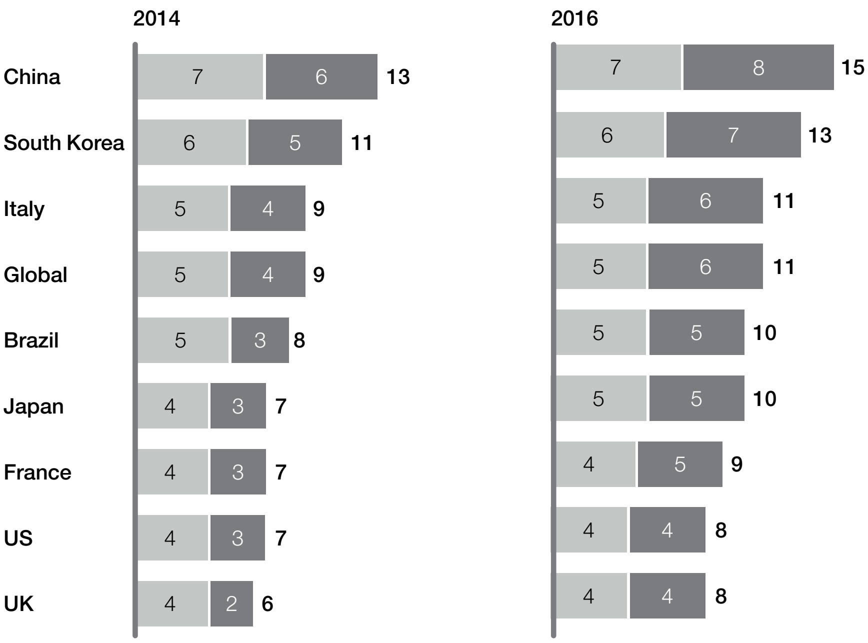
The traditional, linear customer journey has been blown to bits: today the average luxury shopper engages with brands via multiple touch points – up to 15 in the case of Chinese luxury consumers – along a fragmented, highly personalized journey (Exhibit 6). Half or more of these touch points are digital. Today, the customer expects a seamless and coherent relationship with brands across these different touch points, even as they travel from one country to another. Creating this consistent, seamless experience is quite a challenge for brands that are still organized around channels and geographies.

Digital luxury is increasingly a customer-to-customer (C2C) economy. The consumer is central to the shopping journey, from advocacy to sales. Luxury consumers are highly engaged on social media and are moving from being paying observers of the show to being actors on stage. They are becoming, in effect, another marketing channel. As Exhibit 7 shows, the volume of chatter about brands online is dominated by consumer mentions, not by company posts.

[1] Average based on US figures

Exhibit 6

Digital touch points are multiplying
Number of touch points in the consumer decision journey



SOURCE: Euromonitor; Forrester; McKinsey

So how can brands turn consumers into brand ambassadors? How do you keep the chatter positive, when you are only a click away from a “like” becoming a “hate”? How can you fashion a positive and coherent brand message when the consumer, not your marketing managers, is creating it? Brands will need to learn to deal with ambiguity and accept that some aspects of their messaging will be cocreated with their customers rather than controlled unilaterally by their management team.

Exhibit 7

Consumers are becoming the new marketing channel

The volume of chatter about brands online is dominated by consumer mentions, not by company posts

Chanel	Valentino	Louis Vuitton	Balmain
700 official posts	4,890 official posts	1,970 official posts	3,660 official posts
48 800 000#[1]	24 140 000#[1]	25 380 000#[1]	5 690 000#[1]

SOURCE: Instagram, May 2017

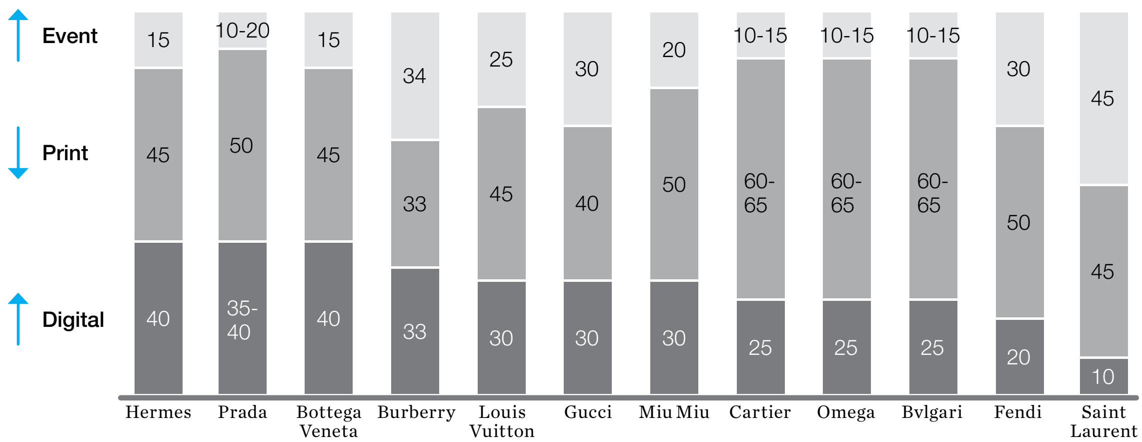
[1] Hashtags, i.e., number of user-generated mentions with the brand’s name

