03. DOMESTIC LUXURIES

Travel has traditionally been a key driver of luxury spending, but international tourism is not expected to fully recover until between 2023 and 2024. To capture the shift in shopping patterns set to shape the year ahead, luxury players should engage more deeply with domestic consumers, rebalance their global retail footprints and duty-free networks and invest in clienteling for local e-commerce channels.

Before the Covid-19 pandemic, 30 to 40 percent of luxury sales were generated by shoppers in transit and abroad.[99] However, international travel flows plunged to new lows at the height of lockdowns and by 2021, global tourism spending had been cut nearly in half.[100] With tourists set to stay local in 2022, consumers and brands alike are doubling down on domestic luxury shopping.

Amid restricted international travel, consumers have switched to buying luxury online and at home, taking advantage of local duty-free offerings and the narrowing price gap between domestic and international markets. With tourism stalled, domestic shoppers helped buoy some of luxury's biggest players. LVMH, Kering and Richemont were among the companies to defy expectations, seeing sales surge above pre-Covid levels by the second quarter of 2021 thanks to consumer enthusiasm to shop locally and online, particularly in Asia and the US. In 2022, much of this new onshore business will remain intact.[101]

Aside from flows between Europe and North America which will get close to their 2019 performance next year, inter-regional travel is unlikely to return to pre-pandemic levels before 2023. Moreover, the recovery of travel between China and Europe — formerly a cornerstone of luxury purchases in Europe — is likely to lag other pairings, only reaching 50 percent of 2019 levels by 2022. In comparison, travel between the Middle East and Europe and between North America and Europe is expected to rebound to 110 and 105 percent of 2019 levels respectively by 2024.

"[Recovery will be] phased across different regions," said Benjamin Vuchot, chairman and chief executive of LVMH-owned luxury travel retailer DFS Group, in mid-2021. DFS is planning to open new T Galleria stores which will be fully operational by 2023 in Australia and New Zealand, two countries Vuchot predicts will be among the early beneficiaries of a resumption in travel. "When travel becomes possible, luxury will be one of the first categories to benefit."[102]

With cross-border travel restricted throughout 2021, domestic markets have had an opportunity to pick up the slack. Indeed, despite some reopening to international traffic, most shopping has been comprised of local customers. Following the reopening of non-essential retail in the UK, the Bicester Village designer outlet reported a flood of domestic shoppers and only a trickle of international visitors. Luxury retailers including Harvey Nichols and Selfridges in London and Galeries Lafayette in Paris have tried to adapt to the changing conditions, with the latter offering online clienteling and next-day home delivery.[103]

Governments have been similarly proactive in encouraging luxury shoppers to spend more at home by cutting local consumption taxes, reducing import duties and promoting duty-free zones. In China, the popular holiday destination of Hainan saw duty-free sales surge by 257 percent in the first half of 2021, to 26.77 billion yuan ($4.13 billion).[104] This followed a Chinese government announcement that it planned to transform Hainan into the world's largest free-trade port. The plan included reduced corporate and individual tax rates, relaxed visa requirements and a drastic expansion of the Hainan duty-free programme. The government also lifted purchasing limits from 30,000 yuan to 100,000 yuan ($4,646 to $15,487) and allowed consumers to buy duty-free products online for six months after returning home.

The success of China Duty Free Group (CDFG), which controls around 95 percent of the Hainan market, has attracted companies such as LVMH's DFS, Dufry and Lagardere over the past year. Looking forward, CDFG expects 20-fold revenue growth between 2019 and 2025. If that is accurate, the island province will account for one third of China's luxury market by 2025.[105] Meanwhile, elsewhere in China, municipalities in the city of Shenzhen are considering developing their own downtown duty-free zones.[106]

Brands have also played their part in the shift to domestic sales. Many have launched or expanded local marketing campaigns and invested in their domestic physical footprints.[107] In November 2021, Dior opened its first Middle Eastern exhibition in Qatar, which was adapted specifically for the region and will run until March 2022,[108] and Chanel hosted its 2022 cruise collection in Dubai. In the US and UK, luxury brands such as Dior and Prada have compressed price differences between markets, reducing the allure of "travelling for a bargain" and shoring up consumer confidence in domestic purchases.[109]

In China, Louis Vuitton and Prada have shifted some of their attention away from tourism hotspots and first-tier locations to new stores in cities such as Wuhan.[110] Meanwhile, the activities of China's *daigou* (grey-market surrogate shoppers who buy goods overseas to sell on the mainland) have shifted, with supply chain bottlenecks and closed stores and factories adding to the complexities of the trade.

While domestic markets have prospered, international airports and city-centre retail locations, which are often designed for the international traveller, have seen store closures and strategic shifts. In Japan, the ongoing travel ban has hurt duty-free retailers and tourist-focused outlets, leading to retailers shuttering more than a dozen stores in Tokyo's high-end Ginza Six mall in early 2021.[111] Meanwhile, tourism shopping tax refund company Global Blue, headquartered in Switzerland, saw a more than 80 percent drop in its first-quarter 2021 revenues compared with pre-pandemic levels.[112]

With airports maintaining strict social distancing measures and border controls, the sense of a fun, airport-based experience will likely continue to diminish in the year ahead. Of course, this does not spell the end of international travel. In countries that have seen rapid vaccine rollouts, the appeal of leisure trips abroad is returning: seven in 10 Americans are eager to book a vacation, according to a recent Nielsen survey.[113] Still, even as international bookings rise, the practical difficulties and risks (such as uneven vaccination rates, testing and quarantine requirements and the threat of viral mutations) will mean many consumers continue to favour domestic trips.

However, some travel retail players are ramping up their duty-paid airport concessions alongside duty-free operations in provincial hubs across markets like Brazil.[114] "With our new shops spread across the whole [Salgado Filho Airport in Porto Alegre] we will be able to… serve both domestic and international travellers [tailored accordingly]," said Gustavo Fagundes, chief operating officer of Dufry in South America.[115]

03. DOMESTIC LUXURIES

Globally, domestic travel is on a steeper upward curve than its international counterpart, and is likely to recover to more than 90 percent of pre-pandemic levels by 2022, compared to 50 to 80 percent for international travel. Demand for weekend and short shopping trips, which historically accounted for a large proportion of luxury tourism spend, will remain subdued. So too will business travel, amid continued adoption of digital alternatives.

Domestic luxury consumption has similarly benefitted local and regional online players. In China, Alibaba expects to see a continued rise in cross-border e-commerce through 2022, as consumers browse for both foreign and domestic goods on local sites.[116] Global luxury e-commerce platforms such as Net-a-Porter may see more traffic from regions like the Middle East, where they have a localised offering with competitive delivery and payment options and offer access to local designers. UAE-based luxury players with an online presence, such as Al Tayer Insignia's Ounass and Chalhoub Group's Tryano and Level Shoes, are also expanding fast across the region.[117]

Citing the shift of international travel-based spending back to countries like the UAE and Saudi Arabia, Khalid Al Tayer, chief executive of Ounass and managing director of Al Tayer Insignia, which operates joint ventures with brands including Gucci and Saint Laurent, said the trend "has really accelerated the brands in their adaptation of local tastes and local cultures and local celebrations by coming up with communication, [events] and merchandising that appeals to them."[118]

Given the increased choice in home markets, both in terms of brands and channels, the rise of domestic luxury is likely here to stay. Another outcome of this shift is that consumers are discovering new local designers or investing more in familiar local names.

Exhibit 7:

Travel flows between most regions will not recover until 2023

RECOVERY OF AIR TRAFFIC FLOWS WITHIN AND ACROSS REGIONS, INDEX (2019 = 100)

Legend: 1–25 | 26–50 | 51–75 | 76–100 | 101–125

		2021	2022	2023
Intra-regional	Intra Asia	54	94	117
	Intra North America	73	97	101
	Intra Europe	36	95	103
Inter-regional	Asia - Europe	20	51	102
	Europe - North America	17	84	101
	Asia - North America	14	47	93

SOURCE: "UPDATE: COVID-19 GLOBAL AIR TRAFFIC DEMAND SCENARIOS" – MCKINSEY TRAVEL, LOGISTICS & INFRASTRUCTURE ANALYSIS; PAX-IS, JULY 2021

"Here in Shanghai, many showrooms are still reporting a big boost in sales of Chinese designer brands," said Shaway Yeh, founder of fashion innovation and sustainability agency Yehyehyeh.[119] "With consumers having less access to international fashion than before, this isn't surprising, but it also speaks to the rising national confidence that consumers are tapping into, and a newfound sense of solidarity to support local businesses that won't go away anytime too soon."

A similar pattern is emerging in key African markets like Nigeria, where luxury consumers have been unable to travel abroad as easily as they did before the pandemic to shop in hubs like London and Dubai. "While we do expect customers to return to previous [international] buying habits, we're certain that [more] 'repatriated spending' will become the norm. As consumers search for quality products they don't have to travel for, local designers and artisans are exceeding expectations and matching — sometimes surpassing — the quality demanded," said Avinash Wadhwani, co-founder of Lagos multibrand store Temple Muse, which stocks both global and local luxury brands.[120]

Looking ahead, brands will need to adopt a two-pronged approach to capture the shift in luxury spend, targeting both domestic shoppers and aligning with new travel and purchasing behaviours. However, in line with projections that a travel rebound and sustained domestic luxury spend will not be mutually exclusive, the pressure will be on — particularly from investors who increasingly expect a full sales recovery in 2022 — to prioritise the right opportunities at the right time. Indeed, consumers may begin to cautiously travel internationally, while temporary VAT exemptions and other domestic incentives support demand at home. But most likely, luxury consumers will shop for more novel, local designs abroad, while continuing to spend on staples, accessibly priced luxury items and local brands in domestic markets.

In response to these dynamics, travel retail and duty-free players will need to expand their horizons, offering more than the usual merchandise mix to travellers and broadening the travel retail proposition beyond the simple offer of tax savings. Companies must offer value-adds, such as unique local products or collaborations, that enrich the customer experience and create a pull factor for reluctant travellers.

European luxury hubs will be especially hard-hit by the sustained domestic spending boom in China and other markets and will need to find ways to compensate. In Paris, London and Milan, brands and retailers most dependent on international shoppers will likely see sub-par performance through the end of 2022 at the earliest.[121] Leading European luxury department stores that are able to adapt their approach will remain influential in their respective cities. However, while many have expanded their e-commerce operations, they will continue to rely largely on in-store shoppers, meaning they will need to increasingly court local customers using enhanced localisation strategies.

Luxury brands will need to continue to expand their footprints across regions, moving away from an over-reliance on tourist destinations. In towns and cities, retail locations in transport hubs and domestic terminals offer potential for growth. To build meaningful relationships with domestic customers, players will need to sharpen their localised marketing strategies. This may mean introducing enhanced clienteling, holding community-building events or offering tailored merchandise mixes to accommodate local tastes.

As the dynamic between travel and luxury shopping shifts, luxury brands need to formulate new solutions to capture both domestic shoppers and incoming tourism in the longer term, reallocating their investments accordingly. This, in turn, will require a rethink of all aspects of doing business, across product development, marketing, merchandising and retail.

04. WARDROBE REBOOT

After focusing on the likes of loungewear and sportswear for nearly two years, consumers will reallocate wallet share to other categories as pent-up demand for newness coincides with more social freedoms outside the home. To anticipate these nuanced and sometimes paradoxical preferences, brands should lean more on data-driven product development, adjusting their inventory mix accordingly to ensure that assortments resonate with consumers adjusting to new lifestyles.

The pandemic fashion era will be remembered for a surge in comfortable clothing among other things, but some shifts in spending between categories were temporary, while others will see sustained momentum over the longer term. The net result is an altered consumer demand structure comprised of new baselines for some fashion categories, a change which will compel some players to adjust strategies across product development, merchandising and marketing in 2022.

Consumers' lifestyles were drastically altered through the pandemic, causing lumpy seasonal purchases characterised by irregular spikes and lulls of activity, such as surging demand for athletic wear and loungewear. Resizing needs have also disrupted usual demand patterns. In the US, 40 percent of women and 35 percent of men are a different size than in 2019.[122] Now, some categories and products are starting to experience demand fatigue as the recent torrent of irregular purchases is set to subside.

According to analysis by online fashion platform Lyst, pandemic-resilient categories such as nightwear, activewear and underwear are starting to see decelerating demand compared with the more-than 100 percent growth rates that were common in 2020.[123] While 2022 will certainly not see a collapse of loungewear and leisurewear, some brands operating in these categories are beginning to slow down their inventory turnover. Launches of new activewear shorts and tops in the US and UK were down 20 percent and 50 percent respectively in late 2021 compared with the same period in 2020, according to e-commerce trend research by data analytics platform StyleSage,[124] reflecting a similar trend in China.

On the other hand, as more people return to the workplace and formal occasions are reinstated on social calendars, consumers will reinvigorate the formalwear business in the year ahead, building on momentum established in the latter half of 2021, as pent-up demand manifests as so-called "revenge shopping" in some markets after people's social lives resume.[125] Global monthly searches for occasion dresses, such as homecoming, wedding guest, cocktail and formal dresses, were already up 200 percent in 2021 compared to the previous year, according to StyleSage.[126]

Similarly, in footwear, consumers will look beyond the sneakers and comfy sandals that ruled lockdown-era shopping. In August 2021, online searches for women's heels were up more than 200 percent compared with the same month in 2020.[127] However, more practical heel shapes that cater to adjusted consumer preferences will likely remain popular even as people dress up again: footwear styles with the highest number of units sold in 2021 were wedge heels, rubber heels, thick or block soles and kitten heels.[128] In summer 2021, similarly comfortable options like Gucci pool sliders and Tory Burch "Miller Cloud" sandals were cited as bestsellers by Bloomingdale's footwear merchandiser.[129] Dressier sneaker styles were also high on consumer wish lists, particularly in the US, where searches for platform sneakers and brands such as Golden Goose were up 28 percent and 104 percent respectively.[130]

In contrast to the reinvigorated demand for occasion dressing, workplace wardrobes will witness increased casualisation in some markets, such as the US and UK, as people adjust to new ways of working, including hybrid office-home patterns. "Work looks and feels different now," said US-based retail consultant Kathy Gersch. "Virtual work and flexible hours aren't going to go away. Brands that believe old patterns will revive will fall by the wayside."[131]

Workplace wardrobes will witness increased casualisation in some markets, such as the US and UK, as people adjust to new ways of working, including hybrid office-home patterns.

In another sign of creeping casualisation, workplace returnees in many regions have been shopping for casual blazers rather than suits: global search volumes for blazers were more than 100 percent higher in August 2021 than in August 2019. In some markets like Germany, searches for suits were down. Even some traditional and corporate offices will adopt hybrid styles, replacing suits and heels with business-casual styles and sneakers. Of course, there are nuanced differences between markets, where dress codes in some regions and professions will necessitate a return to formality. This said, brands will still find opportunities to tap into the casualisation shift by developing products with new fabric options or hybrid styles. For example, athletic brands Lululemon and Athleta have expanded into workwear, while Hugo Boss collaborated with Russell Athletic to produce suits in jersey fabric, some of which have shorts in place of trousers.[132]

In addition to the changes companies make across design, product development and merchandising, they may also need to employ fresh marketing strategies that align with those changes. For example, exuberance in marketing campaigns will likely mirror consumers' eagerness to dress up for social occasions again. As such, brands should consider bold ads and ambassadors suitable for the new mood, fine-tuning their approach to rapid shifts in social marketing trends on platforms like TikTok and Instagram to enable customers a seamless and instantly gratifying route to purchase new styles. At the same time, leveraging marketing channels that were largely ignored during pandemic, such as in-store events, will be increasingly important to build a sense of community and loyalty.

With consumer demand rebounding alongside ongoing logistics challenges in many global markets, 2022 pricing strategies should also be re-examined. Indeed, fashion executives across different value segments have cited plans to increase prices in 2022, with an average expected rise of 4 percent in luxury, 2 percent in mid-market and 5 percent in value, according to the BoF-McKinsey State of Fashion 2022 Survey.[133] These price hikes are in part due to ongoing supply chain disruptions that will impact margins (see "Logistics Gridlock" on page 32). However, they will also have downstream effects on how consumers in each segment shop new styles to reboot their wardrobes.

Looking ahead, there will likely be increased appetite for experimentation and self-expression as consumers seek out more playful and energetic ways of dressing, boosting demand for novel designs, more adventurous colourways and creative pairings across categories in 2022.[134]

"Often it's the case during times of crisis, people revert back to shiny fabrics, bright colours, clothing that can inspire happiness," said London-based trend forecaster Geraldine Wharry. "If you look at the 2008 [global financial] crisis, a couple of years after that, there was the trend starting to really gain traction in terms of bright clothing, almost clothing inspired by toy colours."[135] In the US, patterned trousers and women's garments in bright colours such as fuchsia, green, orange and purple were more commonly sold out through 2021 versus 2020, according to StyleSage.[136]

The budding new consumer mood, which was captured in late 2021 by fashion critics like *GQ* magazine's New York-based Rachel Tashjian, is likely to continue feeding into aesthetic preferences in 2022. "During the opening stages of the pandemic, there was defeatism… but that's evolved into this type of exuberant attitude," she said.[137] Brand leaders are increasingly aligning their creative teams with the changing consumer sentiment: "People are ready for a little bit of optimism… [and] looking to be inspired," said J.Crew Group chief executive Libby Wadle.[138]

> "There will be more awareness of 'how can this [wardrobe] item also be recycled into other occasions?'"

Executives, merchandisers and buying team leaders at retailers including Moda Operandi and Intermix noted soaring appetite for bold and risqué styles in late 2021.[139] Indeed, this theme will likely extend into next year, with luxury players' Spring 2022 collections by brands such as Michael Kors and Chanel showing skin-baring looks at fashion weeks in New York and Paris.

In a bid to capture demand for new styles, particularly from younger consumer cohorts, fast and ultra-fast fashion players are upping their inventory turn. Asos, Boohoo and PrettyLittleThing are among those to have recently accelerated product introductions.[140] Chinese ultra-fast fashion player Shein consistently introduces more than 6,000 new products per day in limited units, with designs informed by customer data, which can be turned around in as little as three days.[141] However, companies reliant on these business models are facing increased scrutiny for their environmental impact and labour conditions.[142]

"There are huge contradictions at the moment [with the concurrent rise of both ultra-fast fashion and]… the mindful consumer," said Wharry. "I think we're at a tipping point when it comes to people associating the item they buy with its contribution to society… [but even for those who are less concerned about that aspect], there will be more awareness of 'how can this item also be recycled into other occasions?'"[143] As such, a growing number of consumers are likely to allocate more of their wallet share to investment pieces and versatile items, even as inexpensive items and impulse purchases remain an important part of the wardrobe mix for many in 2022.

