McKinsey Global Institute

Future of Asia

Corporate Asia: A capital paradox

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The Asian Century has arrived. Today, the region accounts for 42 percent of global GDP in purchasing power parity; and this number is expected to rise to more than 50 percent by 2040. Its share of global consumption grew from 23 percent in 2000 to 28 percent in 2017, and could increase to nearly 40 percent by 2040. Asian corporations now account for 43 percent of the world's largest 5,000 companies, contributing $19 trillion in revenue to the world economy every year. But has this been growth at any cost?

This article is the first of a series that will decode corporate Asia, looking at profits made and lost. We will break down value creation by sector and country and dissect the winning strategies of Asian firms. In this article, we explore the following key messages:

1. Asia was the destination for $1 of every $2 in new investment in the past decade; 43 percent of the world's top 5,000 firms by revenue are headquartered in the region.

2. The capital influx has not resulted in higher economic profit; Asia accounts for half of the deterioration in global economic profits from $726 billion to an economic loss of $34 billion from 2005-07 to 2015-17.

3. Capital intensification of the world accounts for 90 percent of the global fall in return on capital that is driving down economic profit, particularly in Asia.

4. The decline in global economic profitability over the decade largely reflects the cyclical energy and materials sector, European finance, and Chinese capital allocation to value-destroying sectors.

5. However, pockets of economic-profit-generating excellence can be found in several sectors across Asia.

6. The opportunity: Asia could unlock $440 billion of incremental economic profit from two major levers: turning around troubled companies and capturing companies' latent potential to create more profit champions.

Over the past century, corporations in Asia have helped usher in an unprecedented era of economic development and prosperity that has boosted economies and improved the living standards of hundreds of millions of people. We have already witnessed some of the benefits and economic contributions of Asia's corporations, notably stable employment growth, rising incomes, and a range of consumer benefits including lower prices and more available and competitive products. These benefits have been particularly significant in economies that we describe as outperforming because they have sustained substantial GDP growth for at least 20 years. As noted in our 2018 research, Outperformers: high-growth emerging economies and the companies that propel them, a pro-growth agenda coupled with highly competitive large firms have driven this achievement.

However, as we enter a new decade, we recognize that the role of corporations is evolving. Times are changing. No longer are corporations only obligated to answer to shareholders, they are now held against a broader set of stakeholders. Whether these stakeholders are governments looking to build new infrastructure to keep up with staggering urbanization rates or the mass of growing environmentally and ethnically aware consumers; the role that corporations play in society to answer demands is being redefined. In research on 21st century companies later in 2020, MGI will discuss the evolving nature of the firms. For this paper and later papers in the series, we have focused on analyzing firms by using comparisons across sectors and geographies, centering our analysis on the creation of economic value as our key metric.

1. Asia was the destination for $1 of every $2 in new investment in the past decade; 43 percent of the world's top 5,000 firms by revenue are now headquartered in the region.

Asia has experienced a huge wave of capital investment over the past ten years—indeed, the aggregated level of investment has tripled. More than $1 of every $2 in new investment over this period was in firms that call Asia home. In fact, $1 of every $3 was in China.

This investment has evidently helped many Asian companies rapidly scale. We use the share of companies in the G5000—the world's largest 5,000 largest firms by revenue—as a proxy for broader trends in Asia's corporate landscape. In the past ten years alone, Asian companies have increased their share of the G5000 by six percentage points to stand at 43 percent today. That's the largest share of any region in the world. In comparison, Europe has 25 percent of the G5000 and North America (Canada and the United States) has 24 percent (Exhibit 1).

The increased prominence of Asian companies is to be expected given the weight of global economic activity that is shifting toward the region, but it is the speed of the rise is most surprising. The rapid increase in corporate Asia's representation in the G5000 is much more striking given that the entry bar to this exclusive club has continued to rise over the decade. To enter in 2019, a company required revenue of $1.3 billion—double the revenue required only ten years ago.

It is notable that Asia is the only region of the world whose representation has risen over the past ten years. North America's share of the G5000, for instance, fell by four percentage points, and Europe fell by two percentage points.

Exhibit 1

Asia accounts for 43 percent of the world's largest firms by revenue

Composition of world's 5,000 largest firms
% share of total

Source: McKinsey Corporate Performance Analytics

We are clearly seeing a dynamic shift in business activities away from some advanced economies and toward some faster-growing emerging ones. Three hundred fewer Japanese firms make the cut today than ten years ago. Singapore and South Korea largely maintained their representation at 40 and 160 companies, respectively. However, Chinese companies doubled their share of the G5000 in the past decade to more than 900 firms. The number of Indian firms represented has also doubled from a lower base of 85 to 142, the seventh-highest share. Companies from emerging Asian economies that include the Philippines, Thailand, Malaysia, and Vietnam have also risen to prominence. Bangladesh now has a company in the G5000 for the first time.

2. This capital influx has not resulted in higher economic profit; Asia accounts for half of the deterioration in global economic profits from $726 billion to an economic loss of $34 billion.

Asian companies may be scaling rapidly as capital floods in, but firms have been unable to deploy this capital in a manner that has translated into economic profits—far from it. Although Asian firms outperform on growth in invested capital, they have underperformed when turning it into "economic profit," a measure of a firm's profit after the cost of capital is subtracted. Corporate Asia is also underperforming other regions on average returns.