Digital is also becoming increasingly C2C when it comes to actual online sales. Daigou – the practice of shoppers outside China purchasing luxury goods for consumers back home – is an initial sign confirming the willingness of consumers to take part in the game. Brands might discover that the jump from being a blogger to becoming a commercial channel is shorter than they could have anticipated.

Are brands adapting fast enough to the new digital reality and this more articulated map of influence? The answer is mixed. We see that a good number of luxury brands are reacting swiftly to the new reality and are increasing investments in digital, as well as in events, while shrinking the investment in print (Exhibit 8). Rising spendings on events and digital go hand-in-hand because there are important synergies. Fashion shows and other events become a powerful source of content for digital communication, reaching a much broader audience than the lucky few who make it to the runway or other event venue. But the majority of brands have not shifted their investments this way. Most are incrementally adjusting their marketing budgets, which is not helping them keep up with the pace of change.

Exhibit 8

Brands are reallocating budgets to digital and events, but not rapidly enough
2016 marketing investment by channel, percent

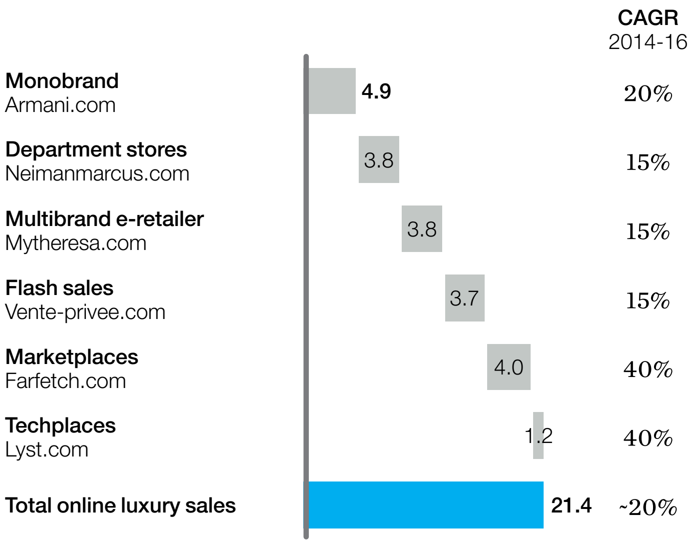


SOURCE: Company reports; Bernstein research

So, who is winning the e-rush (Exhibit 9)? When it comes to online luxury, the battle has just begun: more scalable, agile, and technology-savvy e-retailers are emerging. Darwinism will claim its victims. Successful e-retailers need to run faster than the wind and only the ones growing at 50 percent plus year-on-year (while maintaining an agile, inventory-light model) will generate superior shareholder value.