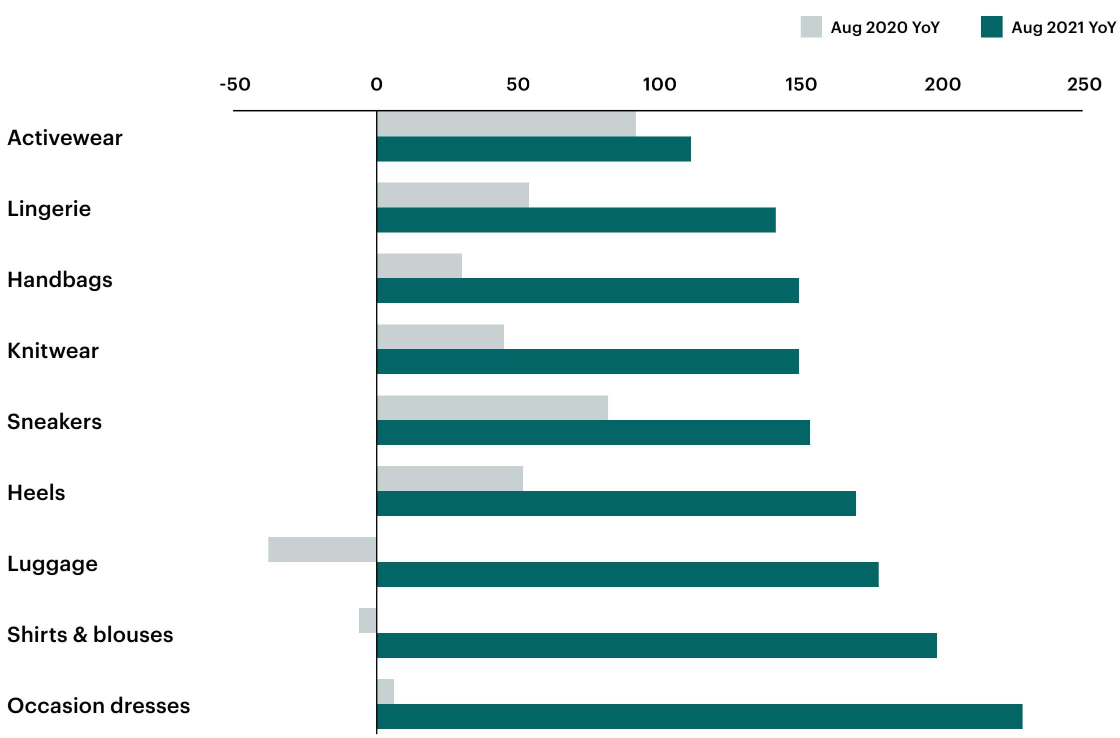
For most brands, the demand for new styles does not necessarily mean adopting bigger assortments, but instead using greater thoughtfulness around data- and demand-driven product launches and inventory mixes. With increased opportunities to collect consumer data through the growth in e-commerce spend, brands should track category shifts and pay special attention to how new assortments resonate with consumers.

To respond rapidly to changing preferences amid next year's wardrobe reboot, brands should also strengthen the reactivity of their supply chains and think differently about the highly seasonal nature of the traditional fashion business. This means reimagining their collections and production cycles, while being prepared for uneven supply and demand. To achieve this, brands will need to collaborate with suppliers to carefully manage orders and inventories. They should also be aware of the need to balance consumer demand and pricing opportunities with the need for increasingly careful allocation of budgets to marketing and supply chain operations.

Exhibit 8:

Interest in categories that were down at the height of the pandemic, such as occasion dresses and workwear, is rebounding quickly

NUMBER OF PAGE VIEWS ACROSS CATEGORIES ON LYST.COM, % CHANGE FROM PREVIOUS YEAR



SOURCE: LYST, AUGUST 2021

05. METAVERSE MINDSET

As consumers spend more time online and the hype around the metaverse continues to cascade into virtual goods, fashion leaders will unlock new ways of engaging with high-value younger cohorts. To capture untapped value streams, players should explore the potential of non-fungible tokens, gaming and virtual fashion — all of which offer fresh routes to creativity, community-building and commerce.

As digital environments come of age, they are transforming from linear and transaction-focused spaces into multi-dimensional, experiential and collaborative virtual worlds. Tech-savvy and younger cohorts are spending increasing amounts of time in these spaces — from social media and gaming to virtual realities — and are adopting multiversal identities along the way. At the vanguard, digital assets in the form of virtual fashion and non-fungible tokens (NFTs) are offering new ways for consumers to shop, exchange goods and inhabit those identities.

Hyper-interactive and creative digital environments are a natural evolution of how people use technology and reflect the ever-growing amount of time consumers are online. Gen-Z spent an average of eight hours per day on screens in 2020.[144] Part of the appeal of virtual worlds is the chance to engage with others and build communities — a need that was exacerbated when global Covid-19 lockdowns put an end to most in-person social contact. As digital spaces become more dynamic, some consumers are participating in "digital campfires,"[145] around which they can connect with others who share their values, have conversations, tell stories and co-create.

These soaring levels of engagement have spawned a new generation of digital fashion creatives, who are pushing the limits of possibility online. Brands, meanwhile, see the emerging "metaverse," in which people work, play, socialise and shop, as an opportunity to engage more deeply and creatively with their customers and unlock new value streams.

"There are more and more 'second worlds' where you can express yourself [but] there is probably an underestimation of the value being attached to individuals who want to express themselves in a virtual world with a virtual product, [through] a virtual persona," said Gucci's chief marketing officer Robert Triefus, citing the 19 million visitors who came to the Gucci Garden within the Roblox gaming metaverse.[146]

The $176-billion gaming industry, which attracts more than three billion players globally, has a long history of community-building.[147] Meanwhile, the metaverse is becoming a big business, with funding pouring in from investors. Epic Games raised $1 billion in April 2021 to accelerate its work in building connected social experiences across a metaverse of linked games and services.[148]

As gaming increasingly becomes an extension of the real world, and with the pandemic supercharging participation, it has become a prime target for fashion brands. In many cases,

Burberry's limited-edition NFT, Sharky B. Burberry.

engagement has taken the form of collaborations with gaming platforms to design virtual fashion assets. Ralph Lauren partnered with South Korean social network and avatar simulation app Zepeto to create a virtual fashion collection, giving users the opportunity to dress their avatars in exclusive products, or appearance-altering "skins." Gucci has created digital assets for gaming platform Roblox, as well as for Pokémon Go and Animal Crossing. Some brands have set their sights even higher. After unveiling its Autumn/Winter 2021 collection in the form of a fully-fledged video game,[149] Balenciaga teamed up with gaming giant Fortnite to unveil a collaboration including shoppable virtual clothing and physical products. It advertised the partnership across traditional and metaverse channels.[150]

As gaming increasingly becomes an extension of the real world, and with the pandemic supercharging participation, it has become a prime target for fashion brands.

The opportunities in gaming are extensive and offer a platform to engage younger consumers, as well as create buzz with cohorts that would not usually interact with brands in physical formats. Tapping into in-game merchandise further allows brands to monetise digital assets where it is the norm to pay for elevated experiences.

Virtual clothing is picking up momentum across a range of digital environments. "Gamers are famous for buying skins in games [but] we have two sets of [broader] customers," said Daria Shapovalova, co-founder of DressX, a platform that estimates the total addressable market for digital fashion at $31 billion[151] and has more than 100 partner designers offering digital fashion items. "First, there are those Millennials who immediately understand the idea of digital fashion and are active shoppers of luxury goods; they want to try something new, so they use it to elevate their social media. Then there are Gen-Z customers who are on platforms like Snapchat or TikTok, where video is becoming the main communication tool rather than the still image."[152]

Indeed, for some consumers, digital fashion is the natural extension of applying social media filters on platforms like Instagram and Snapchat, says Simon Windsor, co-founder and joint managing director at Dimension Studio, an agency that worked with Balenciaga on its video game.[153] "We're just at the tipping point of this new era... It starts to change the meaning of fashion itself."[154]

Beyond social media and gaming, artificial intelligence (AI) and augmented reality (AR) technologies present additional opportunities for new business models leveraging virtual fashion. Online fashion wholesale platform Ordre uses 360-degree view technology to present seasonal collections through online showrooms, offering a complementary channel to facilitate management of luxury wholesale networks. Elite World Group and Tommy Hilfiger have recently partnered on various virtual ventures, including avatars of models walking 3D virtual runways.[155]

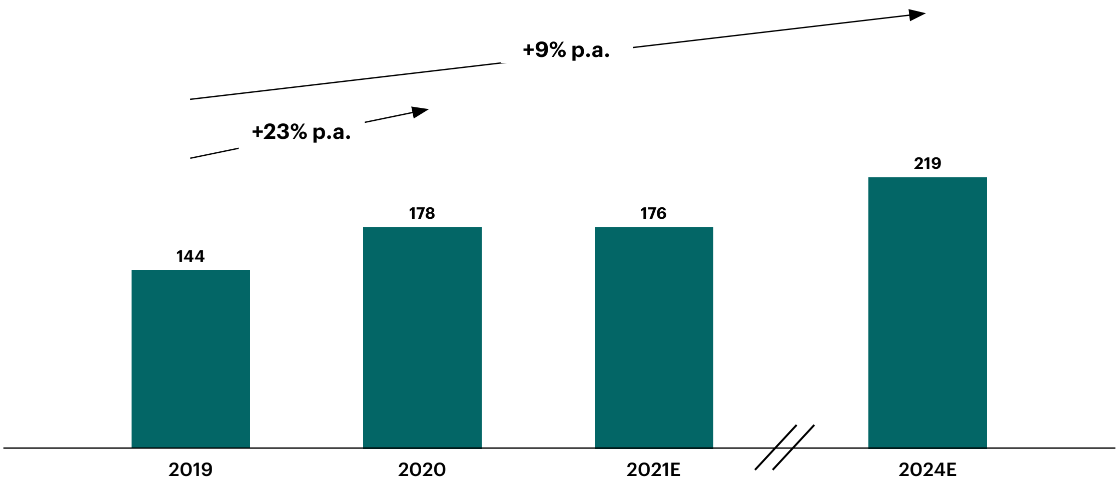
Much of the excitement around virtual environments is directed towards NFTs, which have seen an explosion of interest over the past year. NFTs are unique crypto assets whose authenticity and ownership are verified on blockchains and are bought, sold and exchanged in the metaverse, often with cryptocurrency. Their uniqueness means that the value of some NFTs can skyrocket: one created by digital artist Mike Winkelmann — also known as Beeple — was sold at Christie's auction house in 2021 for a record-breaking $69.3 million.[156] NFT platform OpenSea exceeded $1 billion in sales in the first seven months of 2021.[157]

Proponents of NFTs argue that the recent boom is no flash in the pan. "This is fundamentally going to change digital ownership, creative structures, the creative economy, how we view

Exhibit 9:

The global gaming industry grew rapidly in 2020 and is on track to be worth $219 billion by 2024

VIDEO GAME MARKET SIZE, USD BN



SOURCE: NEWZOO, KEY NUMBERS 2021

money even," said Karinna Nobbs, co-chief executive and chief experience officer of NFT marketplace The Dematerialised. "This is bigger than the internet."[158]

In fashion, NFTs have a wide range of use cases, ranging from product authentication (see "Product Passports" on page 88) to serving as collectable pieces in their own rights. With consumers seeking to collect and invest, digital fashion creators such as The Fabricant, DressX and RTFKT are finding audiences for digital clothing authenticated by NFTs. Meanwhile, some companies are tapping into the excitement around NFTs by experimenting with alternative engagement models: Adidas attracted headlines when it collaborated with The Fabricant and model Karlie Kloss to launch a competition for creators to make their own NFT versions of the WindRdy parka jacket.[159]

In 2021, there was a wave of NFT engagement among luxury players, often via the gaming universe. For its 200th anniversary, Louis Vuitton launched a video game with collectible NFTs partially designed by Beeple. The game contained NFT art that could be acquired by players in a story echoing the journey of the brand's founder.[160] Burberry created NFTs within the Blankos Block Party game, featuring digital vinyl toys that live on a blockchain. Adorned with Burberry's TB summer monogram, the limited-edition Burberry Blanko Sharky B NFT can be purchased, upgraded and sold. The collaboration also includes branded in-game NFT accessories, including a jetpack, armbands and pool shoes.[161]

Beyond gaming, Farfetch has partnered with digital fashion platform DressX and Crypto.com, a marketplace for NFTs, to launch a virtual collection.

Dolce & Gabbana collaborated with Unxd, a curated marketplace for digital luxury and couture, to create an inaugural nine-piece collection of NFTs sold alongside physical couture.[162]

With no shortage of marketing hype, there are indications that digital fashion assets can generate significant revenue streams. Dolce & Gabbana's collection fetched the equivalent $5.7 million.[163] Still, monetisation opportunities are likely to be contingent on the psychology of scarcity and limited editions driving NFT mania — together with the security of authentication and the potential for community-building that they provide. The most likely fashion segments to lead the way are luxury and streetwear.

What is undisputable is that fashion industry leaders are interested in exploring the potential of virtual fashion.

"We say to any fashion brand we work with: it's experimental. It's not always going to work and we can't guarantee it will work," said Amber Slooten, co-founder and creative director of The Fabricant, a digital fashion house that helps brands create their own virtual products and has worked with brands including Adidas, Marques Almeida and Buffalo London.[164]

Amid the hype, there are also reasons to exercise caution. One concern is the environmental impact of the blockchain technologies that underlie NFTs and, in particular, the energy required to validate transactions. Cyber security is also a potential cause for concern (see "Cyber Resilience" on page 97), with counterfeiting and security breaches a significant threat. A recent cyber attack on the artist Banksy's official website caused a collector to pay £244,000 ($334,000) for a counterfeit NFT.[165]

"To assume that... NFTs or more generally blockchain won't be an incredibly volatile environment for the next five years is to have forgotten the lessons of history when it comes to the internet," said Ken Seiff, a managing partner at Blockchange Ventures, a venture capital firm investing in early-stage blockchain technology.[166]

At a minimum, fashion's foray into the metaverse promises new routes for consumer engagement. This will support creative branding strategies, enable immersive consumer experiences and generate excitement among highly sought-after consumer groups.

Looking ahead, the buzz around NFTs will continue to build as increasing numbers of fashion brands seek paths to differentiation and launch creative experiments. As consumers spend more time interacting online, their interest in collecting and displaying digital objects is likely to deepen. However, they will also seek out opportunities for co-creation and will expect brands to engage with digital assets in a format that is native to the spaces they inhabit, rather than content that repeats across channels.

The crypto fashion opportunity will demand significant investment, experimentation and a new playbook. Brands will need a strategic mindset and a willingness to develop partnerships and harness a variety of talent to deliver high-quality content, either in-house or via third-party collaborations. In an arena characterised by a large amount of hype, it will pay to seek out business cases that spark excitement but remain on-brand.

The crypto fashion opportunity will demand significant investment, experimentation and a new playbook.

To do this, it may be necessary to take a new lens on ROI, focusing on less measurable benefits such a brand awareness and marketing impact, as well as setting flexible targets that are calibrated to potential, rather than focusing exclusively on the bottom line. Flexibility will be key, and brands should remain cautious in deploying their capital. However, the risks should not deter them from engaging with this rapidly growing digital universe.

06. SOCIAL SHOPPING

Social commerce is experiencing a surge in engagement from brands, consumers and investors alike as new functionality and growing user comfort with the channel unlocks opportunities for seamless shopping experiences from discovery to checkout. Though use cases differ across global markets, brands should double-down on tailored in-app purchase journeys and test opportunities in technologies such as livestreaming and augmented reality try-on.

The use of social media to discover and shop for fashion gained traction over the course of the Covid-19 pandemic as customers — unable to visit stores or socialise in-person during global lockdowns — spent more time at home scrolling through their feeds. Indeed, 74 percent of consumers say that they are now more influenced to shop via social media than they were before the pandemic, and 70 percent cite clothing as one of the product categories they shop for most on social media.[167]

While Western markets may still lag China in rates of adoption, social shopping has gained a global foothold and is poised to grow in the year ahead as social media giants from Facebook and Instagram to YouTube and Snap Inc. invest heavily in shopping features and take advantage of new functionalities. Looking forward, in the US alone, annual sales through social commerce are expected to surge from approximately $37 billion in 2021 to $56 billion in 2023 (this includes sales of all products and services agreed on social platforms regardless of the method of payment or fulfilment).[168] By 2027, worldwide social commerce sales are set to reach over $600 billion.[169]

In some markets, social media is fast becoming a preferred way of shopping and interacting with brands, as social platforms are increasingly augmented with advanced technology. Indeed, social commerce — from in-app checkouts on social media platforms to sales transactions on livestreams — is already booming in China, where super-apps like WeChat offer users a wider array of functions than just social networking and messaging services, and social media players like Douyin and Xiaohongshu have boosted their e-commerce capabilities.[170] In 2021, sales from social commerce across all sectors in China are set to top $363 billion (which includes products or services purchased on social networks regardless of the method of payment or fulfilment), up 35.5 percent from the previous year.[171] This is approximately 10 times higher than social commerce sales in the US.[172]

Product discovery and engagement with brands on social media is already commonplace across most global markets, with customers used to seeing brand activity and references alongside social exchanges with one another and influencers and within entertainment platforms. In fact, nearly half of US TikTok users say they have purchased a product or service from a brand after seeing it advertised, promoted or reviewed on the platform.[173] However, the next frontier for social commerce in Western markets is at the narrow end of the marketing funnel — seamlessly checking out in-app and paying for products within the social media ecosystem — where a reduced number of clicks to convert an impression into a sale offers a promising route to sales for brands.

As such, social media platforms are making moves to embed the entire shopping journey — from discovery to checkout — into their core user experiences with functionality ranging from livestream sales and integrated product catalogues to augmented reality try-on. Fashion is the largest single category sold via social media in the US, as well as the leading category for livestream events,[174] suggesting that brands will find consumers willing to shop on these channels.

"There's no reason to say that just because we [in the West] don't have [companies like] Alibaba [whose platforms Tmall and Taobao have livestreaming functionality baked into their ecosystems], we won't have [livestream] e-commerce," said Sophie Abrahamsson, chief commercial officer at Bambuser, a B2B player equipping brands with livestream technology that in 2021 entered into a master agreement with LVMH. "I don't see it as an obstacle, it's just a different starting point."[175]

Engaging with social commerce formats including those in livestream channels in China can provide brands with learnings that are beneficial when adapted for other geographies and platforms. Tommy Hilfiger held a livestream in China that attracted 14 million viewers and sold 1,300 hoodies in two minutes, which encouraged the brand to extend its livestream programme to Europe and North America thereafter.[176] However, specific market characteristics in China — including longstanding consumer comfort with in-app shopping and the outsized influence of key opinion leader (KOL) hosts for livestreaming — cannot be simply replicated in other markets.

"Tech, corporations and consumers need to be at the same pace. In China, all three things came together way before Europe and the US," said Mei Chen, Alibaba Group's head of fashion and luxury for the UK, Spain and Northern Europe.[177]

Nevertheless, interest in social commerce is growing fast in markets like the US, where the number of people who make at least one purchase on a social channel during the calendar year is expected to be 50 percent higher in 2022 than it was in 2019, reaching 96 million customers.[178] In the UK, where consumers have been more hesitant, compound annual growth rates for social commerce usage are still expected to be more than 15 percent from 2019 to 2022, growing a further 9 percent in 2023 — suggesting that 15 million people will have made a social commerce transaction during that year.[179]

Social commerce consumers typically skew young, meaning the medium has special appeal for brands targeting Gen-Z and Millennial consumers. This means there is still significant room to grow as consumers become more comfortable with in-app payments and platform functionality improves. Brands have a window of opportunity to tap into local consumer needs and build strategies that capture market share early.

