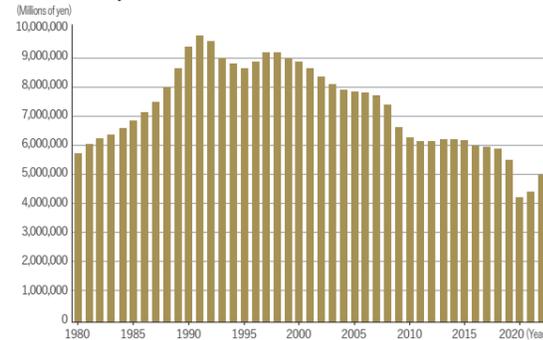


Department Store Business Model

Is the Revival of Department Stores Down to Their Own Capabilities or “Wind Assistance”?

National department store sales trends



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

The industry enters phase beyond pre-pandemic levels

Department stores, which had been the slowest to recover from the COVID-19 pandemic in the retail industry, have entered a full-fledged upward trend in sales, thanks in part to the nationwide travel support that began in October 2022, the significant relaxation of border control measures, and the effects of surplus savings accumulated during the pandemic. In addition, the momentum has gained further strength since the category of COVID-19 was reclassified to Class 5 under the Infectious Diseases Control Act in May 2023.

On the other hand, Japanese society is currently undergoing a major structural change from deflation to inflation, and domestic consumption is showing differences in strength across sectors. Against this backdrop, department stores showed sustained strength in consumption as a business category that is resistant to inflation, with the added support of the wealth effect. Domestic customers showed a steady recovery, driven by consumption by the wealthy, and many stores, especially in urban areas, have already exceeded their pre-pandemic levels. Furthermore, with the rapid depreciation of the yen also providing a boost, consumption by inbound tourists, especially for high-end goods, accelerated month after month, and by the end of the fiscal year, monthly sales exceeded the pre-pandemic levels, backed by an increase in the average spend per customer.

Looking back at history, 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.

Behavioral changes caused by COVID-19 have had a tremendous impact on department stores. Not only was the flow of people reduced due to the voluntary restraint of going out, but all aspects of consumption and business were rapidly moving online. This has exposed the deadlock in business models that are overly dependent on the flow of people or real stores. It is no exaggeration to say that the very existence value of department stores was questioned.

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.

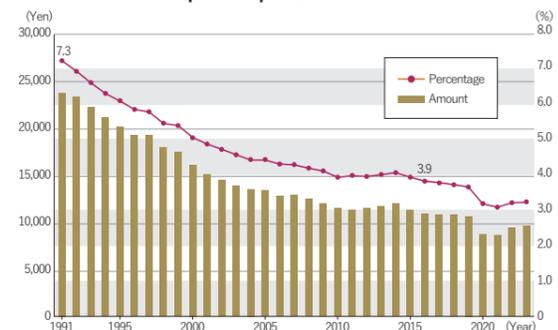
Should the current situation, supported by robust consumption by the wealthy and inbound tourists, be seen as a sign of real strength, or should it be seen as a good opportunity for change with “wind assistance”? Department stores are being tested on their ability to respond to changes.

The history of department stores is a series of responses to changes

The department store business model was born about 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. This was further accelerated due to COVID-19 and the content of department stores and the way of providing it, that is to say, the business model itself became outdated, and they are seeking fundamental change.

Trends in “clothing and footwear” as a percentage of household consumption expenditures



*Source: Monthly Expenditure per Household from the Family Income and Expenditure Survey by the Ministry of Internal Affairs and Communication

Adapting the business model to the times

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

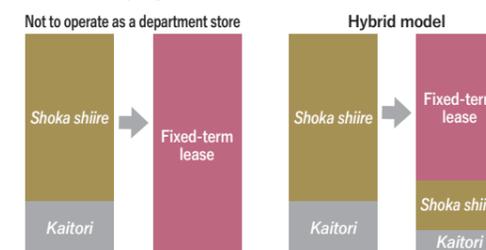
One is a choice “not to operate as a department store.” That is to say, we converted some stores to a 100% real estate rental business without adopting department store's traditional transaction formats of *kaitori* and *shoka shiire*. Its typical example is GINZA SIX, a luxury mall which was created 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 flagship store is the main building of the Daimaru Shinsaibashi store, which opened in 2019. Also for small and medium-sized stores, we pursue the optimal format by analyzing local customers and the surrounding environment.

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.

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.



Capturing market changes

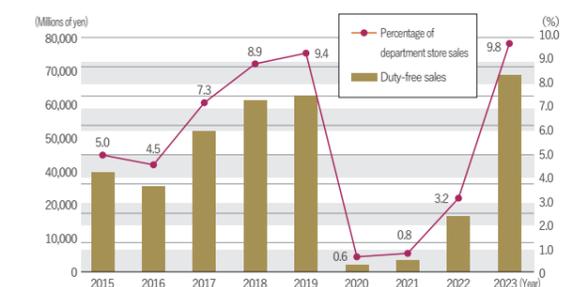
Sales of luxury content has steadily increased even amid the COVID-19 pandemic, and are already well above pre-pandemic levels. In fiscal 2023, sales of luxury items showed a high growth of 97.0%, almost doubling the fiscal 2019 level. While capital investment has been limited due to the COVID-19 pandemic, we have strategically focused our investments on expanding the luxury offerings at our flagship stores, and we have great results by capturing changes in both domestic consumption and inbound consumption.

On the other hand, even in fiscal 2023, sales of mass-produced and widely distributed women's clothing remained at about 70% of pre-pandemic levels. In order to address this issue, the Matsuzakaya Nagoya store, which is currently undergoing a major renovation, will work to develop new markets, including attracting younger customers, by substantially replacing its existing brands.

In addition, sales of our *gaisho*, which have organized wealthy customers, have already exceeded 200.0 billion yen, a double-digit increase from before COVID-19. The core of the *gaisho* business is “people” to “people,” and the COVID-19 pandemic has triggered the digitalization of the *gaisho* business as well. The closed website “*connaissigne*” has become an important tool to demonstrate new possibilities for *gaisho*. The promotion of online sign-up has also helped attract younger affluent customers.

Inbound sales finally grew to 67.3 billion yen in fiscal 2023, exceeding pre-pandemic levels. The main driver of this growth is a significant increase in average spend per customer. In other words, this is an increase from before the pandemic while customer numbers remain at about 70% of pre-pandemic levels, so we believe there is still room for growth through an increase in customer numbers in the future.

Daimaru Matsuzakaya Department Stores inbound sales (duty-free sales) trends



Value of real experience and space becomes more important

The COVID-19 pandemic has rapidly accelerated the digitalization of society. We have come to realize in many aspects of our lives that digital technology can help us transcend the constraints of time and place. On the other hand, it was also an opportunity to reaffirm how irreplaceable and precious the value of real experience obtained through the five senses is.

Under such circumstances, one of the topics of the Matsuzakaya Nagoya store, which is currently undergoing a major renovation, is the creation of overwhelming space value. Its concept is “learning from history and creating the future.” We have appointed Yuko Nagayama & Associates as our partner and are proceeding with the design based on the themes of “creating an impressive focal point” and “a spatial composition that is easy to recognize and navigate.” We will deliver a luxurious, comfortable, and exclusive customer experience that only a real store can provide.

Our main task is to increase the value we deliver through people-to-people communication, which is our strength. We will expand human power using digital technology. Its starting point is in real stores. From now on, it will also be important to be more aware of content that takes advantage of the locality of each store.

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