Exhibit 9

Who is winning the e-rush?
2016 online luxury sales by channel, € billions

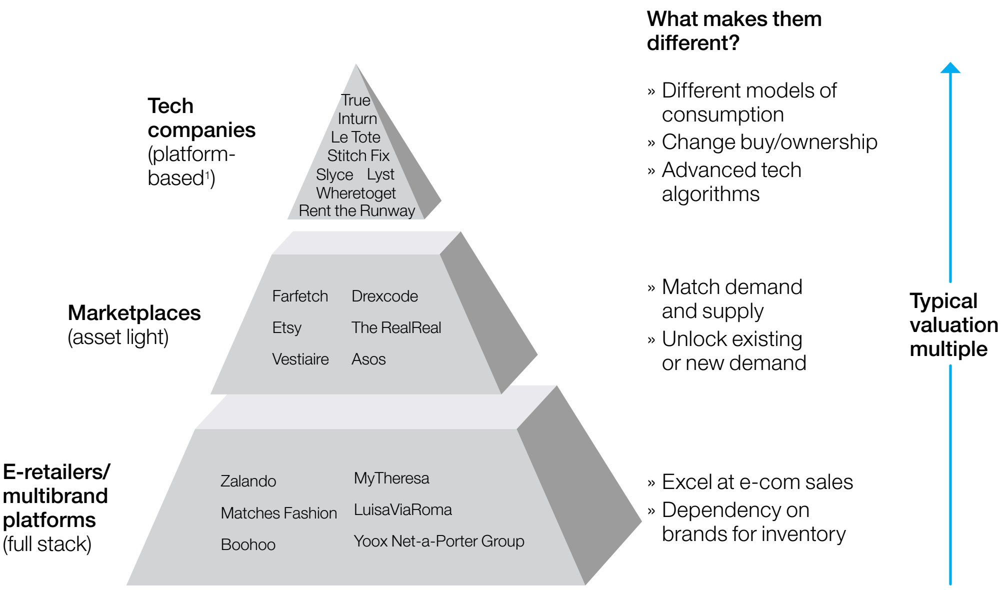


SOURCE: Previous Digital Luxury Experience reports; Fondazione Altagamma; LuxuryScope: A unique city guide to luxury growth, McKinsey, 2016; online luxury market model

If we look at the breakdown of online luxury sales, we see that monobrand sites — those set up to sell the wares of a single brand — still represent the lion's share of online sales. However, they are growing less rapidly than multibrand marketplaces (Exhibit 10). Indeed, the digital luxury consumer is increasingly seeking a multibrand experience. Among multibrand marketplaces, the new winners seem to be those that have built scalable business models, which allow them to offer a curated assortment without the risk of carrying the full inventory needed to fuel their growth.