To connect brands with consumers, global social media giants are doubling down on developing in-app shopping experiences. Instagram, which launched its Shop feature in 2020 and partners with brands such as Chloé, Michael Kors, Oscar de la Renta and Marc Jacobs to make products shoppable either in-app or by steering customers back to their own websites, is ramping up shopping features such as Drops. This is a new destination within the app where consumers can discover and buy the latest and upcoming product drops from brands like Adidas.[180]

Meanwhile, Snapchat is applying its augmented reality capabilities to enable users to virtually try on clothes and accessories from brands such as Prada and Piaget, and TikTok has been expanding commerce partnerships and functionality, testing livestreamed shopping with select brands.[181] In the US, during Walmart's first shoppable livestream fashion event with TikTok, it gained seven times more views than anticipated and grew its TikTok followers by 25 percent, according to William White, chief marketing officer for Walmart US.[182] In August 2021, the social video platform announced an expansion of its partnership with Shopify including a pilot test of TikTok Shopping with select merchants across the UK, US and Canada, which could help brands enable social commerce.[183]

Looking beyond tech giants and incumbents, new venture capital-backed entrants, such as Flip and Chums, are offering fashion brands opportunities to engage with shoppers on hyper-immersive platforms, while platforms such as Amazon-owned Twitch, Discord and Clubhouse (which do not currently offer in-app checkout features) enable brands to target specific demographic cohorts. In the case of Twitch and Discord, for example, their gaming-enthusiast user skews male, attracting attention from menswear and streetwear companies such as sneaker marketplace StockX, which joined Discord to promote its latest products.[184]

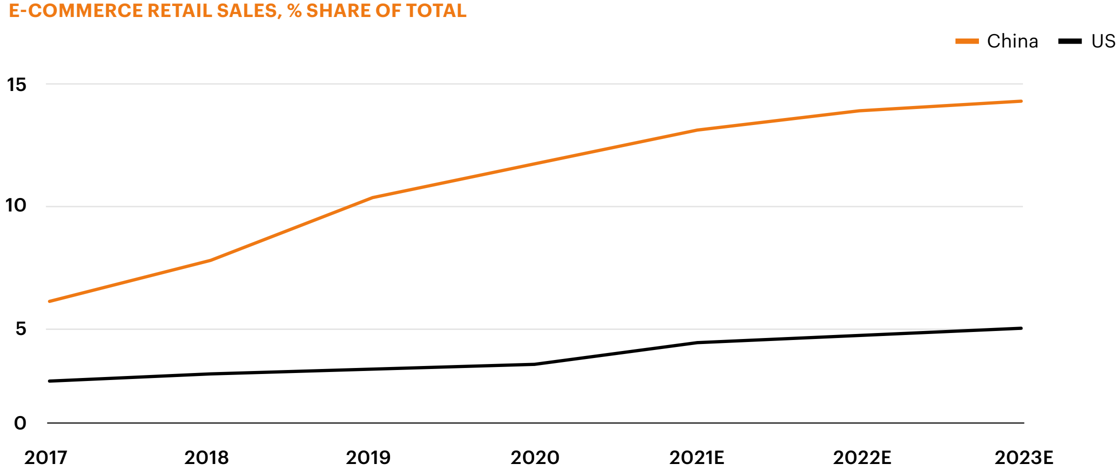
Brands looking to leverage community-specific platforms as a way of boosting the discovery phase of social commerce should take care to engage authentically with users. "You don't have to be like the audience, you don't have to pretend [to be] one of them if you're not, they'll see straight through it. All you have to do is show you understand them," cautioned Adam Harris, global head of Twitch's brand partnerships studio.[185] Meanwhile, outside the tech ecosystems of the US and China, specialist social commerce platforms are gaining ground such as Trell in India, which saw investment from the likes of H&M Group.[186]

While social media channels have typically been viewed as a means to increase reach and drive traffic to brand-owned websites or

Exhibit 10:

Social commerce penetration in both China and the US will continue to grow

E-COMMERCE RETAIL SALES, % SHARE OF TOTAL



SOURCE: EMARKETER, JANUARY 2021

multi-brand e-tailers — owing to limited platform functionality, hesitation on the part of brands to relinquish control of checkout and payment data to third-party channels and previously lukewarm reception from consumers — social commerce is reaching an inflection point. "The old 'buy' button doesn't work… you are taking your shopper away from their online experience to fulfil a purchase… [so] you burst the bubble. You create what we call an 'abandoned basket effect,'" said Maria Prados, head of vertical growth teams at Worldpay.[187]

Soon, however, even seamless payments will become table stakes, so brand laggards must overcome the reluctance to surrender control and increasingly have conversion in mind when investing in social. With the number of fashion brands adopting Instagram as a sales channel growing, more are likely to follow their lead next year, moving away from a focus purely on reach and seizing opportunities to generate paying social customers.

Largely thanks to WeChat, China has seen huge strides in frictionless payments, shortening the sales funnel by reducing the time and friction between discovery and purchase. The ability to interact with sales agents on WeChat to make purchase decisions, and the importance of mini-programmes both on WeChat and other platforms in the Chinese social ecosystem, point to a future integrated model that global platforms could look to for inspiration.[188]

Brands that may have had concerns about relinquishing valuable customer and conversion data to third-party channels will need to devise innovative ways to collect data, such as through discount code-driven sign-ups. Alternatively, some brands are choosing to build their own in-house social channels. For example, US retailer Nordstrom created its own livestreaming platform in 2021, where it hosted shopping events at which customers could chat and purchase products from featured brands such as Burberry.[189]

Brands bold enough to test social-first strategies will be rewarded as younger consumers increase their time spent on digital platforms and spark trends that are born on social media. "Whether or not Gen-Z is your primary consumer, they definitely set the trends and drive brand heat. And when you look at where trends start and where things go viral, it is almost always with Gen-Z," said Jenny Campbell, chief marketing officer at Kate Spade.[190]

To capture the demand for social commerce, brands will need to implement a strategy that can scale fast. The speed at which TikTok took the world by storm is just one example of the pace of uptake, so fashion brands will need to be agile to ensure they are meeting consumers in the digital spaces where they are spending time. As such, companies should tailor their approach for existing mainstream platforms, while conducting A/B testing on emerging platforms to experiment with reaching specific customer segments.

However, brands will need to apply a tailored approach to users of each platform; while some might welcome a more playful style of engagement, such as those on TikTok, others are more conventional. There are regional differences, too, with consumers in some Asian markets approaching livestreams with more of a transaction-forward, deal-focused mentality than consumers elsewhere. While navigating these nuanced considerations, brands will also need to stay abreast of the latest trends and innovations, as currently niche platforms could very quickly become mainstream — or currently buzzy platforms could just as quickly lose their edge over rivals.

Looking ahead, as shoppers place increasing importance on convenience, brands that can unlock the potential of social commerce by offering simple, frictionless shopping will be well-positioned to unlock revenue streams. Indeed, brands thinking ahead to the longer-term growth of social commerce and permanent changes in global consumer shopping habits will use next year to test and learn from approaches that leverage social media platforms to create seamless shopping experiences from product discovery to checkout.

07. CIRCULAR TEXTILES

One of the most important levers that the fashion industry can pull to reduce its environmental impact is closed-loop recycling, a system which is now starting to be rolled out at scale, promising to limit the extractive production of virgin raw materials and decrease textile waste. As these technologies mature, companies will need to embed them into the design phase of product development while adopting large-scale collection and sorting processes.

Globally, the fashion industry is responsible for around 40 million tonnes of textile waste a year, most of which is either sent to landfill or incinerated.[191] Textile production, meanwhile, consumes vast quantities of water, land and raw materials. Engaging in closed-loop recycling is seen as a critical opportunity to both reduce the extractive production of virgin raw materials and limit textile waste. Closed-loop systems recycle materials again and again, so that they theoretically remain in constant circulation.

Textile production is more resource-depleting than many other sectors. In the European Union, for example, the textile sector is the fourth-biggest consumer of primary raw materials and water (following food, housing and transport),[192] while the industry's reliance on fossil fuel-based textiles like polyester only adds to the challenge. Yet there are pockets of the global fashion industry that are starting to get serious about addressing these challenges at scale by working towards developing closed-loop recycling processes that have the potential to limit textile waste, reduce carbon footprints and partly upend fashion's extractive business model.[193]

Currently, less than 10 percent of the global textile market is composed of recycled materials,[194] and this is largely the product of open-loop recycling using PET (polyethylene terephthalate) bottle waste, which does not address the need to recycle materials from the fashion industry and has been criticised for breaking the well-established closed-loop process of recycling plastic bottles into other plastic bottles.[195] If the industry is to reduce the volume of waste going to landfill and limit the extractive production of textiles, closed-loop recycling systems will be required at scale.

The shift to more closed-loop systems is underway, driven in part by regulatory efforts to support a circular economy, which aim to relieve some of the pain points relating to waste collection and sorting. The EU's Circular Economy Action Plan, scheduled for adoption in the third quarter of 2021, incorporates an objective to ensure circular economy principles are applied to textile manufacturing, products, consumption and waste management.[196] Meanwhile, the EU's Waste Directive Framework requires countries to separate all textile waste by 2025, and several European nations have implemented extended producer responsibility schemes, making brands and retailers responsible for post-consumer waste and requiring financial contributions from producers for the collection, recycling and reuse of products.[197]

"Regulators should keep on putting that

Fibre processed by The Billie System. Novetex Textiles.

pressure on markets," said Patrik Lundstrom, chief executive of Swedish textile recycling company Renewcell. "Every country needs to take responsibility and create that circularity."[198]

China published a five-year plan in July 2021 to develop its circular economy by promoting recycling, remanufacturing and renewable resources. In the US, the National Institute for Standards and Technology is making progress in its ambition to facilitate a circular economy for textiles.[199] Still, if the industry is to align with global climate objectives and its own commitments on sustainable materials, it will also need to take action at a brand level to make a difference.

One challenge the industry faces is achieving sufficient scale in closed-loop processes. However, recent innovations are starting to reach maturity, moving from pilots to proofs of concept on industrial levels.

If the industry is to align with global climate objectives and its own commitments on sustainable materials, it will also need to take action at a brand level to make a difference.

Mechanical cotton recycling, through which cotton is shredded into reuseable fibres, has been in use for a long time. One example of mechanical recycling is the large-scale pilot in Bangladesh by the Circular Fashion Partnership, led by the Global Fashion Agenda, which aims to capture and direct post-production waste back into the production of new textiles, as well as developing solutions for deadstock. The partnership plans to roll out to countries including Vietnam and Indonesia.[200]

Mechanical cotton recycling has historically been more difficult to implement for garments that are already worn, mainly due to challenges in collection and sorting. As a result, less than 1 percent of cotton was recycled in 2020.[201] However, among recent initiatives, Hong Kong-based yarn spinner Novetex Textiles, in collaboration with the Hong Kong Research Institute of Textiles and Apparel (HKRITA) has developed a method called The Billie System for the mechanical recycling of cotton blends. The system does not consume water or produce chemical waste and currently processes up to three tonnes of fabric per day.[202]

To enable recycling of the various textile fibres on the market, more innovative recycling solutions other than shredding are required. For non-blended materials, a number of industrial-scale solutions are beginning to hit the market, and further capacity is set to become available. For example, Renewcell has partnered with brands including H&M and Levi's and has an agreement with Beyond Retro's parent company Bank & Vogue, which supplies post-consumer waste to Renewcell.[203] Renewcell is building a new plant that will be able to recycle 60,000 tonnes of textiles a year by 2022. Meanwhile, US materials company Eastman is investigating using polyester in its new $250-million recycling plant.[204]

One of the technical challenges facing the industry is the high proportion of garments made from material blends such as cotton and polyester, which make them hard to separate. Still, after years of research and development and pilot ventures, this is another area that is reaching maturity and scale. In Europe, viscose producer Lenzing and recycling company Sodra are working in partnership to increase the annual capacity of Sodra's technology for blended fibre, with the goal of processing 25,000 tonnes of textile waste per year by 2025.[205] In Turkey, denim company Isko has signed a licensing agreement for the "green machine" technology developed by HKRITA, which recycles cotton and polyester blends.[206] The technology is also being scaled with partners in Indonesia.[207] In Australia, BlockTexx is building a textile recycling facility for polyester-cotton blends that aims to recycle 10,000 tonnes a year by the end of 2022.[208]

A critical piece of the used clothes recycling puzzle is collection and sorting. “If there can be larger-scale collection and sorting, that would help us tremendously,” said Ronna Chao, chairman of Novetex. “I have limited space where The Billie System is housed, so I can’t be the collector, storer and sorter all at once… [but] if we can partner with, for instance, NGOs or other players within the industry [in other countries], where they can do the collection and the sorting… then we can process that in a more meaningful way.”[209]

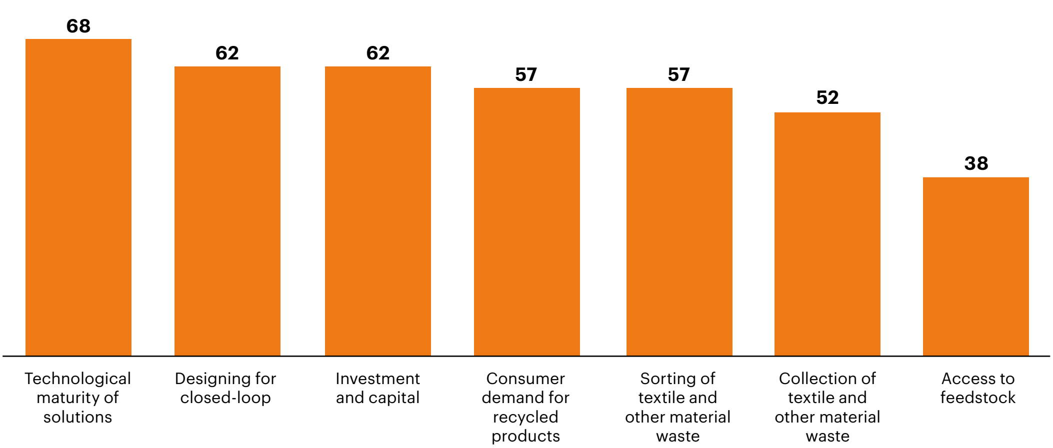
To that end, authorities, waste companies and brands are making efforts to develop solutions. These offer some promise, but further efforts are required, including moving from manual to automated sorting at scale. For example, in Sweden, Sysav waste treatment and recycling company opened the world’s first industrial-scale, fully automated textile sorting plant in 2020, with the capacity to sort 24,000 tonnes of textile waste a year.[210] In the same year, Belgium-based Valvan Baling Systems launched Fibersort, an automated sorting machine that can sort around 900 kilograms of post-consumer textiles per hour.[211]

Some companies are also pioneering digital solutions to manage material flows. Sorting for Circularity, created by Fashion for Good in 2021, is planning to launch a digital platform on which textile waste from sorters can be matched with recyclers. Brands including Adidas, Bestseller and Zalando are facilitating the project. In addition, a number of brands are helping to solve the sorting

Exhibit 11:

Technological maturity, changes to design processes and investment are considered most important in scaling closed-loop recycling

MOST IMPORTANT[1] FACTORS TO EFFECTIVELY SCALE CLOSED-LOOP RECYCLING, % OF RESPONDENTS



1 Responded “very high importance” or “high importance”

SOURCE: BOF-MCKINSEY STATE OF FASHION 2022 SURVEY

problem by encoding detailed information about materials into products with digital identifiers (see "Product Passports" on page 88).

A critical piece of the used clothes recycling puzzle is collection and sorting.

While these initiatives show the industry is making progress, some issues remain to be resolved. One significant challenge is that recycling facilities are sometimes far from the source of the feedstock, which could lead to significant emissions resulting from long-distance transport.

"We're taking clothes from [Asia] and bringing it all back to Sweden, making new Circulose [material], stripping it back and then making new viscose fibre. However, our next plant is going to be next to a harbour [and], of course, in the long-term, we probably want to have a plant also in Asia, and maybe one in the Americas," said Lundstrom of Renewcell. "There will be capex investment needed to make all this happen. How do we make that as low as possible and manage that? So that's another trade-off with going circular."[212]

Experts mostly agree that closed-loop recycling will not realise its potential until products are specifically designed for that purpose, for example by facilitating the easier separation of materials through design. Claire Bergkamp, chief operating officer at Textile Exchange, a nonprofit aimed at improving the environmental standard of raw materials production, suggests that this also means incorporating the intention to recycle into design curriculums and industry-wide organisational thinking: "What's going to happen to the product when the first user is done with it? Is it durable? Will it have a long enough life? That's the crux. If you are intentionally making something that is not long-lasting, it needs to be recyclable," she said.[213]

For that reason, some parts of the industry are coalescing around common design standards, such as the Jeans Redesign Project by the Ellen MacArthur Foundation. By May 2021, 80 percent of the project's participants had made fabrics or jeans that complied with the guidelines.[214] Additionally, designers have more access to software that can support design with recycling in mind, such as the Circular Material Library from Circular Fashion, which showcases materials that have been tested and validated for future recyclability.[215] Furthermore, innovations such as Ecocycle, a dissolvable thread recently launched by industrial thread company Coats, are making the recycling process more efficient, unlocking the removal of non-textile components and facilitating easier sorting of materials from the same garment.

"We know that it will be more challenging for some fashion brands — probably SMEs, for instance — to invest in closed-loop solutions at this early stage in the technology's development," said Shaway Yeh, founder of Shanghai-based fashion innovation and sustainability agency Yehyehyeh. "But designers really do need to make meaningful efforts to embed this principle in their studios now, if they haven't already. The creative teams in the business should be incentivised by leadership to harness some of their innate creativity to scale up circular material use. It's just a matter of priorities."[216]

As an increasing number of fashion players commit to circular materials, scaling will be essential in collection, sorting and recycling. However, the rollout of industrial processes will drive down prices and boost demand for garments made from circular materials. To maintain a competitive advantage and secure access to circular textiles, fashion players may need to invest directly in recycling facilities and contribute to finding solutions for collection and sorting. Scaling, of course, will require capex and will mean decision-makers will need to look past the still comparatively cheap costs of virgin materials.