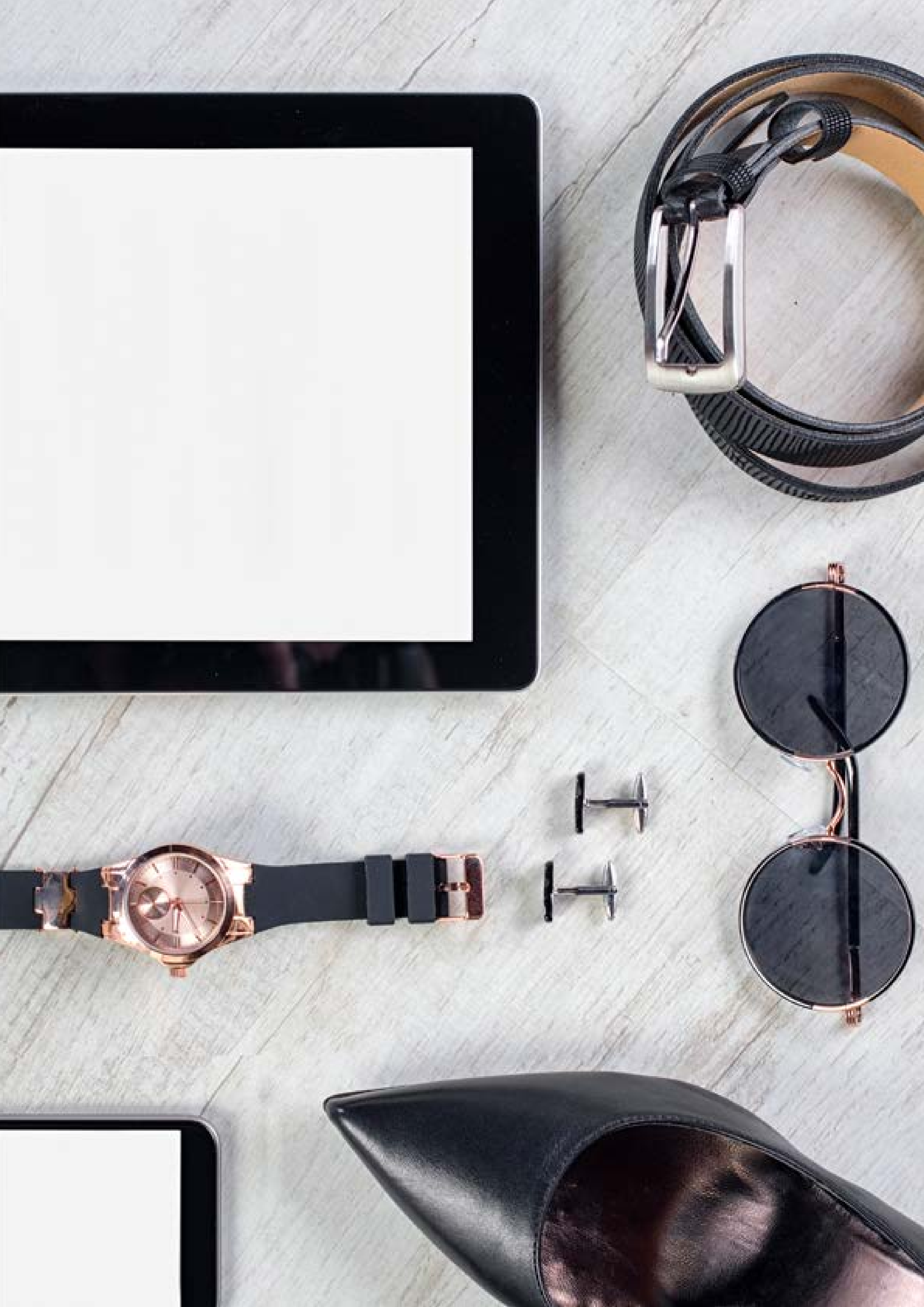
Exhibit 10

E-luxury business models are evolving



SOURCE: Press search; McKinsey & Company Strategy & Corporate Finance Practice; McKinsey analysis

1 Selected business models use a tech-based approach disrupting traditional retail but still holding inventory, limiting scalability and attractiveness



Enterprise: transforming luxury brands into digital enterprises

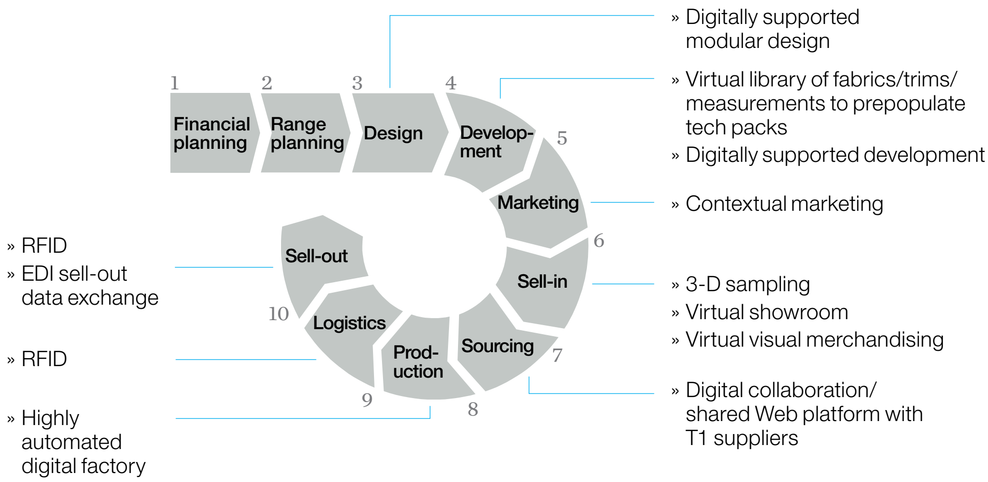
Digital is penetrating the value chain and creating opportunities to be more effective and responsive. While brands and retailers recognize that it is essential to experiment on this front, there is a wide variation in what companies are doing. The most forward-looking brands are focusing on three things: they are digitizing their businesses — building a "Luxury 4.0" operating model that increases their speed and agility. They are using data to take customer knowledge and relationships to a new level. And fast-moving leaders are forming partnerships across the luxury ecosystem to accomplish what they cannot do on their own.

Luxury 4.0 is catching on

Luxury 4.0 is inspired by Industry 4.0 — the fully digitized model for manufacturing. In industries ranging from autos to consumer electronics, Industry 4.0 is creating a new seamless system that ties together self-aware machines in factories, smart logistics, customer data, and design. This enables rapid response to shifts in demand and customer needs, reduces costs, and allows companies to quickly turn customer data into new products and business models that drive growth. Industry 4.0 is already a reality in the sportswear industry, penetrating key steps of the apparel value chain (Exhibit 11).

Exhibit 11

Industry 4.0 approaches are penetrating the apparel value chain



Can we can envisage the impact of 4.0 approaches in luxury, a sector in which art and other intangibles are dominant factors in the value equation?

Just-in-time design and manufacturing has huge implications for luxury fashion brands. We expect digital and Industry 4.0 will impact luxury operating models in ways that will allow more agile and responsive operations without diluting the essential DNA of luxury products: craftsmanship, unique design, personalization.

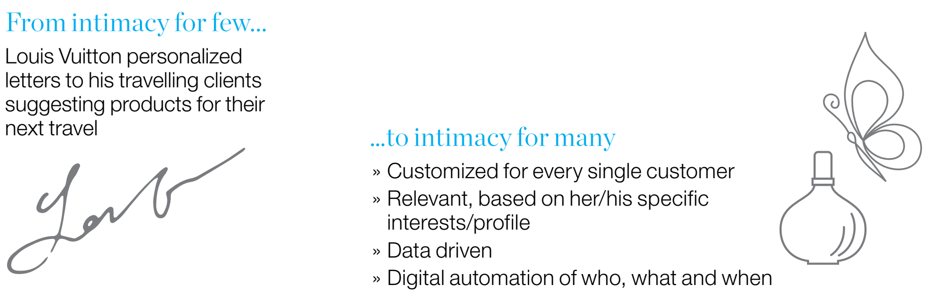
How far will Luxury 4.0 go? Recently, we asked 100 luxury managers if — and when — they expect their companies to offer customers 3-D printed products in stores. Thirty percent of them believe it will happen in the next three to five years. Another 30 percent say it will happen within five to ten years[1].

1 McKinsey 2017 survey to luxury managers

Customer intimacy

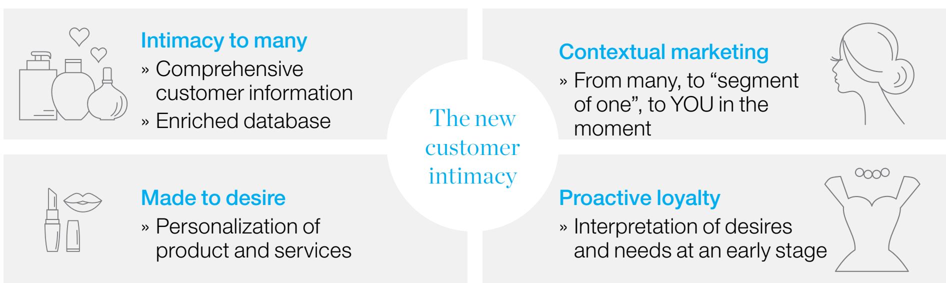
Big data and machine learning are bringing authenticity and relevance back into the customer relationship. It may seem paradoxical to use machines to get “real and personal”, but luxury brands can win big by using technology to be as authentic with their consumers as luxury brands were historically. In the early days of the luxury époque, Louis Vuitton hand wrote specific suggestions to a customer to recommend particular travel bags for a transatlantic journey to New York City. Today, big data and advanced analytics help brands find opportunities to provide services that are uniquely tailored to each customer and occasion, making the brands appear as authentic as Vuitton’s notes. This will make consumer relevance ubiquitous in luxury (Exhibit 12).

Exhibit 12 **Digital extends the frontier of customer intimacy**



The era of contextual marketing has started and it will play an important role in personalization. Contextual marketing recognizes that your customer is essentially a different person on different occasions. When she is booking a hotel for a business trip to Paris, the marketing vice-president has a different customer profile she has when she is looking for a room in Paris for a romantic weekend. Indeed, using data analytics and contextual marketing, brands are creating intimacy and better anticipating customer desires — powerful ways to retain core customers and drive growth with new ones (Exhibit 13).