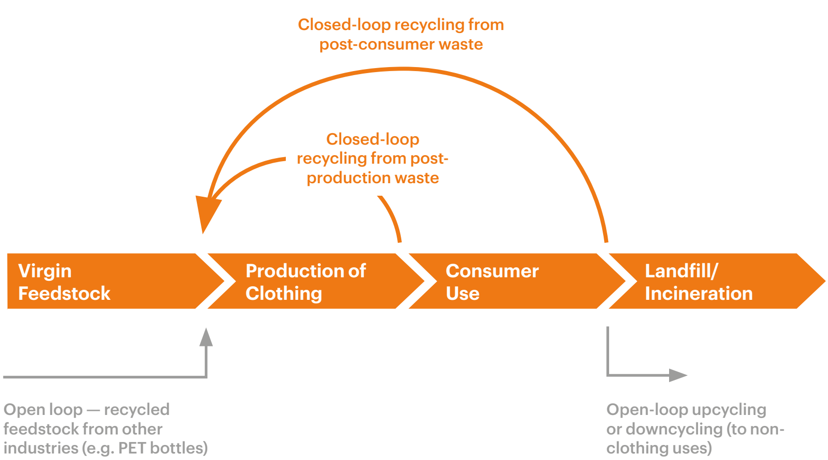
To be sure, closed-loop recycling processes also present environmental challenges, including greenhouse gas emissions and significant water use, with some critics suggesting that the reduction in impact from closed-loop processes will not be enough to slow down fashion's negative impact on climate change.[217] "[Closed loop] is not the silver bullet… the silver bullet is producing less stuff," said Bergkamp of Textile Exchange.[218]

However, seen in the context of comparisons with open-loop — or indeed linear — models, closed-loop processes are an important part of a wider system change for circularity. "Recycled always has lower impact [than linear]. There's no questioning it," said Bergkamp. "It's probably a perfect solution for an imperfect situation."[219]

While there is reason for optimism that many closed-loop technologies will reach industrial scale in 2022, fashion leaders will need to approach the challenge holistically, incorporating circular textile solutions into a wider effort to eliminate toxic chemicals, decarbonise the supply chain and reduce emissions, if the industry is to significantly reduce its levels of environmental harm.

Exhibit 12:

The shift from linear to circular models requires closed-loop recycling technologies to be scaled



In fashion, **closed-loop recycling** is when textile product waste (both post-production and post-consumer) is recycled into new textile products so that the materials remain in constant circulation (garment-to-garment).

This process contrasts with **open-loop recycling**, in which one product is recycled into a different product, simply delaying the material from going into waste once it cannot be recycled again.

SOURCE: SIMPLIFIED FORM OF A NEW TEXTILES ECONOMY: REDESIGNING FASHION'S FUTURE, ELLEN MACARTHUR FOUNDATION WITH ANALYSIS BY MCKINSEY, NOVEMBER 2017

How are fibres separated out, if at all?

As a mechanical recycling system, we cannot separate the fibres through the upcycling process, so we prefer to collect items that have no more than two fibre combinations to maintain the purity of the recycled fibres.

Regulators are increasingly turning their attention to environmental policies that will implicate the fashion industry, both directly and indirectly. How do you think the apparel industry can really seize this as an opportunity to become circular?

Well, I'll take ourselves as an example. [We have] difficulty shipping our fibres directly from our Hong Kong factory to our Zhuhai factory because there's a rule against importation of waste. Now, I know that this rule probably came from many, many years ago when China was, like many developing countries, accepting other countries' garbage... [but] the rigidity of that rule affects us because what goes through The Billie is sanitised three times, but it's still labelled as waste. [As one company] it's very difficult for us to go and lobby [regulators] to change that rule, so ideally, if... there are 20 people like us going to lobby them then it probably makes more sense for them to really take a stand, but if it's just me and The Billie it's harder for them to make a case. Those are the kind of things that we face, and it is frustrating.

This interview has been edited and condensed.

The Bille System factory. Novetex Textiles.

IN-DEPTH

Time for Fashion to Raise Its Sustainability Ambitions to Deliver on COP26

Countries, companies and communities are mobilising around climate change. Amid mounting evidence of fashion's climate impact, and the gathering of nations at the COP26 Climate Change Conference, there is a renewed impetus behind the need for decarbonisation and a much sharper focus on the imperative to adapt and mobilise private-sector capital to fund the required changes. A new era of climate action will therefore be required, meaning fashion leaders must focus not only on decarbonisation but also on building resilience and reversing nature loss as the effects of climate change take hold.

by Harry Bowcott, Leigh Chantal Pharand and Libbi Lee

The COP26 meeting in Glasgow, UK that took place in October and November 2021 was the latest in the United Nations' series of conferences that aims to tackle climate change and its impacts. COP stands for "conference of the parties," which refers to the UN member states that are represented parties of the climate change convention, and this is the 26th year the secretariat met to discuss plans. Previous COPs have led to international climate treaties like the Kyoto Protocol and the Paris Agreement. The COP26 agenda focused on four goals: 1) securing global net-zero carbon emissions by 2050 and keeping the 1.5-degrees Celsius limit on global warming within reach, 2) adapting to protect communities and natural habitats, 3) mobilising finance, and 4) working together to deliver on commitments.

For the fashion industry, the run-up to the event galvanised companies such as Arezzo & Co, Cartier, New Look, Prada, Soorty Enterprises, Under Armour and YKK Corporation into making specific commitments or announcements of broader sustainability initiatives, and provided an opportunity for collective discussion and advocacy.[220] Fifty textile, apparel and luxury companies announced their commitment to science-based targets in the six months before the event, which is more than three times the number in the same period in 2020.[221] Fashion-focused events were also planned for COP26, including The Fashion Dialogue, featuring prominent speakers from the global fashion industry, and the Fashion Industry on the Race to Zero.[222]

In addition, as COP26 heightened the focus on communities and natural habitats — both of which are for the most part negatively impacted by the fashion industry — many companies honed their biodiversity agendas through "nature positive" commitments, aimed at proactively enhancing the resilience of the planet against climate change and reversing nature and biodiversity loss.

While these commitments are all positive indications that parts of the industry are keen to change, the proof will be in tangible actions taken over the next few years. While specific outcomes of COP26 are not included in our analysis owing to the time of writing, below we outline the main goals of COP26 and what the fashion industry will need to do to respond.

COP26 Goal 1: Secure global net-zero emissions by 2050 and keep the 1.5-degrees Celsius warming limit within reach

To get on the 1.5-degrees Celsius pathway — or, in other words, limit the increase in global temperature to 1.5 degrees Celsius above pre-industrial levels — and make progress towards net-zero carbon emissions by 2050, the world needs to cut CO_2-equivalent (CO_2-e) emissions in half before 2030.[223] Yet, the UN's NDC Synthesis report published in September 2021, which aims to give a comprehensive picture of actions being planned or undertaken by governments that impact greenhouse gas emissions, projected a 16 percent *increase* in emissions by 2030.[224]

Within the fashion industry, key parts of the supply chain could still be at risk from climate change even if the 1.5-degree pathway is maintained. Despite these risks, fashion is still one of the least environmentally sustainable industries. It accounts for approximately 2.1 billion tonnes of CO_2-e emissions per year — that's 4 percent of annual global emissions. More than 70 percent of these emissions comes from production processes, with the remainder from retail, logistics and product use (such as washing and drying).[225] The fashion industry is resource-intensive, using significant amounts of water, land, wood and pesticides for the farming of raw materials such as cotton. On top of this, 17.5 cubic metres of textiles — the equivalent of one garbage truck — is either burned or sent to landfill every second.[226]

Companies should consider both firming up and accelerating action on their near-term commitments. Every sector needs to focus on its own breakthrough actions if it is to meaningfully and proportionately contribute to meeting the goal of halving emissions by 2030 and progress towards net-zero emissions by 2050. Within the fashion industry, many companies have already committed to ambitious reductions in greenhouse gas emissions. Some 125 companies have committed to drive the fashion industry towards net-zero greenhouse gas emissions by 2050 through the UN Fashion Industry Charter for Climate Action, which launched in 2018.[227] Most public commitments made by fashion brands in the run-up to COP26 were to reduce emissions by 30 percent by 2030 (from 2015 levels or later). Some companies, such as Levi Strauss & Co., have committed to reducing emissions across their supply chain by 40 percent by 2025, while others, such as H&M, are striving to be "climate positive," reducing more greenhouse gas emissions than its value chain emits, by 2040.[228]

> Every sector needs to focus on its own breakthrough actions if it is to meaningfully and proportionately contribute to meeting the goal of halving emissions by 2030.

Sourcing more sustainable materials, including fibres that are recycled and recyclable, regenerative and/or sourced responsibly, is a critical component of decarbonisation. As such, many brands are setting targets on their use of materials. For example, Lululemon has committed to making 100 percent of its products from "sustainable" materials (that are recycled, renewable, regenerative or sourced responsibly) by 2030, while Stella McCartney has committed to using 100 percent recycled polyester (from garments and plastic waste) by

2025.[229] Various alternative materials that offer reduced environmental impact compared to virgin raw materials are also being developed: Nike, for example, is using a product called ELeather for its Flyleather shoes. ELeather is a reusable leather, originally developed for seat covers in the transportation industry, which is made from either used shoes or scrap material.[230]

Despite these commitments towards more sustainable materials, however, the reduction of environmental impact by some of the alternative materials currently available is not sufficient. The industry needs to scale up closed-loop recycling processes (see "Circular Textiles" on page 72) while acknowledging that no singular solution will offer the key to emissions reduction on its own. To achieve tangible improvements, fashion will also need to invest further in areas such as material innovation and improved industrial processes and manufacturing techniques to deliver on targets.

While commitments to source and use better materials are encouraging, fashion brands will need to understand and address emissions in the entire production and consumption process down to the deepest tiers of their supply chain. This includes establishing more sophisticated tracking of emissions across all tiers in order to be able to first quantify the impact at each stage, and second to design and implement mitigation measures. Technologies such as product passports (see "Product Passports" on page 88) are scaling up to help address these challenges.

Beyond decarbonisation of existing business models, brands and retailers will also need to decouple from current volume-driven measures of success. The Global Fashion Agenda and McKinsey & Company's "Fashion on Climate" report finds that if the industry could reduce the share of stock sold at a discount by 15 percentage points, it would achieve a volume and emissions decline of about 10 percent, without any impact on value growth. To realistically remain on a 1.5-degree pathway, the industry should reimagine a world with smaller individual wardrobes, with more focus on longer-life garments and a flourishing resale and rental market.[231]

COP26 Goal 2: Adapt to protect communities and natural habitats

Although mitigating climate risk by reducing CO_2-e will be critical in the long run, much of the warming likely to occur in the next decade will be the result of emissions that have already been produced.[232] Over the next decade, when experts agree that temperatures are likely to warm by 1.5 degrees Celsius, almost half of the world's population could be exposed to a heat-, drought-, flood- or water stress-related climate hazard, according to a recent McKinsey report.[233]

At their most extreme, these events could be life threatening. But another insidious impact is likely to be on people's wellbeing and livelihoods. In a scenario whereby the world were to warm by two degrees above pre-industrial levels by 2050, the number of people exposed to severe heat stress could increase to 15 percent of the global population, compared with less than 1 percent today.[234] Chronic heat stress could make it impossible to work outdoors or in rooms without air conditioning in some places, including parts of India, a critical region for cotton production.[235] As climate conditions change and become more extreme, yields of raw materials could also fall in their traditional growing regions, including the south of the United States, Pakistan and Australia.[236] Meanwhile, coastal and riverine flooding could jeopardise manufacturing sites in parts of Southeast Asia, such as Bangladesh and Vietnam.[237] This could significantly disrupt fashion supply chains and affect business continuity, not to mention raise the volatility of demand in these key consumer markets.

Therefore, in addition to accelerating action to decrease emissions, fashion leaders need to build resilience against climate hazards into their plans. This will require making some tough choices, particularly when resources are scarce, on where to invest now rather than later; where to either invest in protection of physical assets against growing climate risks, or consider a managed retreat; and, critically, how to include community voices in decision-making.

> **In addition to accelerating action to decrease emissions, fashion leaders need to build resilience against climate hazards into their plans.**

COP26 has put resilience and adaptation to climate risks on a par with emissions reduction as a cornerstone of tackling climate change. Vulnerable countries and communities need significant help, and COP26 offered an opportunity for a moment of global solidarity. Even in regions less vulnerable to extreme climate hazards, such as Europe, the impact of climate change is so severe that the European Central Bank predicts a worst-case scenario of a 10 percent drop in the European Union's GDP and a 30 percent rise in corporate defaults as a result.[238]

Fashion companies need to move quickly to build resilience. In some cases, established technologies, such as flood defences or solar powered air-conditioned warehouses for workers, can be deployed in the supply chain. In others, fashion companies will need imaginative solutions, such as securing multiple raw material sources to mitigate the risk that extreme weather events destroy primary sources such as cotton. The faster companies build resilience, the better for employees, consumers and suppliers, and the greater competitive advantage established. There is, of course, a tension between creating business resilience by relocating parts or all of the supply chain while supporting vulnerable countries as they seek to secure the economic welfare of their populations. For example, as the use of virgin materials decreases and recycled materials increases, it will be the poorest and most vulnerable, including farmers and workers at virgin fibre mills, who will likely suffer the most financially. Business leaders should be prepared to make hard, long-term choices with the welfare of all stakeholders considered.

Establishing resilience is also about protecting and restoring natural environments, as biodiversity and climate agendas are critically interdependent. It is estimated that around half of greenhouse gas emissions could be eliminated through natural measures such as reforestation and limiting land degradation. However, the fashion industry contributes to significant biodiversity loss, with 23 percent of the world's insecticide used in cotton agriculture and 25 percent of industrial water pollution resulting from textile dyeing and treatment.[239] Fashion companies that manage biodiversity in the same way they manage value creation use impact-weighted accounts (which reflect financial, social and environmental performance) and establish measurable biodiversity targets. For example, Gucci's "nature-positive" climate strategy aims to proactively protect forests and biodiversity by restoring mangroves, whilst investing in and incentivising farmers to shift to more sustainable practices, such as regenerative agriculture which supports soil health and water quality to enhance carbon sequestration.[240]

Shifting to alternative materials and investing in materials that reduce non-biodegradable waste are also critical actions for fashion companies to reduce their biodiversity impact. Several brands, including H&M, have been changing their dyeing processes in an attempt to eliminate the need for water and chemicals that pollute waterways.[241]

Increasingly, investors will scrutinise companies' climate resilience as they scrutinise decarbonisation efforts today and will expect companies to disclose their climate risk exposure and mitigation plans. Over the medium term, companies are likely to unevenly bear the cost of building resilience and transitioning to net-zero emissions, investing different amounts and causing the competitive landscape to shift. Customer demands are also changing, with environmental credentials becoming a prerequisite to compete, not a differentiating factor.[242] As such, companies should look to develop technological solutions to climate hazards across their ecosystems, whilst stimulating investment and assessing the carbon intensity of their full value chain.

The investments and actions required will not always demonstrate clear payback in the short term, meaning companies will have to update how they measure ROI by adjusting the time frames they assess and how they effectively incorporate competitive advantage into these decisions.

> Increasingly, investors will scrutinise companies' climate resilience as they scrutinise decarbonisation efforts today and will expect companies to disclose their climate risk exposure and mitigation plans.

COP26 Goal 3: Mobilise finance

It is clear that decarbonisation and adaptation of operational practices both require significant investment. COP26 is the first major COP Climate Change Conference that has had such a sharp focus on the financial commitments needed to tackle climate change, especially by the private sector.

Climate finance tracked by the Climate Policy Initiative (CPI) reached an average of $579 billion over the two-year period between 2017 and 2018, reflecting an average increase of 25 percent from the previous two years and a steady increase in financing from different types of investors — despite many investment budgets being restrained during the Covid-19 pandemic. However, even though investment has reached record levels, the annual investment that would be required to achieve a 1.5-degree scenario is estimated to be between $1.5 trillion and $3 trillion. Such volumes of capital must come from mainstream finance: from corporations, banks and institutional investors. In 2017, only 1 to 2 percent of investments in climate adaptation projects came from the private sector.[243] A core argument at COP26 is therefore that more money must be spent — up to 10 times more than in 2017 by 2030 for developing countries alone[244] — and more of that money needs to come from the private sector. This implies a radical reallocation of capital and investment, with a particular focus on flows into countries whose economies are particularly vulnerable to climate change, as well as into the technologies needed both for decarbonisation and resilience.

Fashion companies are setting up grant and venture funds which aim to target specific sustainability challenges, in both their own operations and their supply chains. These vehicles present an opportunity to harness external innovation and build credibility and internal knowledge. For example, Kering's Regenerative Fund for Nature provides grants to farming groups, non-governmental organisations and other stakeholders to scale regenerative practices in leather, cotton, wool and cashmere production.[245] Kering is also involved in a joint venture alongside Stella McCartney, Burberry and the Apparel Impact Institute, which focuses on improving the environmental impact of Italy's luxury fashion supply chain by establishing a platform for manufacturers to coordinate, fund and scale environmental programmes.[246] At the same time, many companies are ramping up investments in recycling technologies (see "Circular Textiles" on page 72). One example is Infinited Fibre, which recently completed a funding round led by H&M Group and including players such as Adidas and Zalando, during which it raised €30 million ($35 million) to boost production at its pilot plant and prepare for building its new 30,000 tonnes-per-year flagship factory.[247]

> Fashion companies are setting up grant and venture funds which aim to target specific sustainability challenges, in both their own operations and their supply chains.

Beyond specific funding vehicles, company leaders across all sectors need to give significant attention to resource-reallocation issues. However, there is still a lack of awareness and acceptance of the urgency and scale of the risk and the opportunity. Climate is still not tightly enough integrated into organisational management — too often it is an individual agenda point and siloed into teams, rather than something that underpins every decision and that is supported by executive-level advocacy.

COP26 Goal 4: Work together to deliver on commitments

Fashion companies will need to work together with both upstream partners and downstream retailers to make real progress on sustainability, as well as collaborating with non-fashion companies and technological specialists to catalyse change. No one part of the value chain can make enough impact by itself; meaningful change requires a concerted effort across the industry and sufficient investment must be funnelled into relevant technologies. Brands need to drive sustainable decision-making at the design stage, in their choice of materials, production of waste and adoption of recycling. In many cases, brands and retailers should consider joining together to invest in research fields such as alternative materials and regenerative farming to ensure progress is made fast enough to have a meaningful impact. Coalitions are starting to form across the value chain, including the Aura Blockchain Consortium, supporting the development of product passports for materials traceability and transparency, among other things, and the Higg Index, which aims to standardise the measurement of value chain sustainability. While multi-stakeholder initiatives can divide opinion, industry-wide collaboration will be required to drive progress beyond the current baseline.

Ultimately, business leaders in the fashion industry — as in other sectors — need to increase awareness of the environmental and social impact created by the industry and the end use of its products. This will mean embedding a climate strategy to reach net-zero emissions as a core part of corporate strategy; being conscious that there is a competitive advantage in becoming a leader in sustainability; forming an innovation ecosystem to support the development of new technological solutions; and finally, mitigating for the changes ahead, including the impact on workers and jobs, by building resilience. The agenda set by COP26 for fashion is multifaceted, but it is essential to secure the future of the industry.

Disclosure: As COP26 had not yet commenced at the time of writing, specific outcomes are not reflected in this text.