Exhibit 13 **The new customer intimacy**



Luxury ecosystem

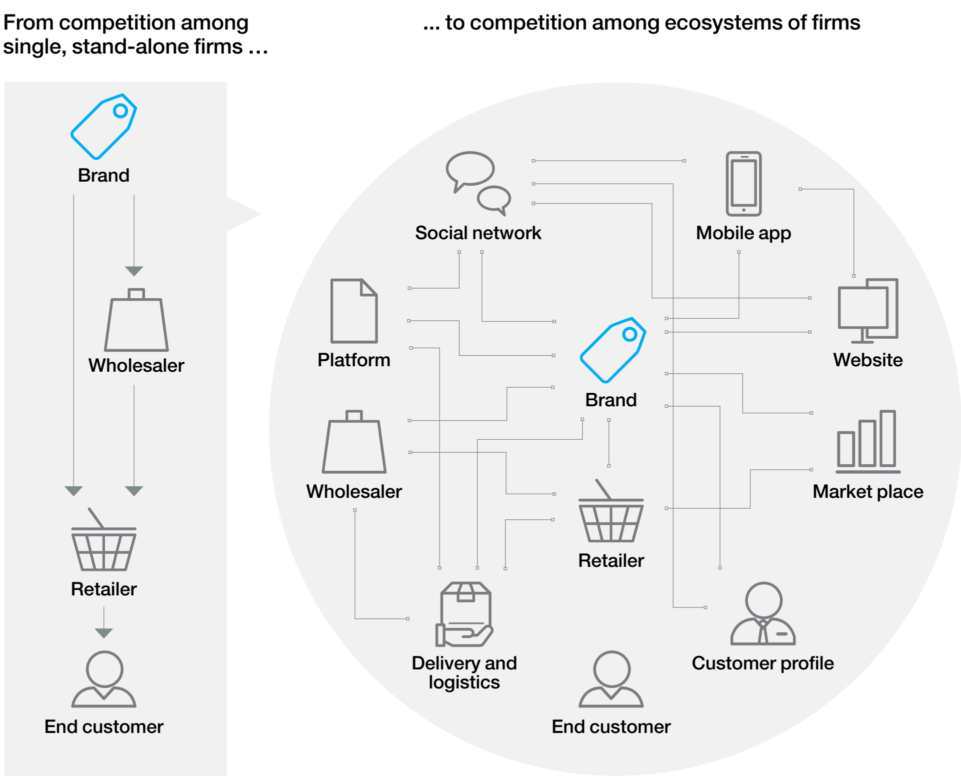
Players in the luxury market have a lot to accomplish on the journey to digital and not much time to do it. To get where they need to go, luxury brands and retailers can use strategic partnerships to complement in-house competencies, including by enlisting help to create novel and exciting customer experiences (Exhibit 14). Burberry, for example, collaborated with Google to create The Burberry Booth, where consumers are filmed dancing to the T-Rex song Cosmic Dancer, as in the company's TV ad. Once the clip has been created, a copy is sent to the consumer for sharing on YouTube, Twitter, or email. In another promotion, with DreamWorks Animation, Burberry created an interactive marketing campaign using new 3-D technology on Piccadilly Circus corner screens[1]. Pedestrians can use interactive system to design their own Burberry scarves and up to five people at a time can interact and manipulate the movement of the on-screen scarf on the big screen.

When it comes to developing the new competencies required for digital, we believe that companies should become very adept at answering the question of make vs. buy vs. partnership.

Exhibit 14

The age of ecosystems: building partnerships is the next competitive advantage

Working across the ecosystem will be essential to keep up with the evolution of digital luxury



1 Company website; store visits

E-future: disruption ahead

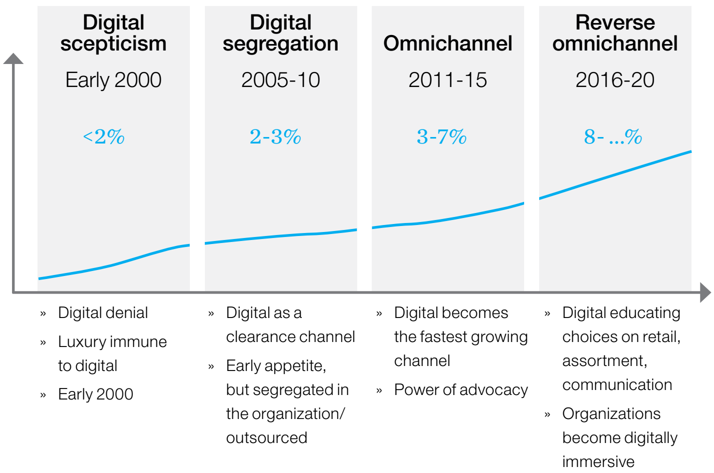
What else can we expect? We expect offline to decline further and not come back. Store space will become predominantly experiential and lifestyle-oriented. Department stores will struggle to survive outside their iconic location unless they manage to completely reinvent themselves. For consumers renting becomes the new owning. Amazon will crack fashion and luxury. Indie or “insta-brands” will take increasing space in the market. Sustainability will matter more and more, with digital creating further transparency into brands’ product processes for consumers.

Store wars: the era of reverse omnichannel

Digital will continue changing consumer behavior, fostering an appetite for experience rather than simply shopping and buying. Consumers are no longer simply buying a product. They are purchasing the experiences and emotions that the brand can offer them. Digital has trained consumers to expect continuous excitement. The most recent and most exciting experience that a consumer has online not only sets the bar for the next online shopping experience, but also for the kind of experience the consumer expects when shopping in a store. The time of reverse omnichannel has started — when it is the store that must match the quality of the online experience (Exhibit 15). Digital is no longer only a sales or communication channel. Instagram becomes the new store window, and digital now becomes the source of inspiration for re-inventing the role of the store and the customer experience.

Exhibit 15

From omnichannel to reverse-omnichannel
Online sales, percent



Renting is becoming the new owning

Will digital bring disruptive change to luxury, the way iTunes and Spotify redefined the music industry? It is not easy to predict how far digitization will go in luxury. However, we do see early symptoms of a broader change, which in the not-too-distant future might fundamentally alter the way consumers approach luxury. For example, start-ups such as Rent the Runway are offering access to a “fashion library” of clothes and accessories on a subscription basis, similar to how Spotify provides a music service (Exhibits 16). It is too early to say if this will become a sizable reality, but some initial symptoms show a growing relevance of this sociobusiness dynamic: in 2016, Rent the Runway served 6 million customers and generated about €1 billion in revenue.

Exhibit 16 **Is the revolution of music happening also in fashion?**

	Music industry	**Fashion industry**
2000	» Physical products in physical distribution » Collection of artists/long play » Product ownership » Pay-per-selection of a limited number of songs	» Physical products in physical stores » Brand/collection » Product ownership
2005	» Digital products stored on own device » Pick-up of individual songs » Product ownership » Pay-per-song	» Physical products in digital distribution » Presentation by product category » Pay-per-product
2015	» Digital product stored in the cloud » Presuggested play lists » Shareable play lists » Flat fee for unlimited number of songs	RENT THE RUNWAY » Shared physical products in digital distribution » Flat fee

Amazon cracks fashion and luxury

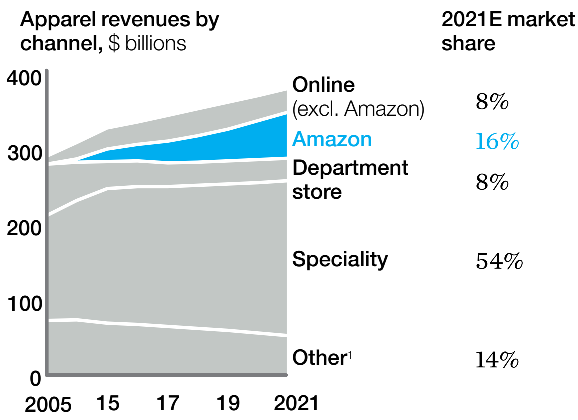
Amazon is on track to grab nearly 16 percent of the US apparel market by 2021 (Exhibit 17).

This is quite an impressive market share, and confirms another fact in the .com rush: it is a "winner takes all game", with clear scale benefits in terms of customer acquisition and retention, supply chain, and advanced analytics.

Amazon is already a clear winner in the contest for first screen, surpassing Google when consumers enter search terms for consumer items, including apparel and footwear (Exhibit 18).

Exhibit 17

In the US, Amazon is on track to own 16% of the apparel market by 2021



Amazon top brands

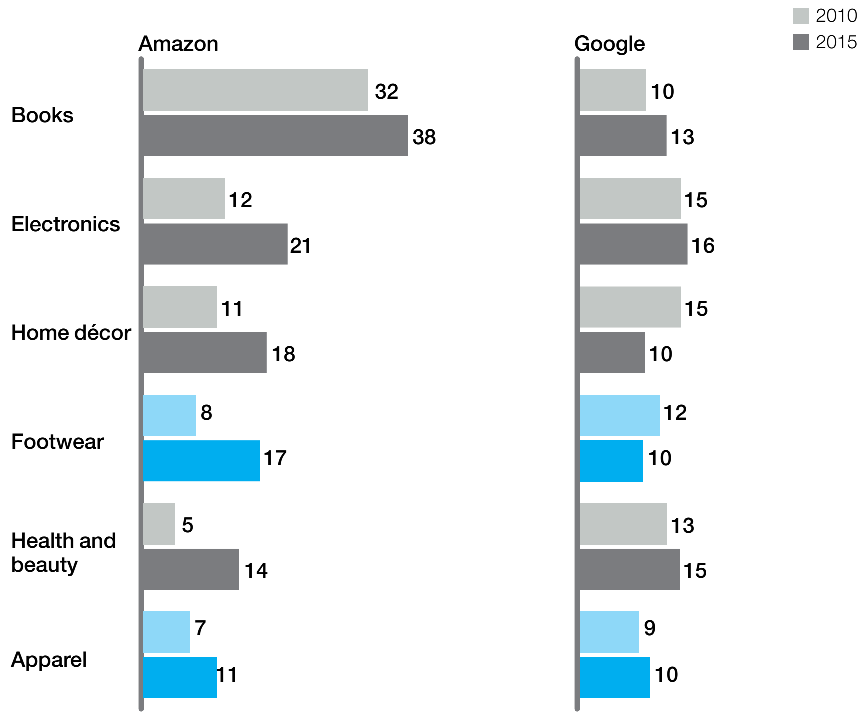
» BCBGeneration
» Erin Fetherston
» Ivanka Trump
» Adrianna Papell
» Donna Morgan
» Cynthia Rowley
» Calvin Klein
» Anne Klein
» Taylor
» Jessica Simpson
» Maggy London
» Kenneth Cole
» Vince Camuto
» Tommy Hilfiger
» Nine West
» Ellen Tracy
» Theory
» Vince
» Rebecca Taylor
» Joie
» Splendid