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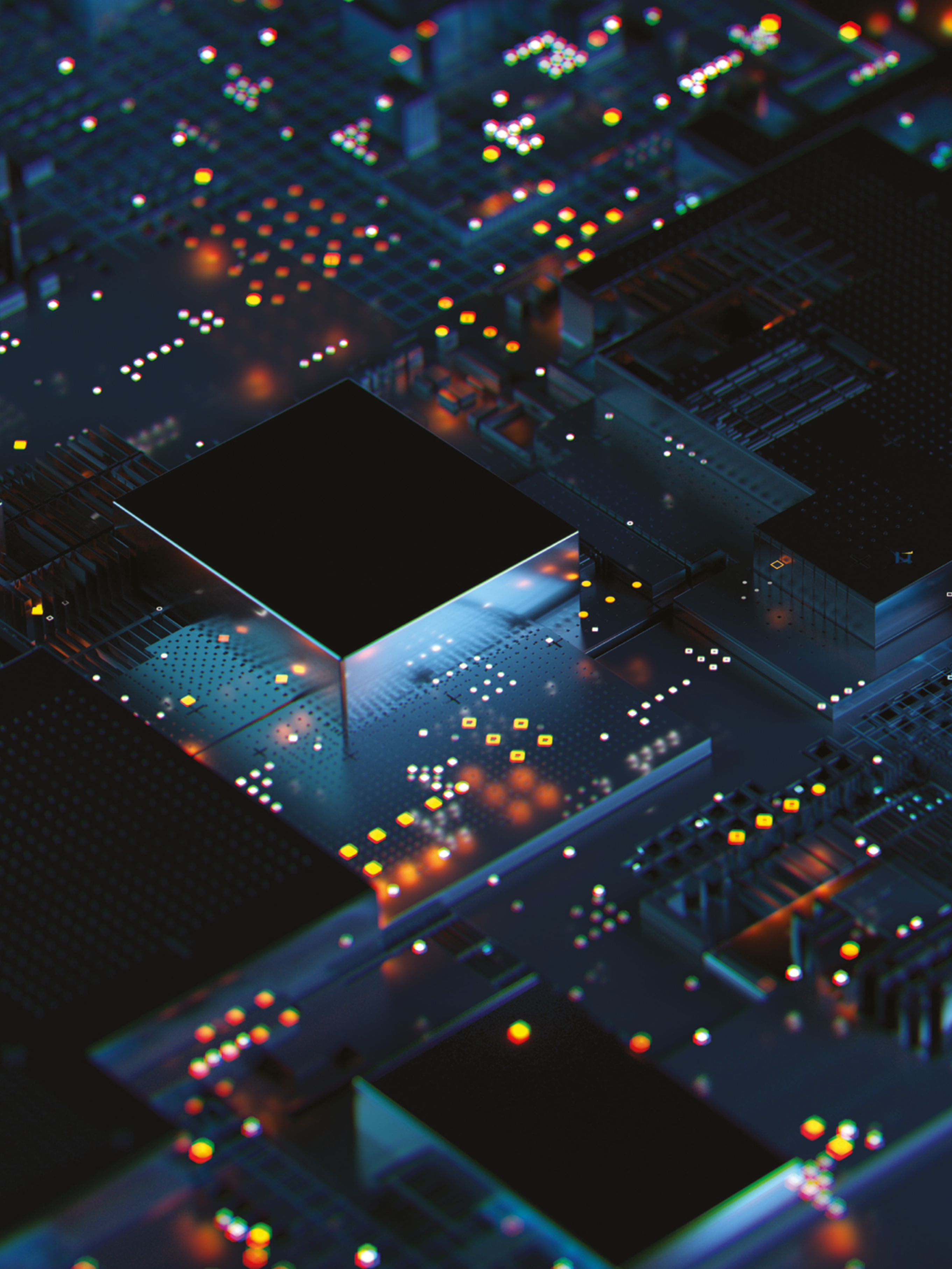


08. PRODUCT PASSPORTS

In a bid to boost authentication, transparency and sustainability, brands are using a portfolio of technologies to store and share product information with both consumers and partners. To get the most from these digital 'product passports,' which can help brands tackle counterfeiting, differentiate themselves and build loyalty by enhancing consumer trust, businesses must coalesce around common standards and engage with pilot projects at scale.

Fashion businesses are pouring investment into digital technologies that allow unique identifiers and other digital information to be added to products. These "product passports" link information that is valuable to both consumers and partners to individual products by leveraging a combination of technologies centred around blockchain and supported by the likes of radio-frequency identification (RFID), QR codes and near-field communication (NFC). Indeed, these technologies are helping businesses to tackle significant industry pain points, such as counterfeiting and the need for more responsible and transparent business practices amid rising consumer engagement with climate change and labour conditions in fashion.

Demonstrating progress in sustainability is particularly important in gaining the trust of younger fashion consumers, as some 43 percent of Gen-Zers say they actively seek out companies that have a solid sustainability reputation.[248] One way to store and transparently share information on a product's sustainability credentials is through technology-based product passports. This information could include details about the product's materials (providing a more detailed and permanent record than traditional sewn-on labels), where and how it was made, and the working conditions at the manufacturer.[249]

For example, Eon's Connected Product Platform allows companies such as Pangaia and Yoox Net-a-Porter to create "digital twins" for their products and private-label collections respectively, containing information that can be updated in real time, such as details on a product's provenance.[250] Similarly, Reformation is partnering with blockchain platform FibreTrace to give customers QR-code access to information on the lifecycles of its denim garments, while TS Designs uses QR-enabled passports to certify garments are made in the US.[251] Though product passports are not a silver-bullet solution to sustainability concerns — as companies still face the challenge of making sure the data they get from suppliers is accurate — they are setting higher standards for supply chain transparency and traceability for fashion.

Product passports are also supporting circularity initiatives like resale and garment-to-garment recycling. In providing detailed data on materials, they facilitate easier collection and sorting of garments for recycling at scale. Like Eon, closed-loop recycling platform Circular Fashion

Digitally generated image of data. Getty images.

has developed an open data standard that can be read by a variety of applications along the product lifecycle. The company has launched a pilot project with fashion brands such as Armedangels, as well as stakeholders in used clothes collection and sorting, to test applications for scaling garment-to-garment recycling (see “Circular Textiles” on page 72).[252] Initiatives such as the European Commission’s European Data Space for Smart Circular Applications and the American Apparel and Footwear Association (AAFA)’s call for the digitisation of apparel and footwear labelling are also supporting these kinds of efforts.[253]

“Consumers often remove labels from their garments, separating the garment from its legally mandated fiber content, identity, care, and origin information for the rest of its life,” wrote AAFA president and chief executive Steve Lamar in a 2020 letter lobbying the US Federal Trade Commission to support digitised labels in a technology-agnostic way. “[This] would reduce the likelihood that the information gets separated from a product. Consumers, even secondhand consumers, would have constant access to the information over the life of the garment, without having to sacrifice the comfort of the garment.”[254]

The growth of resale businesses means it has never been more important to prove authenticity and track a product’s history, particularly in luxury. Analysis from the BoF Insights report “The Future of Fashion Resale” suggests that the resale market will reach $57 billion in sales by 2025, up from $27 billion today,[255] while second-hand marketplace ThredUp estimates that resale will grow 11 times faster than the overall clothing retail sector over the next five years.[256]

As resale grows, product passports will ease operational processes by offering readily available digital twins and standardised product information. These will support authentication and valuation, as well as streamline a process that was historically manual, reducing reliance on authenticator specialists who have been in significant demand on industry jobs boards.[257] For example, one feature of Eon’s digital passport is to suggest the price of a garment based on its history, including who wore and owned the product, as well as repairs history and advice on marketing. Certainly, the digital authentication offered by product passports will help boost trust in second-hand luxury goods and collectibles, meaning resale platforms such as Vestiaire Collective and The RealReal stand to benefit.

The growth of resale businesses means it has never been more important to prove authenticity and track a product’s history, particularly in luxury.

Another application of product passports is in anti-counterfeiting measures. Valued at around $500 billion a year globally, counterfeiting generates more than 60 percent of that value from fashion and luxury goods.[258 259] The China Certification and Inspection Group is among the organisations to be making strides in the battle against counterfeiting with product passport technology. Its “one item one code” technology allows customers to scan a code and see a simple confirmation of a product’s authenticity.[260] Brands are similarly ramping up their efforts. Chanel is launching a digital passport to replace physical authenticity cards in its bags, which will be accessible through a scannable metal plate in the product. This will enable the brand and consumers to immediately recognise authentic products and ensure after-sales services such as repairs are only provided for genuine bags.[261]

Initiatives to develop product passports are emerging in both private and open-source forums. The Aura Blockchain Consortium, a shared private platform launched by companies including LVMH and Prada in spring 2021, leverages unique codes to provide authenticated product records, including ownership history, product authenticity data and provenance of materials. When a customer buys a product, he or she receives an encrypted certificate containing information about the production process. In the open-source space, meanwhile, IBM and luxury and fashion non-fungible token (NFT) platform Arianee are partnering to pilot digital product passports for brands such as Swiss watchmakers Breitling and Vacheron Constantin.[262]

In addition to supporting authentication and traceability, several brands are leveraging these product technologies to drive brand engagement, loyalty and repeat purchasing. Prada is rolling out NFC solutions to offer personalised information and purchasing suggestions to customers who scan NFC tags embedded in products with their mobile devices. Meanwhile, Paco Rabanne has launched its first NFC-enabled fragrance, which allows customers to access digital content such as interactive games and educational features by connecting their smartphone to an NFC chip, and Breitling is leveraging digital passports to share promotions with customers and demonstrate authenticity.[263]

Pressure to establish supply chain transparency and adopt circular business models will fuel demand and help justify scaling pilot projects to mainstream applications.

Looking ahead to 2022, a growing number of fashion brands are set to ramp up development of product passports across various B2B, B2C and C2C use cases. Pressure to establish supply chain transparency and adopt circular business models will fuel demand and help justify scaling pilot projects to mainstream applications. At the same time, the growth of luxury e-commerce and resale markets and the need for authentication will encourage adoption, either as part of a collective initiative (such as Aura) or independently (as with Chanel). While the cost of some product passport technologies has historically been a pain point in scaling, costs are coming down: the price of an RFID tag has fallen by 80 percent over the past decade.[264]

A customer uses a smartphone to scan a garment label. Getty Images.

A success factor for widespread adoption of product passports will likely be the industry's ability to establish common standards. "Brands are competitors, and there's a lack of cooperation," said Tyler Chaffo, sustainability manager at RFID labelling and supply chain solution company Avery Dennison.[265] Currently, some digital passports only operate on closed platforms, while others are open-source and compatible across a range of applications. Still, there are signs that players are starting to converge around a few solutions, with Aura and Arianee frequently cited in many discussions.[266]

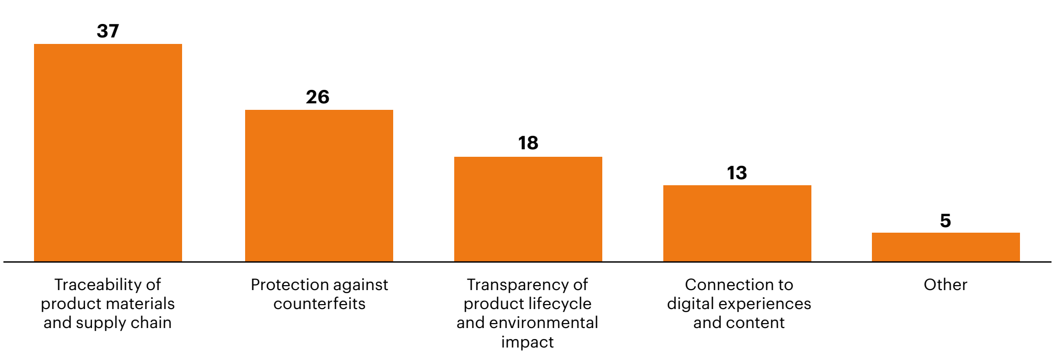
Accessibility and affordability will also be success factors in the burgeoning product passport ecosystem. "It's really important that there's been a democratic process so we could create a governance structure and a standard that works for both smaller brands and big brands," said Timothy Iwata-Durie, Cartier's global innovation director and a member of the Aura board.[267]

From a commercial perspective, product passports will deliver the most advantage to players that can expand their functionality across use cases. For those who get it right, passport technologies will reinforce consumer trust, create exclusivity, support repurchase and enable more sustainable and responsible practices. To encourage scaling, standardisation and compatibility should be top priorities. As these dynamics play out, the key for brands will be to keep pace with innovation and consider collaborations selectively to meet their business objectives.

Exhibit 13:

Effective use cases are emerging for product passports relating to sustainability and protection against counterfeits

MOST IMPACTFUL[1] USE CASE FOR PRODUCT PASSPORTS, % OF RESPONDENTS



1 Respondents ranked 3 most impactful use cases out of 7, based on order of impact from 1 to 3. Only ranking 1 (most impactful) is considered in the exhibit above.

SOURCE: BOF-MCKINSEY STATE OF FASHION 2022 SURVEY

09. CYBER RESILIENCE

As the digitisation of fashion businesses reaches new heights, companies face more threats of cyber attacks and growing risks relating to improper data handling. Amid increased sophistication in cyber crime and rises in consumer and regulatory pressure, brands need to act urgently to shore up their defences and invest more to make digital security a strategic imperative.

Arguably, it has never been more urgent for fashion leaders to build resilience against cyber attacks. Cyber crime is becoming increasingly common and sophisticated, and consumers are shopping online more frequently and enthusiastically, giving businesses access to valuable data in the process. The concurrent growth of both activities leaves companies increasingly vulnerable to risks associated with data security and — ultimately — with company reputation.

The pandemic-induced acceleration of e-commerce uptake has played a role in heightening these risks. With e-commerce's share of global fashion sales nearly doubling between 2018 and 2020 in some regions,[268] momentum has been building for further growth. By 2025, e-commerce is expected to account for one third of all global fashion sales, reaching 40 percent and 45 percent in the US and China respectively. A record number of cyber attacks took place worldwide in 2020, resulting in significant data losses across industries.[269] Retail, including fashion retail, was the fourth most-attacked industry, with companies across different categories and value segments suffering breaches.

Events compromising the integrity, confidentiality or availability of data in retail rose by 152 percent in 2020 compared to 2019, and the number of security breaches increased by 33 percent.[270] Several fashion companies have already experienced severe attacks, such as Hudson's Bay Company's Saks Fifth Avenue and Lord & Taylor, which were victims of the theft of more than 5 million credit and debit card numbers in 2018,[271] and Neiman Marcus, which more recently suffered a data hack on the personal and payment data of 4.6 million online customers in 2021.[272]

"[Cyber crime] is getting worse for two reasons," said Lance Spitzner, senior instructor at the US-based SANS Institute, a cooperative for cyber security professionals. "It's becoming more and more profitable, so cyber criminals are going to follow the money… [and they] are getting much better at it, too. It's become an entire industry now… [with] the cyber criminal community specialising in different fields."[273]

If fashion leaders are to protect their e-commerce growth in 2022 and beyond, they must shore up their cyber defences. That means reducing data risks throughout the data handling lifecycle, through collection, use and disposal, and in operations spanning the entire value chain.

In product development, for example,

processes including design, drafting of manufacturing standards, certification, sketching and prototyping have been widely digitised, and the data is now routinely stored online, meaning that intellectual property (IP) in the digital realm requires more robust protection. With the rise of valuable digital assets such as NFTs, the need to protect online assets will only intensify.

In the e-commerce sales environment, distributed denial-of-services (DDoS) or ransomware attacks could lead to entire website or app shutdowns, directly impacting revenues. For example, one of Brazil's largest clothing store chains, Lojas Renner, faced a ransomware attack on its e-commerce system in August 2021 which resulted in the shutdown of its systems and operations.[274]

Digital risks associated with sales are not confined to e-commerce, however. Stores are increasingly augmented with technology, both on the shop floor and at checkout. Premises with virtual fitting rooms, in-store tablets and customer apps are vulnerable to attacks that can cause operational failures. In food retail, the supermarket chain Coop Sweden was the victim of a ransomware attack on a software supplier in 2021, which led to the closure of around half of its physical stores. The attackers demanded $70 million to restore data from all companies affected by the attack.[275] Similarly, South Korean fashion conglomerate E-Land suffered a ransomware attack in 2020 that caused 23 of its 50 stores to close.[276]

Another critical weak spot for fashion businesses is in customer data collection and handling. With the personalisation of customer experience increasingly playing a role in online interactions and companies seeking out an even wider array of data points to inform which products are brought to market, customers are sharing more personal data than ever before. This includes their names, addresses, location history, preferences, payment card data, shopping history, loyalty programme information and even information about their body shape and size. Not only does this increase the risk of improper data handling internally, it can also expose companies to risk externally when they share customer data with third parties — and when those third parties are located in different legal jurisdictions, they are subject to different privacy and data laws.

Another critical weak spot for fashion businesses is in customer data collection and handling.

The shift to direct-to-consumer business models has both increased the potential to collect consumer data and made brands more vulnerable to breaches and attacks. In September 2021, fashion and beauty subscription service FabFitFun agreed to a monetary settlement of $625,000 in response to a claim that it failed to adequately protect and secure consumer data against hacker data scraping, which resulted in a data breach that compromised customers' payment card information.[277]

Attackers can harvest such data to sell to third parties or to attack customers directly. Furthermore, fashion brands' presence on a growing array of social media platforms across international markets exposes both companies and employees to additional threats, including the accidental or deliberate leaking of data that could cause harm to brands.

"Whatever cyber protection you had last year, last quarter, last month, yesterday, it's not going to be enough for tomorrow," said Stefan Larsson, chief executive of PVH Corporation, the parent company of Calvin Klein and Tommy Hilfiger. "To me, it starts with an awareness that the risk is… increasing, and getting really close to it, [and then] getting humility across the organisation that this is a continuous ongoing work of improvement."[278]

Alongside financial and reputational drivers, there is growing regulatory pressure on fashion companies to tighten cyber and data security, largely sparked by Europe's General Data Protection Regulation (GDPR). The consequences for non-compliance can be severe. In July 2021, a Luxembourg government entity alleged that the EU law had been breached by Amazon, prompting it to level a $886.6 million fine against the e-tailer.[279]

In the US, one example of increased legislation is the California Consumer Privacy Act (CCPA) which took effect in July 2021. It gives consumers the right to know what personal data a company has access to and who it is shared with.[280] In Brazil, the Lei Geral de Proteção de Dados (LGPD) came into force in 2021. The law imposes penalties of up to 2 percent of annual revenues on companies that fail to protect customer data.[281] Meanwhile, China's new data security law which came into effect in November 2021 will regulate how companies collect and handle personal data. It also aims to ensure data is protected when transferred outside the country.[282]

Alongside financial and reputational drivers, there is growing regulatory pressure on fashion companies to tighten cyber and data security.