SOURCE: Euromonitor; Cowen; Forrester; Kantar

1 Includes grocery retailers, hypermarkets, mass merchandisers, warehouse clubs, variety stores, home shopping, direct selling, vending, and leisure and personal goods specialist retailers

Exhibit 18

Amazon is now a clear winner in the first screen over Google, including in apparel and footwear



SOURCE: TMT Digital Insights – 2015 US yearly survey

Today Amazon has wide-ranging strengths across many types of merchandise, but its greatest success has come in convenience-led segments and from offering low price points. As a result, its brand portfolio is limited mainly to value or premium brands (Exhibit 19). This means that the typical Amazon customer is not a fashionista: 70 percent of Amazon apparel sales come from men, with a heavy representation of 25- to 34-year-olds. Men make up only half of overall sales on Amazon; women are overrepresented in nonapparel categories, especially health and beauty.

But what if Amazon starts to focus on luxury brands? Will it be able to replicate the success and disruption it is bringing in the apparel industry? How long will brands be able to resist a call from Amazon, given the potential for additional growth? An Amazon move into luxury could pose significant challenges for protecting luxury brand equity and maintaining luxury economics (Exhibit 19).

Exhibit 19

From a brand and retailer perspective, there are clear challenges to maintaining profits when working with platforms such Amazon

Potential concerns

Economics
- » Potential for lower margins than selling on own branded website
- » Potential cannibalization of owned stores, franchise partners, and own brand.com

Brand
- » Lack full control over full brand presentation
- » Poor fit with brand equity
- » Commoditization of brand (e.g., easy to compare across brands)
- » Unable to capture customer data

Product
- » Lose control on price, platform can undercut suggested retail price
- » Fear platforms will fast follow best sellers with private labels

A disciplined approach is required to mitigate these concerns, as chasing quick wins in immediate sales growth can undermine strategic vision and magnify each of these pitfalls in the future

Call to action

Digital is a multifaceted opportunity for luxury brands and retailers, which will require well-considered actions by CEOs. There is not a single recipe for success, but we identify five elements that every CEO and top team should consider:

1. Think and act broadly. Digital is no longer only a sales or a communication channel. In our view, digital has become a key element of the value equation that brands need to master. It spans a range of disciplines, including retail, supply chain, brand management, and customer engagement.

2. Prepare for continuous transformation. Digital should not be the name of a channel or a specific function of the organization. Digital needs to be a stress test that brands need to apply to every single element of their offer in order to better understand which opportunities they can capture or to which risks they are exposed.

3. Evolve the organization. Digital requires organizational changes. There is no longer marketing and digital marketing — there is just marketing. Digital and IT officers are now one and the same. The digital officer sits on the executive committee and participates in key decisions over the life of a brand.

4. Fully leverage the power of big data and machine learning. Advanced analytics is a reality and CEOs should ensure their teams are using it properly to bring back authenticity and intimacy in the customer relationship.

5. Develop ecosystems. Winning brands source competencies from the outside, from their ecosystems, in order to ensure access to cutting-edge skills.

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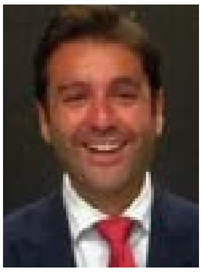

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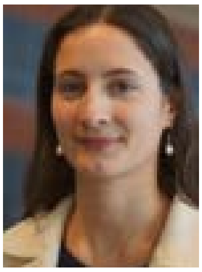

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