"There's a great deal of confusion, because there are so many standards out there [across different jurisdictions]... as well as a desire to — if we can — get global harmonisation, or at least within the US have a federal standard that supersedes state standards," said Susan Scafidi, founder and academic director of the Fashion Law Institute at Fordham Law School in New York. "Hanging over all of this is this question of who owns our personal data, and who has the right to exploit it, and how."[283]

There is evidence that consumers are increasingly aware of their data rights. In 2019, around 60 percent of European consumers knew that rules exist to regulate the use of their data, an increase from around 40 percent in 2015.[284] However, consumer attitudes remain uneven across jurisdictions. Consumers in the US and Europe are more concerned about corporate accumulation of personal data, while those in Brazil and China are more comfortable trading data privacy for personalised services.[285]

In aggregate, the costs of data breaches and ransomware attacks are significant. Direct costs could include penalties and fees, lawsuits, remuneration to customers and the cost of recouping data. Experience shows that significant data breaches can cost companies tens of millions of dollars.[286] There are also indirect costs associated with a potential loss of consumer trust and the struggle to acquire new customers following an incident.

Though complex cyber security measures often require significant investment, there are ways for SMEs and companies with fewer resources to take steps to improve their security. According to Spitzner, since the majority of attacks are still somewhat rudimentary, company leaders should at least focus on the basics. "If you don't know where to start, start improving your defences in phishing and passwords," he said.[287]

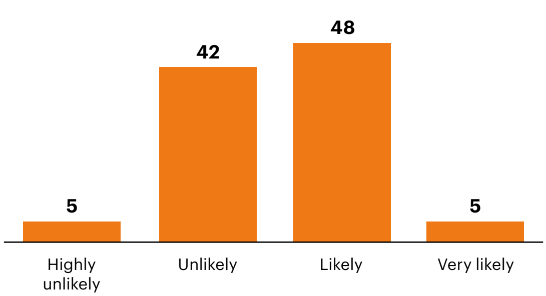
In an increasingly complex online ecosystem, there is an imperative for fashion companies to boost their operational resilience when it comes to cyber security and allocate a greater proportion of their budget to such defences. That means assessing and actively managing cyber and data risk exposure in the business itself, its third parties and its value chain. Leaders will need to take a risk-based approach, building in-house knowledge and resources while also considering leaning on external support from cyber security firms. Other industries have concentrated these efforts around a dedicated role such as the chief information security officer, who closely ties into legal and privacy teams.

Data is becoming both a strategic asset and a source of financial, reputational and operational risk. To meet customer expectations and comply with regulation, companies should put in place clear standards for the collection, use and storage of data. Moreover, they need to increase awareness of — and accountability for — threats while testing their cyber resilience through initiatives such as training frontline personnel on the sensitivity and handling of data. To prepare employees for the occurrence of a breach or attack, they should regularly organise cyber-attack simulations to test their response practices in real time, including the handling of communications to internal and external stakeholders. While there are many competing items on the C-suite agenda, cyber risk cannot be neglected.

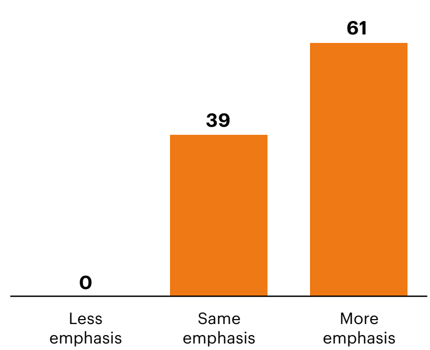
Exhibit 14:

Investment in cyber security and data handling has ramped up, reflecting the risk perceived by fashion executives

LIKELIHOOD OF EXPERIENCING A SIGNIFICANT CYBER ATTACK IN 2022, % OF RESPONDENTS



EMPHASIS PLACED ON CYBER SECURITY AND DATA HANDLING COMPARED TO PREVIOUS YEAR, % OF RESPONDENTS



SOURCE: BOF-MCKINSEY STATE OF FASHION 2022 SURVEY

Five Imperatives to Protect Fashion Businesses from Cyber Risk

In an increasingly digitised fashion economy, cyber risks are rising fast. To protect their customers, business operations and creative assets, fashion companies need to strengthen their defences, test regularly and embed cyber resilience into decision-making across the business. The benefits of getting this right will include both a reduction in risk and an uptick in performance.

by Benjamin Klein

Cyber attacks and data breaches are among the top risks for fashion companies, their customers and the wider economy. The theft of corporate, customer and employee data or funds can reverse years of hard work, undermine relationships and have a significant impact on reputation and performance.

The number of cyber incidents — including attempts to gain illegal access to a system, network, infrastructure or device for the purpose of causing damage or harm — is rising fast. Publicly reported US data breaches were up 38 percent in the second quarter of 2021 compared with the first quarter, and breaches in the first half of the year alone reached 76 percent of the total reported in 2020.[288]

Cyber security risks exist across a range of fashion industry processes, from digital design and data analytics to online transactions and supply chain operations. Many back-office systems have only recently been digitised, meaning they present a potential point of weakness for fashion leaders and security teams who had not previously been required to identify, assess and mitigate potential risks in those areas. Indeed, shifting ways of working create constant challenges, requiring flexible decision-making muscle and continuous re-invention of defences. There are two recent evolutions in fashion industry practices that have increased cyber vulnerabilities.

The first is a movement toward more agile ways of working. New products and services are increasingly developed and brought to market through fast-paced iterations using agile methods, where rapid timelines often do not allow for rigorous risk checks. Security teams must be involved early in the development process and embedded into the full digital lifecycles of new products and services. The second is the ongoing evolution of technologies. Increasing use of cloud computing, artificial intelligence and machine learning is exposing companies to more cyber risks by widening the scope for attack. Security teams must be innovative in finding ways to apply common security patterns and methods to new technologies.

Cyber risk is on a long-term upward trend that accelerated during the Covid-19 pandemic, partially as a result of widespread adoption of work-from-home patterns and technologies and soaring demand for e-commerce. Indeed, online retail has been one of the most attacked sectors over the past year, accounting for 10.2 percent of all attacks across industries.[289] Given the growing frequency and severity of incidents, regulators are requiring businesses to protect themselves, their partners and their customers, and punishing those that fail to do so. Europe's General Data Protection Regulation (GDPR) imposes fines for non-compliance of as much as 4 percent of a company's global annual revenues.

A challenge for companies looking to invest in cyber defences is that the cost of initiating an attack is significantly lower than that of protection. This creates an asymmetric battlefield in which hackers, companies, state-sponsored agencies and other perpetrators can enter systems with relative ease. Moreover, for victims, the cost of being attacked continues to rise. The average cost of a data breach rose by nearly 10 percent year on year in 2021 to $4.24 million, the largest single annual increase in seven years, according to IBM's Annual Cost of Data Breach Report 2021.[290] In addition, the longer that systems remain compromised the more the costs mount.

> A challenge for companies looking to invest in cyber defences is that the cost of initiating an attack is significantly lower than that of protection.

Across industries, corporate approaches to cyber security are maturing, with companies acquiring new capabilities and bolstering their resilience. Banking and healthcare are among the most mature industries when it comes to cyber resilience, while fashion has a long way to catch up. In response, fashion decision-makers need to adopt a dual mindset, reconciling short-term needs created by the pandemic with the longer-term demands of the digital economy. To increase resilience, security should be embedded into products and processes, while customers, partners, third parties and regulators should also be incorporated into enterprise-resilience management.[291]

The rewards of doing so are clear for decision-makers: there is a direct relationship between cyber resilience and business performance. According to a recent McKinsey survey, higher cyber security maturity correlates with better margins, so the payoff from strong risk management extends beyond security.[292]

A successful roll out of improved cyber capabilities should be predicated on action across five key areas:

Identify the playing field and risk environment.

Cyber security leaders should focus on identifying relevant cyber risks (including potential "black swan" events) across their value chains. That starts with understanding legal and regulatory ground rules, and moving to a risk-based approach. This recognises that not all assets are created equal, and not all can be equally protected. It is vital for business leaders to take a global view of both the company's operations and its supply chains, and to communicate cyber security requirements to suppliers and third parties. Insurance against cyber attacks is an option, but it is worth reading the small print; there are likely to be areas of risk that are not covered, and market conditions are changing rapidly.

Build capabilities to prevent cyber attacks.

Rules and standards should be developed (such as acceptable use policies for email and anti-phishing guidelines) and technical prevention measures should be deployed across systems, including data encryption and next-generation firewalls. While some systems may need an extra level of protection, a general baseline is essential, such as keeping software up to date and regularly scanning systems for vulnerabilities. Where the cyber risk extends to production and manufacturing systems or other connected devices, measures should be expanded into those areas, too.

Reinforce the ability to detect and respond to cyber attacks.

The traditional focus of cyber security has been on prevention, but the spotlight is now moving towards detection and response, acknowledging that attackers will inevitably succeed in breaching systems. Internally, that means closely monitoring systems and applications, as well as encouraging employees to report suspicious activities. Customers, partners and third parties should be fully incorporated into both detection and response measures. Externally, businesses should keep a close eye on cyber threat intelligence and be on constant alert, even if their own mechanisms have not yet triggered an alarm.

The traditional focus of cyber security has been on prevention, but the spotlight is now moving towards detection and response.

Clarify responsibilities across the business.

Clear roles and responsibilities are vital to cyber resilience. Companies need to define what "good" looks like, who owns which part of cyber security and how relevant capabilities and skills should be developed. It is essential for the company's front line personnel and anyone who is not an IT or security professional to understand their role in identifying and mitigating cyber risk, and to know what level of support they can rely on. Some companies have created the role of chief information security officer (CISO), an executive who defines and leads the overarching approach to cyber security, establishes central cyber security capabilities and helps to build capabilities across the business. While companies will need to build in-house capabilities in certain areas, they can also consider external support.

Simulate the worst case and build muscle memory.

Leading organisations test their plans and prepare for the worst by carrying out attack simulations. The aim is to assess decision-making, ensure clarity of roles and responsibilities, including decision-making power, and identify weaknesses. This enables companies to develop an effective response mechanism and improve upon their reaction speed in the event of a real attack.

Companies that lead in cyber security are defined by their outstanding performance in several key areas, including maintaining a low "click rate" in employee phishing programmes;[293] regularly revisiting and updating cyber security priorities; deploying solutions for managing applications; scanning the IT environment for vulnerabilities; and sourcing intelligence on threats. As an overarching principle, senior managers should incorporate cyber risk into all decision-making. In this way, they will get on the front foot and ensure the organisation's defences are as resilient as possible.

The author of this article focuses on cyber security strategy and transformation at McKinsey. This article draws on a larger body of research on cyber security. The latest report in this series is Organizational Cyber Maturity: A Survey of Industries.[294]

10. TALENT CRUNCH

Companies that rely on brand appeal or the allure of fashion to attract and retain talent will need to raise their game as competition from both within and outside the industry intensifies, leading to more vacancies next year. As employees from upper management to the retail front line reconsider their priorities, companies must refresh their talent strategies for an increasingly flexible, diverse and digitised workplace.

Fashion companies face a talent deficit in the year ahead.[295] Amid all-time-high vacancy rates, businesses are struggling to attract and retain talent — particularly in digital, creative and commercial roles. Employees now have more choice than ever about where, when and how to work in a rapidly evolving job market. To complicate matters further, shifting employee priorities are changing the way people think about job satisfaction. As a result of these and other challenges, there will continue to be a shortage of interested, qualified workers in 2022.

Fashion's public image is only adding to the challenge. Employee concerns over the industry's environmental and social impact, in addition to inadequate progress on diversity, equity and inclusion (DE&I), are having a real effect on its desirability.[296] Indeed, 49 percent of fashion professionals believe the industry has lost some appeal as an employer in the past 18 months, a BoF survey shows, with the industry's reluctance to change and poor sustainability credentials cited as common reasons. In the C-suite, the proportion rises to 56 percent.[297] Given these attitudes, fashion companies need to adapt to stay competitive, improving employment conditions and reimagining workplace cultures to reflect changing talent needs.

"There [may be] a perception among some fashion companies that they are 'too big to fail,' … [or a notion that employees should feel] 'lucky enough to be here,'" said Caroline Pill, London-based partner at fashion and retail executive placement firm Kirk Palmer Associates. "[But] people are now attracted to [factors like] 'what is my impact in the bigger scheme of things?' [so]… companies who are not going to adapt are going to struggle."[298]

One contributor to the talent crunch is the impact of the Covid-19 pandemic on business models. With e-commerce's share of global fashion sales nearly doubling between 2018 and 2020 in some regions,[299] as even digital laggards got in on the act, the imperative to secure the best digital talent became more urgent.[300] With online acceleration came a plethora of new vacancies, as companies scrambled to hire for roles such as authenticators for fashion resale platforms, analysts and data scientists, reflecting brands' increasing emphasis on big data.[301] Other specialist roles, such as those relating to sustainability, have also proved challenging to fill.

At senior levels, brands saw a wave of resignations in 2021, with some company leaders leaving fashion for other sectors like technology.[302]

A fashion employee working from home. Unsplash.

Indeed, a significant proportion of C-suite executives remain on alert for opportunities in other industries, with 34 percent saying they have considered leaving the fashion industry in the past 18 months.[303] This is a common sentiment across job levels, with nearly half of all fashion professionals in the BoF survey reporting that they have considered moving to another sector.[304] Among this group of potential leavers, 60 percent cite a desire for a deeper sense of purpose as one of their top three reasons, followed by 45 percent citing better salary and benefits.[305] Tellingly, only 14 percent of this group indicate that industry prestige is one of their top three reasons to leave or remain in fashion.

Brands saw a wave of resignations in 2021, with some company leaders leaving fashion for other sectors like technology.

These trends are reflected in the wider economy. Across sectors, a significantly higher proportion of the global workforce is considering leaving their employer this year compared to previous years. Coupled with the specific challenges facing fashion, this suggests a refreshed approach to employer branding and retention strategies will be required in the year ahead.[306] In particular, revised policies will be needed on the front line.

Retailers have struggled to staff their stores and distribution centres in 2021, while rising e-commerce order volumes have challenged in-store fulfilment.[307] Additionally, there were waves of redundancies in the same year amid widespread company restructuring and store and department closures. As a result, some workers re-evaluated their priorities and opted to move away from arduous, low-paid work.

One critical factor in the talent crunch is wage levels: 51 percent of fashion professionals in the BoF survey rate the industry's competitiveness in salary and benefits as "poor" or "very poor."[308] With many retail floor and entry-level jobs offering close to minimum wage at a time when inflation is set to rise in major economies, attracting and retaining staff has become a real challenge.[309] Meanwhile, on the first rung of the career ladder, unpaid internships are still commonplace in the US and elsewhere, despite many other industries largely ending the practice. While these challenges are likely to continue throughout 2022, some companies are taking steps to secure a pipeline of future talent, such as LVMH, which plans to recruit 25,000 people under the age of 30 across internships, apprenticeships and permanent positions by the end of 2022.[310]

In e-commerce, negative headlines about low wages and poor working conditions have hit multiple e-commerce companies around the world.[311] At some digital giants in China, a new generation of employees and consumers are campaigning against excessive "996" work culture, prompting both pay increases and local labour regulator interventions. Pressures to increase minimum wage in the US have resulted in some retailers increasing average starting salaries in an attempt to fill vacancies.[312]

In the coming year, fashion companies will no longer be able to rely upon the appeal of their brands or the glamour of the industry to attract talent. Instead, to compete with other sectors, companies will need to reimagine their talent strategies and move away from some unhealthy entrenched practices, such as hiring from inner circles. In addition, they should broaden their talent pools, embrace objective candidate assessments and leverage cutting-edge software, such as resume screening and job simulation tools, to safeguard fairness.[313]

Post-recruitment, leading companies will foster a sense of belonging and equity of opportunity, engaging more closely with employees to develop comprehensive recruitment, retention and inclusion policies. This will include clearly articulating their corporate purpose, values and career development opportunities.

In 2022, authenticity, flexibility and employee wellbeing will prove to be stronger pulls than ever. Some companies have already made public moves to demonstrate these values: Nike closed its offices for a week to give staff a "mental health break,"[314] while Tapestry plans to extend remote working as long-term solutions for some employees.[315] Hybrid home and office working can also boost loyalty. Some 46 percent of fashion respondents to the BoF survey say flexible working is one of their top three most important factors when choosing to remain with their employers.[316] Hybrid working is set to become table stakes in some markets, alongside flexible working hours, and reluctant or slow-moving brands are likely to lose out to their more adaptable peers.[317] Where hybrid working is not possible, on-site employees will demand other flexible conditions.

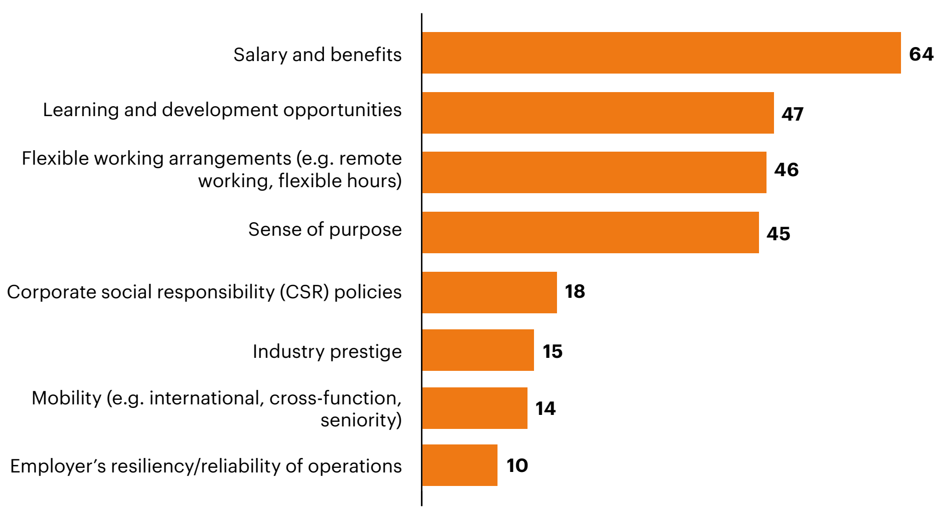
In 2022, authenticity, flexibility and employee wellbeing will prove to be stronger pulls than ever.

Employees today want their employers to reflect their values, meaning that a company's position on corporate social responsibility (CSR) issues, including sustainability and DE&I, will play a big role in attracting and retaining talent. Indeed, one recent study revealed that 64 percent

Exhibit 15:

Employees cite learning and development, flexible working and sense of purpose as important retention factors after salaries

MOST IMPORTANT [1] CONSIDERATIONS FOR EMPLOYEES IN 2022, % OF RESPONDENTS



1 Respondents selected top 3 most important factors when choosing to remain at their current employer or to seek employment elsewhere.

SOURCE: BOF COMMUNITY SURVEY 2022

of Millennials said they would not take a job if the employer did not have a strong CSR policy.[318] In addition, some 83 percent say they would be more loyal to an employer that helps them contribute to social and environmental causes.[319] That said, when putting their values into practice in different markets and working cultures, companies need to ensure they take local sensitivities and priorities into account.

"[Our values] are not different in any region [and] that's very important to us... but there may be nuances to the way that a goal is achieved... [in markets as distinct as China and Brazil, for example, so we have] a level of independence in each geographical region, to do what's right by that culture and that country. The end goal is still aligned," said Sian Keane, chief people officer of luxury e-tailer Farfetch.[320]

"[We have] a level of independence in each geographical region, to do what's right by that culture and that country."

There is plenty of evidence to show that gender-diverse and ethnically diverse companies financially outperform their peers.[321] However, there is still little diversity at the top of fashion companies, with senior roles regularly dominated by white men — one of the only exceptions being the chief diversity officer role.[322] Some 42 percent of fashion professionals rate the industry's performance as "poor" or "very poor" in prioritising DE&I as a core value, the BoF surveys shows.[323] According to a separate survey by the Council of Fashion Designers of America (CFDA) and PVH, industry professionals most frequently describe the state of DE&I in fashion as "evolving" and "improving," while less than half of respondents believe actions taken in 2021 will lead to lasting change.[324] Furthermore, some 50 percent of employees of colour say that a career in fashion is not equally accessible to all qualified candidates.[325]

Still, some companies are taking steps to show employees, consumers and investors that improving DE&I is a priority. In 2021, Target and Nordstrom were among the companies to publish more detailed employee demographic information, taking responsibility for the lack of diverse representation at leadership level and committing to regular updates on progress. Prada, working with the Dorchester Industries Experimental Design Lab, launched a three-year programme for artists of colour, aiming to recruit talent from outside the company's regular Italian fashion school recruiting grounds.[326]

Over the coming year, the fashion industry's progress on DE&I and sustainability will continue to be put under the spotlight, with brands held accountable by their employees for putting their public values into practice.[327] Listening and responding to these shifts will be crucial for many brands that are aiming to attract a new, diverse generation of talent. Companies that lose momentum and fail to demonstrate progress, conversely, could end up closer to the bottom of employer league tables. These measures are also key to ensuring the relevance of their brands with customers.

While many of the forces currently shaping the fashion industry employment landscape have evolved slowly over time, there is now an urgency to implement changes. Companies that have long relied on the inherent allure of the industry and the power of their brands to secure the best talent will need to accelerate their efforts to improve workplace culture — ensuring that employees are sufficiently represented in key decision-making processes and that the company is "walking the talk" when it comes to demonstrating their values. In the years ahead, these actions will draw a line between employers that win the battle for talent and those left behind.

Sportswear and Luxury Emerge as Star Sectors Amid Broader Value Destruction

As the industry comes to terms with record levels of value destruction, a subset of players tapping into shifting consumer behaviour and resilient geographies will consistently outperform the market.

Key Insights

- The impact of the pandemic in 2020 meant the industry posted negative economic profit for the first time in at least a decade, causing record levels of industry consolidation in 2020 and 2021.
- A record 69 percent of fashion companies destroyed value in 2021, reaching new depths of negative economic profit and dragging down overall industry performance.
- Fashion's recovery looks set to be V-shaped, as performance in the first half of 2021 points to a possible return to positive economic profit by 2022.
- The companies on this year's 'Super Winners' list remained relatively stable in comparison to the list published in The State of Fashion 2020, with particularly strong performance from sportswear and luxury players.

The McKinsey Global Fashion Index (MGFI) offers a bird's-eye view of the fashion industry, tracking financial development and value creation across regions, value segments and product categories. The index, comprised of a proprietary data set of over 350 public companies, was created to track the industry's performance through the key financial metrics that provide decision-makers with an informative and holistic benchmark.

In this sixth edition of the MGFI, we continue our exploration of economic profit — a measure of value creation defined as operating profit less adjusted taxes and cost of capital. The metric measures absolute value created over time, taking into account how much each company invests to generate its performance. First, we unpack 2019-2020 economic profit composition and development across the industry. We then explore the devastating impact of Covid-19, which has caused value destruction across the industry. Finally, we look at stock market valuations and their implications for what it will take to succeed in 2021 and 2022. This year, we revised our analysis of drivers of economic success (which we did not assess in The State of Fashion 2021 due to the pandemic) and determined which companies are the industry's "Super Winners." The deep analysis of these leading companies extrapolates the driving forces behind their success and explains how these forces have evolved over time.

Looking Back at 2020

The fashion industry posted significant revenue declines in 2019-2020, and companies were unable to compensate through significant adjustments to costs or capital intensity. Within our sample of listed companies, revenues declined by 14 percent, although losses in the rest of the industry are estimated to be even more severe, particularly as a few large players pulled up the sample average. As a result of these drops, average earnings before interest, taxes and amortisation (EBITA) margins declined by 3.4 percentage points to 6.9 percent, the lowest levels in the 10-year period. Invested capital fell by 6 percent, while capital intensity rose from 75 percent in 2019 to 83 percent in 2020.

As a result of these economic challenges, the industry posted negative economic profit in 2020, declining to minus 63 percent of 2010 levels; a momentous decline of 133 percentage points compared to 2019.[328] With this unprecedented destruction of economic profit, around 7 percent of listed companies left the market from January 2020 to September 2021, either due to bankruptcy or consolidation through acquisition. This rate is roughly three to four times higher than the average exit rate observed prior to 2020.

In September 2020, for the previous edition of The State of Fashion report, we predicted a drop in economic profit of 93 percent for the full year of 2020, but the outcome was much more devastating than originally anticipated. High consumer and investor confidence in September were soon replaced by a winter of lockdowns, second and third waves of Covid-19 infections and a significant hit to retail.

Signs of a V-Shaped Recovery

Despite the losses experienced in 2020 and 2021, investors are optimistic about the industry's earnings potential, ascribing some 43 percent of enterprise value to reported earnings projections discounted to perpetuity in 2021,[329] and 57 percent to future earnings growth. In most other consumer industries, this ratio is typically closer to 50:50, which suggests investors in the fashion industry are bullish on its value-creating potential in the long run. Still, to drive long-term value creation, fashion companies have their work cut out. The pressure is on for decision-makers to focus on scaling growth, as well as finding operational and capital efficiencies.

Recent evidence suggests that the worst is over in many markets, with positive signs that the industry is delivering on investor expectations. In the first half of 2021, 280 listed companies that published results reported aggregate top-line growth of 5.3 percent, compared with the same period in 2019. The luxury segment outperformed, posting growth of 16 percent, compared with the rest of the market at around 4 percent.[330] Digital pure play companies also outperformed, as did sportswear brands and some discounters. On the other hand, offline players such as large department stores and some mid-market fashion brands lagged.

Among the same cohort of companies, net operating profit after tax was up 22.7 percent from 2019 levels in the first half of 2021, resulting in a corresponding aggregate 1.4 percentage point improvement in margins. Looking ahead to the remainder of 2021 and beyond, profits are expected to see a stronger recovery than revenues because the cost base remains lower than 2019. This follows significant cost cutting in 2020, much of which will persist for the next few years. However, cost uncertainties will remain in the short to medium term, as input cost rises due to ongoing supply chain congestion could temper margins.[331]

Given the significant declines in invested capital in 2020, we could assume that stronger revenues and operating profits have been achieved with less invested capital in 2021 than in 2019. Total invested capital fell by 6 percent between 2019 and 2020, partly because of bankruptcies and restrained investments. The evolution of investment patterns over 2021 also remains uncertain however, partly because market consolidation could contribute to a rise in invested capital through creation of goodwill.

Overall, strong revenues and operating profits combined with potentially lower invested capital in 2021 means we anticipate positive economic profit overall in 2021, with some possibility that it will even exceed 2019 levels. However, factors such as the impact of ongoing supply chain disruptions mean that predictions are inherently uncertain, as some companies are already noting.

Growth observed among listed companies in the first half of 2021 is in line with the McKinsey Fashion Scenarios predictions for the full year, which takes a more conservative view of H2 2021 in light of supply chain concerns, and accounts for lower top-line performance of non-listed companies and revenues lost through bankruptcies. Overall, McKinsey Fashion Scenarios project the total industry to reach 96 to 101 percent of 2019 levels in 2021, with luxury driving recovery and reaching 105 to 115 percent in the same period.

Further Polarisation — New Depths in the Industry's Bottom Performers

Until this year, the evolution of economic profit within performance quintiles has reiterated an established narrative: economic profit gravitating towards the most successful companies.

While all quintiles saw declines in economic profit in 2020, the relative impact on the top versus the bottom contributed to further polarisation, driven by dramatic declines in economic profit for the bottom quintile, which fell by 109 percentage points from 2019 levels. This is relative to the 60-percentage-point drop of the top quintile. Unlike previous years, where the story was one of "winners take all," the story in 2020 shifted to one of severe value destruction.

Similarly, 2020 revealed a steadily expanding group of value destroyers that delivered negative economic profit. Accelerating a trend that has been developing for a decade, a record 69 percent of companies destroyed value in 2020, compared with 61 percent in 2019 and just 28 percent in 2011. Underlying this longer-term polarisation is a continuing shift in consumer behaviour, with the highly populated mid-market suffering at the expense of a relatively few dominant luxury, value and sportswear players.

Companies that transformed from value creators in 2019 to significant value destroyers in 2020 strongly represented the mid-market, alongside discount players and department stores, which all rely heavily on physical channels and therefore have been disproportionately impacted by lockdowns. As in-store retailing rebounds, some of these players will return to value creation, as already observed in the discount segment.

Last year, we warned that the increasing share of value destroyers could imply that companies will struggle to re-finance, as they cannot earn their cost of capital. This has played out in the 7 percent of fashion companies in our dataset that either filed for bankruptcy or were sold in 2020 and 2021. Given the high proportion of value destroyers, financial distress and resulting consolidation is likely to continue.

Drivers of Value Creation in 2020

Luxury and sportswear have consistently contributed a large share of positive economic profit to the fashion industry, each contributing some 20 percent of economic profit among value creators every year in the past five years.

Sportswear has been growing steadily for some time, with total economic profit by the sector's value creators growing every year from 2012, doubling in total over the eight-year period. Given the destruction of value in other sectors, 2020 was a breakout year for sportswear, with 42 percent of positive economic profit contributions in the industry coming from sportswear companies and making it the largest contributor by far.[332] Showing their resilience, 14 sportswear companies were value creators in 2020, and 15 were value creators in 2019. By comparison, in many other sectors, the propensity to become value destroyers in 2020 was much higher.

The geographic distribution of economic profit contributions in sportswear is also shifting eastwards. China-based companies contributed 16 percent of positive economic profit in 2020 compared to 9 percent in 2017, driven largely by Anta Sports and Li Ning. Outside China, the largest value creators were North American players, including Nike, Lululemon and Dicks Sporting Goods.

Luxury also demonstrated resilience in 2020. EBITA margins in luxury and affordable luxury dipped from a 10-year average of around 19 percent to 16 percent, but remained within their historic range, contrary to other value segments.

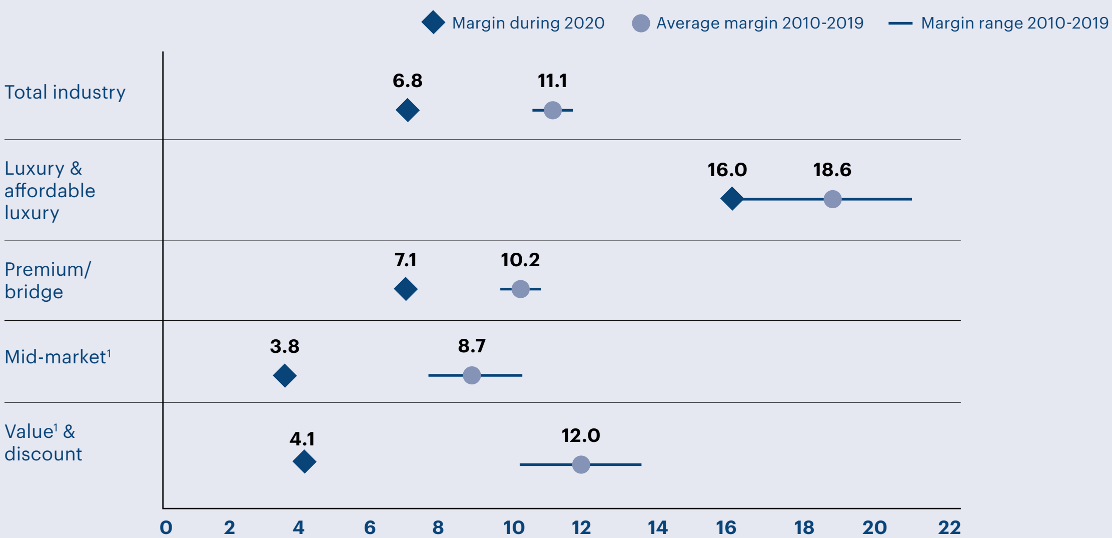
Luxury top lines fared relatively well, with the smallest revenue declines in 2020 compared with other segments. Underlying this was strong performance in China, as well as the fact that most luxury companies succeeded in accelerating digital sales through 2020. Another factor was cost control, where the luxury segment successfully maintained costs roughly in line with revenues, with the aggregate ratio of selling, general and administrative expenses (SG&A) to revenue only increasing by 1.4 percentage points from 2019 to 2020.

Margins in other segments were under pressure in 2020, trending below historic ranges. Within our sample of listed companies, value and discount revenues fell by around 17 percent from 2019, amid weak consumer sentiment and the segments' reliance on physical store networks. The cost of maintaining stores also prevented companies from reducing costs in line with

Exhibit 20:

In 2020, luxury was the only value segment that, as a whole, managed to maintain margins within its 10-year historic range

EBITA MARGINS BY VALUE SEGMENT IN 2020, AVERAGE FROM 2010-2019, AND RANGE FROM 2010-2019, %



1 Adjusted for outliers that are structurally unprofitable due to business model.

SOURCE: ANNUAL REPORTS, MCKINSEY GLOBAL FASHION INDEX (MGFI) revenues, and there was an increase in the share of SG&A to revenue of around 4 percentage points from 2019 to 2020. The mid-market and premium segments, meanwhile, saw revenue declines of 17 percent and 13 percent respectively. However, these segments were able to manage costs more effectively and saw increases in SG&A to revenue ratios of 1 to 2 percentage points in 2020.

Internet retailers also outperformed in 2020 and 2021, reflecting the massive shift to e-commerce. In market capitalisation terms, internet retailers were trading 112 percent higher in September 2021 than in December 2019, compared with the rest of the industry which was trading 28 percent higher. Still, this was a much narrower gap than during the height of lockdowns, when valuations of online players peaked and those across the rest of the industry reached their nadir.

Super Winners — A Mostly Consistent Story

In previous versions of the MGFI, we have highlighted a winner-takes-all trend in the fashion industry that has created a group of "Super Winners." In last year's report, we were unable to publish the list, due to different reporting periods for financial year results, which distorted economic profit results due to varying levels of exposure to the pandemic during the months captured in full-year results. This year, we are taking a different approach, calculating the average economic profit contributed by each company over a two-year period, covering financial years 2019 and 2020. This approach helps to smooth distortions created by market disruption over the past 18 months. To supplement this view, we also ranked the top 20 based on market capitalisation to identify trends emerging beyond current performance indicators.

Our latest group of Super Winners reflects the resilience of luxury and the spectacular growth of sportswear. The top five Super Winners, based on average economic profit over 2019 and 2020, were Nike, Inditex, Kering, LVMH (including Tiffany) and Hermès. The luxury players in this group continue to benefit from demand for bags, luxury jewellery and ready-to-wear from wealthy customers, whose earnings were less impacted by the pandemic and whose funds saved on travel and entertainment were reallocated towards luxury goods. A new entrant on the list from The State of Fashion 2020 report, ranking at number 19, was Moncler with strong growth in China and e-commerce channels.[333] In addition, jewellery players contributed significant economic profit during the period, boosted by Pandora, which saw excellent turnaround performance, doubling their online sales during the pandemic — a result of the previous years' investments in digital capabilities and data, and increased brand desirability.[334]

The changes in category focus of some shoppers accelerated existing strengths in sportswear, athleisure and outdoor brands as people sought out comfortable work-from-home and home workout attire. Sportswear giants Nike, Adidas, Anta Sports and Lululemon remain on the Super Winners list this year, with Anta Sports moving up the ranking and posting more economic profit than observed in the 2020 report, benefitting from Chinese breakout growth and domestic spend on local brands. In addition, all new entrants to the list this year, namely JD Sports, Deckers and Moncler, come from the sports and outdoors category. Other players benefitted from a strong business in underwear, nightwear and casualwear during the period.

Some Super Winners saw declines in economic profit during the period, with market valuations also growing slower than the industry average. Indeed, value and discount players saw earnings drop due to their physical stores halting sales during the pandemic. Additionally, mid-market fashion players saw economic profits decline in 2019 and 2020 compared to 2018, and saw their valuations grow in line with or slower than the industry average. These players saw revenue fall as spending in the category decreased overall. Particularly in Europe and the US, where lockdowns were extensive, shoppers also shifted some of their spend on clothing to essential retailers such as grocers.

Looking Ahead — Big Bets for 2022

This year, we also assessed the top 20 companies by their market capitalisation, to identify where valuations have grown above market levels and understand future trends based on investor expectations. In addition to the continued strength of sportswear and luxury, three additional focus areas for investors were jewellery, Chinese companies and disruptive business models.

Jewellery companies (particularly fine jewellery) saw gains in market capitalisation that reflected overall luxury resilience and rising consumer demand for investment pieces.[335] The branded fine jewellery segment is expected to grow by between 8 and 12 percent from 2019 to 2025.[336] Richemont saw its valuation increase by 40 percent from December 2019 to September 2020, and Chow Tai Fook doubled its market capitalisation in the same period. Titan, a leading Indian jewellery player, realised the fruits of its pre-pandemic investment in omnichannel and continued formalisation of the Indian jewellery market and saw an increase in market capitalisation of 80 percent.[337]

Overall, three Chinese companies, Anta Sports, Li Ning and Chow Tai Fook, were among the top 20 and showed the highest market capitalisation growth across all players. For example, Li Ning increased its market capitalisation by a multiple of 3.9 during the period. These players benefited from the repatriation of Chinese spend as consumers embraced local brands, particularly as global travel was restricted.[338] As travel disruptions are likely to continue through to the beginning of 2023, meaning consumers increasingly shop local via domestic travel and duty-free shopping, China's local fashion sales growth will continue to benefit through 2022 and beyond.

Finally, companies with business models that aligned with accelerated shifts in consumer behaviour during the pandemic are being rewarded. For example, online clothing marketplace Zalando saw its market capitalisation rise by a factor of 1.9 amid surging consumer demand for e-commerce. Majority private-equity owned Burlington also crept into the top 20 on a market capitalisation basis, as investors rewarded its big bets on the value segment, taking advantage of the reshuffle of market share, consumer loyalties and retail space that is likely to continue to play out among players in the industry in 2022 and beyond. Burlington opened 100 discount stores in 2021 alone.[339]

In terms of outright stock market performance, the top 20 by market capitalisation outperformed the rest in 2020, reflecting comparatively lower revenue declines (minus 4 percent, compared with minus 20 percent across the industry). Several of the top 20, and particularly sportswear and jewellery players, even saw revenues rise. The EBITA margins of the top 20 were around 12 percent on average in 2020, compared with 3 percent across the industry. Meanwhile, profit margins of both groups saw similar 3 to 4 percentage point declines.

While the tide is turning with 2021 and 2022 looking significantly more positive for the global fashion industry than the previous two years, the shakeout is not over as weaknesses exposed during the Covid-19 pandemic will continue to plague the industry. However, those that are able to pivot quickly to meet the changing expectations of consumers, while appropriately managing inventory and supply chain costs, will leapfrog ahead into a new dawn of recovery.

Beauty’s Cautious Recovery

After being hit significantly by the pandemic, all categories within the beauty sector are performing strongly, driven partly by burgeoning social commerce channels for which beauty products are perfectly suited. Amid the growth, the sector’s competitive intensity shows no signs of abating, as luxury fashion houses continue to expand their beauty ranges at pace in a bid to boost revenues and attract new customers without eroding their brand values.

by Vanessa Goddevrind, Dale Kim, Sakina Mehenni, Michael Straub, Samantha Phillips and Kristi Weaver

Consumers cut spending on discretionary items amid Covid-19 stay-at-home restrictions, and sales of beauty products plunged. In 2020, global sales fell 15 percent from $538 billion in 2019 to $458 billion. In 2021, as lockdowns ease, the sector is close to reversing that fall. A 13 percent increase in sales to $518 billion is projected for 2021 and, in 2022, sales should top 2019 levels.

Asia Pacific and North America should be the first regions to completely recover 2019 sales performance, followed by Europe, while Latin America, the Middle East and Africa will take longer. China, where the beauty market continued to grow during the pandemic, will pick up speed, fuelled by skin care and colour cosmetics.

In terms of product categories, sales of fragrance and colour cosmetics predictably fell abruptly in 2020. Although both categories are growing again, we expect consumers to continue to indulge in the “self-care” categories of skin care and hair care, which remained in demand during the pandemic. These categories do not rely on in-store trialling and lend themselves well to online discovery and purchase. Skin care will see the strongest performance, growing 22 percent in 2021 and a further 10 percent in 2022. By 2024, we estimate skin care will account for 34 percent of the global beauty market.

One overarching category that both brands and retailers are betting big on is “clean beauty.” The category has grown fast as independent brands claiming to use safe, natural and cruelty-free formulas flourished. Traditional players have started expanding their ranges to meet the demand, with some even reformulating hero products. When Dior launched Capture Totale C.E.L.L. Energy as an update to its established anti-ageing product line, it claimed both eco-friendly packaging and to be made from 85 percent natural ingredients.[340] Retailers have also visibly invested in clean beauty in their choice of brands, products and store layouts. Sephora’s flagship Champs Élysées store in Paris, for example, has a large space dedicated to the category. However, some leading skin care influencers, such as Dieux Skin founder Charlotte Palermino, have expressed scepticism around the clean beauty trend, claiming specifically that non-natural ingredients are not intrinsically harmful. Both her social media posts and her own line of "non-clean" beauty products have proved highly successful.[341]

> **One overarching category that both brands and retailers are betting big on is "clean beauty."**

The pandemic had a varied impact across value segments. The premium segment was hit more in the short-term as its traditional physical channels were closed. The mass segment, however, was not only more readily available online but it also skews more towards the hair and personal care products that better withstood the crisis. Premium products, including those from luxury fashion houses, are nevertheless expected to gain market share in the long run, exceeding their 2019 share by 2023, and growing at 13 percent per annum between 2021 and 2024 (see "Competition Intensifies in Luxury Beauty" on page 128).

In terms of channels, digital continues to grow fast and is taking share from bricks-and-mortar retail. Online sales will account for 23 percent of the beauty market by 2022 and will become the most important channel by 2024. In China, where digital channels are more embedded in the consumer consciousness and integrated into heavily used social apps, we expect more than half of all sales to take place online by 2023. Globally, digital sales constitute a diverse group of channels encompassing social selling on platforms such as Instagram, TikTok, WeChat, Xiaohongshu and others; marketplaces such as Amazon and Lookfantastic; and traditional retail and brand e-commerce sites. Company announcements show the extent to which the beauty industry anticipates a digital future: L'Oréal, for example, has said very publicly that it is aiming for half of its sales to be generated via digital channels.[342]

Physical stores have seen a bounce-back as lockdown restrictions lifted, and some beauty brands have even reinforced their physical presence. In the US, for example, Sephora has opened dedicated spaces in some Kohl's department stores, while Ulta Beauty now sells a curated product range at Target.[343] The nature of beauty products — especially colour cosmetics — means that, while customers will browse online, in-person testing is still hard to beat. As Margaret Mitchell, chief merchandising officer at UK beauty chain Space NK, explains, a customer "may want to try something from a VR perspective on a website, but… that's not replacing coming into a store for a complexion match."[344]

The desire to see and try a product, and the enjoyment of trialling and shopping for beauty products in person, should help to boost physical sales. However, in the long run, all non-digital channels, except travel retail, are expected to maintain market share at best, while most will lose.

One digital channel attracting a lot of attention and investment is social commerce, whereby brands and retailers use social media platforms throughout the sales and marketing funnel to drive discovery, conversion and purchase. Social commerce has been a popular sales channel in China for some years, already accounting for more than 13 percent of total e-commerce sales (see "Social Shopping" on page 65). Meanwhile, in the West, many customers are comfortable with social media for discovery, but sales are yet to take off due to a lack of platform functionality and some hesitance among shoppers. However, times are changing: both customer attitudes and technology are evolving quickly, and brands are starting to capture this opportunity.

The beauty sector is particularly well-placed to maximise the potential of social commerce. It is a highly engaging category: consumers are already familiar with online beauty tutorials, and the majority of Gen-Z and Millennials in the US prefer to discover beauty products through social media ahead of any other channel.[345] Beauty companies

Makeup artist applies eyeshadow during a social media livestream. Getty Images.

must prioritise these new channels and ensure they have the right capabilities in place to ride the next wave of growth by converting social users into social shoppers.

The popularity of social commerce in China is enabled by seamless payment methods within apps such as WeChat. Brands that get social commerce right in this market have seen astonishing growth rates. Revenues at Chinese beauty company Yatsen Holdings Limited multiplied by more than 50 from 2017 to 2020, reaching over RMB 500 million ($78 million),[346] with its local "C-beauty" brand Perfect Diary, which focuses on sales via its social direct-to-consumer model on WeChat, making up the majority of revenues.

Social commerce sales in the West are expected to grow, though the pace of adoption and direction of travel may differ from China, owing to the plethora of platforms in the West and the lower levels of seamless payment integration compared with China. The lack of an established livestreaming culture in the West also means brands will need to devise new strategies to attract customers. Nevertheless, there is potential for growth: half of US TikTok users have purchased a product or service from a brand after seeing it advertised, promoted or reviewed on the platform.[347] Overall, social commerce sales in the US are expected to double from 2020 to 2023, reaching $53 billion.[348]

To succeed with social commerce, brands and retailers will need platforms to deliver the experiences that both they and their customers want. The underlying technology needs to evolve fast to keep pace with trends, and beauty companies must innovate both their marketing and customer engagement techniques as they move customers seamlessly from discovery to purchase.

> **The popularity of social commerce in China is enabled by seamless payment methods within apps such as WeChat.**

Platforms that recognise the potential of the beauty sector are partnering with beauty brands to pilot their latest social commerce offerings. For example, TikTok now offers tools that enable brands to manage marketing campaigns via their existing Shopify dashboards, and is piloting the concept with Kylie Cosmetics.[349] Pinterest is enabling influencers to add shopping links via its Shopify partnership and is specifically targeting the beauty market by deploying augmented reality try-on technology that allows users to test different shades of makeup.[350] Meanwhile, Amazon Live is attempting to re-energise the home-shopping format with livestreaming shows that give influencers the ability to tag promotions, chat with users and earn commission on sales.[351]

Emerging alongside these large and established players are smaller, niche platforms. US beauty shopping start-up Flip, for example, has invested heavily in the short video experience. Launched in 2019, Flip's content is focused exclusively on beauty and includes built-in shopping links for featured products. Flip currently sells more than 200 brands and aims to feature more than 500 by the end of the year.[352]

> **Platforms that recognise the potential of the beauty sector are partnering with beauty brands to pilot their latest social commerce offerings.**

Ulta Beauty, meanwhile, has invested in livestream shopping by partnering with beauty app Supergreat.[353] Supergreat has a large and enthusiastic beauty audience that skews heavily towards young women. Users spend an average of 20 minutes a day on the app, and it has received investment from celebrities such as Hailey Bieber, Kate Hudson and Karlie Kloss. The potential for social commerce has also attracted third-party capital. For example, private-equity firm Permira recently invested in CommentSold, a US-based software company that lets influencers sell directly via livestreams. Permira said that "live selling will be the next wave of e-commerce."[354]

Meanwhile, brands are trialling a wide range of innovative approaches. Luxury cosmetics company L'Occitane, for example, had success in South Korea using KakaoTalk Gift, an offshoot of a popular messaging app that lets users give and receive gifts. In China, Yves Saint Laurent (YSL) Beauté opened a flagship store on Alibaba-owned Tmall. YSL broke records on the platform when it launched in 2018 and continues to make it a priority in China.[355]

Newer entrants to social commerce are also testing fresh ideas. For example, after experiencing high conversion rates with one-on-one virtual consultations offered on its website in 2020, Charlotte Tilbury director of digital Harminder Matharu said, "it is encouraging us to explore social commerce further."[356] Meanwhile, specialist US clean beauty retailer Beautycounter has partnered with payments company Klarna to host a series of livestream shopping events from Beautycounter's Los Angeles flagship store.

The rise of social commerce in the West is no longer a question of "if" but rather "how fast." Brands will need to invest now to remain relevant as customer comfort with shopping on social channels accelerates. Consumers will increasingly seek entertainment and engagement in their shopping experience, and brands will have to prepare for a shortened consumer decision funnel. Content will continue to grow in importance, and brands will need to deliver relevant and entertaining shoppable content paired with seamless e-commerce logistics. Winners will invest early and dive in with both feet to ensure they capture the attention of the Gen-Z consumer.

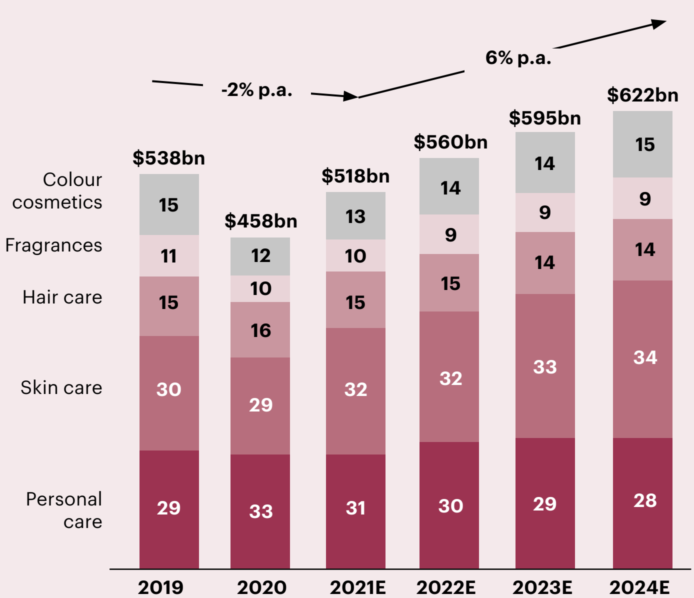
After a challenging couple of years, beauty players should be more optimistic about the future. But even though revenue is expected to grow across all categories, the companies that will secure long-term growth will have clear strategies on which product categories to target and which channels to prioritise. These strategies must sit alongside ambitious and tangible targets on environmental and social sustainability as well as a sharper focus on diversity, equity and inclusion.

Although the picture for the global beauty market in 2022 is relatively bright, players will of course be wary of supply chain issues, and the macroeconomic and geopolitical uncertainty within the broader global economy. These stresses point to a need for prudence, especially for companies with very niche or limited ranges, those who lack a clear purpose-driven story, and those who are over-reliant on offline distribution. At the heart of the mission for the most successful players will likely be a commitment to listen to customers, and to engage with them in a variety of authentic ways across a wide range of platforms.

Exhibit 22:

Global beauty sales are expected to exceed 2019 levels in 2022, with share shifting to skin care

CATEGORY DEVELOPMENT, RETAIL SALES USD BN, % SHARE OF TOTAL



YoY growth

'19-'20	'20-'21E	'21E-'22E	'22E-'24E CAGR
-15%	**13%**	**8%**	**5%**
-33%	22%	18%	7%
-26%	13%	6%	5%
-5%	6%	4%	3%
-16%	22%	10%	8%
-4%	5%	4%	3%

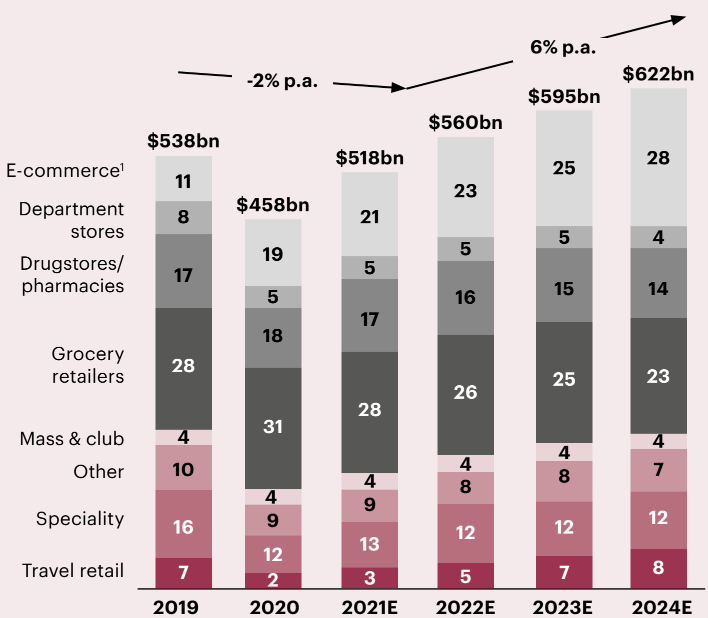
Note: Due to rounding, numbers presented may not add up precisely to 100.

SOURCE: MCKINSEY ANALYSIS BASED ON MCKINSEY GLOBAL INSTITUTE MACROECONOMIC SCENARIOS, EUROMONITOR, NPD, NIELSEN, IRI, AMAZON STACKLINE AND PUBLICLY REPORTED COMPANY FINANCIALS

Exhibit 23:

E-commerce is the fastest-growing channel for beauty sales

CHANNEL DEVELOPMENT, RETAIL SALES USD BN, % SHARE OF TOTAL



YoY growth

'19-'20	'20-'21E	'21E-'22E	'22E-'24E CAGR
-15%	**13%**	**8%**	**5%**
50%	**25%**	**20%**	**16%**
-45%	**10%**	**4%**	**0%**
-10%	**8%**	**2%**	**-2%**
-6%	**5%**	**1%**	**-2%**
-5%	**10%**	**4%**	**2%**
-24%	**14%**	**3%**	**-1%**
-35%	**15%**	**5%**	**5%**
-70%	**55%**	**65%**	**27%**

1 Includes all e-commerce sales (brand.com, retailer.com, marketplace, and buy-online-pick-up-in-store sales)

Note: Due to rounding, numbers presented may not add up precisely to 100.

SOURCE: MCKINSEY ANALYSIS BASED ON MCKINSEY GLOBAL INSTITUTE MACROECONOMIC SCENARIOS, EUROMONITOR, NPD, NIELSEN, IRI, AMAZON STACKLINE AND PUBLICLY REPORTED COMPANY FINANCIALS

Competition Intensifies in Luxury Beauty

The prestige beauty and personal care market is worth $115 billion — approximately a quarter of the total beauty market. It is a lucrative but crowded space, and the growing presence of luxury fashion houses in the market is intensifying the competition. Some have a long-established presence in beauty (Chanel No.5 launched in 1924, after all), but other luxury fashion entries are far more recent, like Valentino Beauty which launched in 2021. Now, as they seek to grow revenues and build brand loyalty among younger customers, almost all the leading luxury fashion brands have a range of beauty products that extends beyond fragrance. In Chanel's case, beauty products are believed to account for a third of its revenues.[357]

However, given the number of players competing in this market, luxury houses will need to target the right sub-categories and listen to their customers, while staying true to their brand.

Skin care is likely to be the next category move for many players. It is a challenging market as consumers tend to be more cautious about skin care products than colour cosmetics. Therefore, according to Mario Ortelli, managing partner of luxury advisors Ortelli & Co., most brands are likely to focus initially on skin care products such as cleansers and primers, rather than the more "science-oriented" skin care categories such as anti-ageing.

To appeal to a sufficiently wide customer base, luxury houses will need to move away from trading solely on a sense of unattainable exclusivity. Today's beauty consumers expect to engage in a two-way conversation with brands. Community-based direct-to-consumer brands such as Glossier and Drunk Elephant have established significant momentum by tapping into customers' desire to be included in the product co-creation process. Luxury houses will therefore need to rethink customer engagement by building or strengthening communities, hosting live events (virtually or otherwise) and seeking out (and being receptive to) feedback.[358]

Working with influencers who can more readily reach their customers is one route, but brands may also consider tapping into the views of younger employees in their workforce — and hiring more young talent like LVMH is doing — to better understand how to target their next generation of customers.[359]

A significant concern for any brand entering new markets and targeting new customer segments is not diluting their brand or confusing their brand values. But expanding into new categories inevitably carries some risk of brand dilution, so it is essential that the essence of the brand remains anchored.

The connection of a luxury fashion brand's DNA to its beauty products may be price-based, with a premium price tag to match its fashion offering, but it can also be more intrinsic. For example, the matte lines of Hermès' Rouge Hermès lipsticks feature shades inspired by its classic Birkin bag, where the texture alludes to the soft leather, while the satin shades pay homage to its classic silk scarves.[360]

The connection should also be apparent and consistent in brand messaging, especially in relation to consumer values around sustainability, gender fluidity and inclusivity. For example, if a brand's fashion shows feature models with a variety of body shapes, or of varying ages, then a beauty campaign that features exclusively young models with flawless skin could muddle the brand's core values for consumers. Similarly, if a brand uses organic cotton in garments and recycled paper for packaging, but then uses parabens for its beauty products, the brands' values can be seen as a mismatch.

The risk of brand dilution should also be a consideration when deciding whether to produce beauty products and categories in-house or outsource expertise by licensing the brand name to a third party. Chanel, for example, produces all its beauty products in-house, while Valentino, Prada and Giorgio Armani license their brands to L'Oréal.[361] Luxury players need to consider the scale of distribution networks, expertise in developing formulations and production capabilities when making such decisions. However, it is not an either/or decision: different stages of the value chain from product development to sales may be better suited to a certain approach. Hermès, for example, develops its skin care and cosmetics products in-house but outsources production to third parties.[362]

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