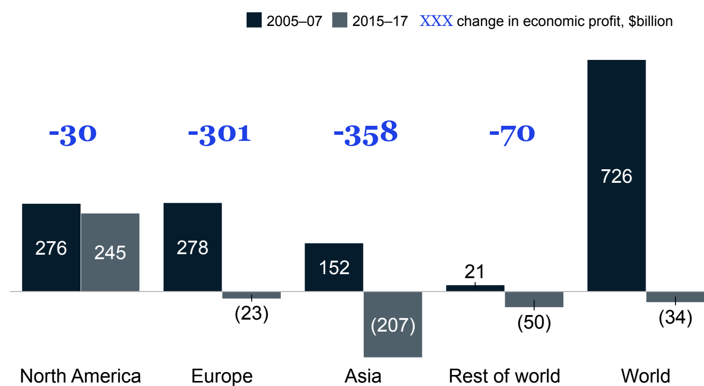
Indeed, in terms of economic profit, corporates globally are not looking particularly healthy. In 2005–07, the G5000 generated $726 billion of economic profit. Only ten years later, they posted economic losses of $34 billion—a staggering turnaround, especially considering the low-interest-rate and loose monetary policy environment globally. How—and where—was this value lost? The answer, largely, is in Asia and Europe.

Corporate Asia turned an economic profit of $152 billion into an economic loss of $207 billion in this period. Indeed, Asia accounts for almost half the global decline in economic profit between 2005–07 and 2015–17 (Exhibit 2). North American firms, by contrast, were largely able to sustain their economic profitability, achieving a total of $245 billion, similar to $276 billion ten years ago.

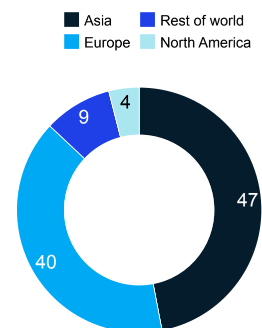
Exhibit 2

Economic profitability has declined around the world over the past decade, with Asia accounting for about half the decline

Economic profit, $ billion



Share of global economic profit decline, percent



Source: McKinsey Corporate Performance Analytics

3. Capital intensification of the world accounts for 90 percent of the global fall in return on capital that is driving down economic profit, particularly in Asia.

The flood of capital in Asia and the decline in economic profit in Asia and beyond is inextricably linked. Lower economic profitability reflects lower returns on invested capital (ROIC) globally. The vast majority of a decline in ROIC—an overwhelming 87 percent—can be attributed to an increase in capital intensity, with the remainder to a decrease in margins. Worldwide, more capital is now needed to generate the same amount of revenue, which then generates lower profits.

Globally, ROIC declined by 3.2 percentage points from 11.0 to 7.8 percent between 2005–07 and 2015–17. During the same period, invested capital grew at almost double the rate of revenue growth, boosting capital intensity (calculated as invested capital divided by revenue) from 0.8 to 1.1. Implying that, you would have needed $0.80 of invested capital to earn $1 of revenue ten years ago. Today, you need almost $1.10 of invested capital to earn that same $1 of revenue. At the same time, profitability (that is, net operating profit less adjusted taxes or NOPLAT) grew more slowly than revenue, reflecting a decline in global margins of 0.3 percentage points, from 8.7 to 8.4 percent. Even when adjusting for the more cyclical sectors such as energy and materials, a similar phenomenon remains present across other sectors.

In Asia, ROIC declined by 2.7 percentage points from 9.7 to 7.0 percent over the same period. The fall in the ROIC of Chinese firms was even more substantial at 4.6 percentage points, from 11.4 to 6.8 percent. For other Asian firms, ROIC declined by 1.7 percentage points, from 9.1 to 7.4 percent. There was a marked increase in capital intensity, which implies that the growth of capital has outpaced the growth of revenue. Capital intensity increased from 1.0 to 1.3 in China, and 0.7 to 0.9 in the rest of Asia.

Trends in margins have diverged from the global picture. China experienced a sharp 2.1 percentage point decline in margins from 11.1 to 9.0 percent. However, margins improved in the rest of Asia, increasing 0.5 percentage points from 8.8 to 9.3 percent between 2005–07 and 2015–17 (Exhibit 3).

This combination of increased capital intensity and reduced margins offers a technical explanation for the decline in ROIC and the destruction of economic profit, but to understand the root causes, we need to look in depth at how the capital has been deployed in different sectors and regions. Where was the value lost?

Exhibit 3

The world is more capital-intensive than it was a decade ago

G5000 companies, 2005–07 to 2015–17

CAGR, % from 2005-07 to 2015-17 | 2005–07 | 2015–17

	World	North America	China	Asia ex. China
Invested capital CAGR, %	8.0	6.1	19.9	6.6
Revenue CAGR, %	4.8	3.2	16.3	3.6
NOPLAT[1] CAGR, %	4.4	3.8	13.8	4.4
Capital intensity Invested capital/revenue, $	0.8 → 1.1	0.8 → 1.0	1.0 → 1.3	0.7 → 0.9
Change in margin, pps NOPLAT/revenue, $	**-0.3**	**0.5**	**-2.1**	**0.5**
Change in ROIC, pps NOPLAT/invested capital, $	**-3.2**	**-2.3**	**-4.6**	**-1.7**

[1] Net operating profit less adjusted taxes.
Source: McKinsey Corporate Performance Analytics

4. The decline in global economic profitability largely reflects the cyclical energy and materials sectors, European finance, and Chinese capital allocation to value-destroying sectors.

Digging deeper into the reasons why so much economic profit has been lost over the past ten years, we find that three factors have largely been responsible: (1) the cyclicality of returns in the energy and materials sector; (2) Europe's underperforming financial sector; and (3) China's allocation of capital to value-destroying sectors (Exhibit 4).

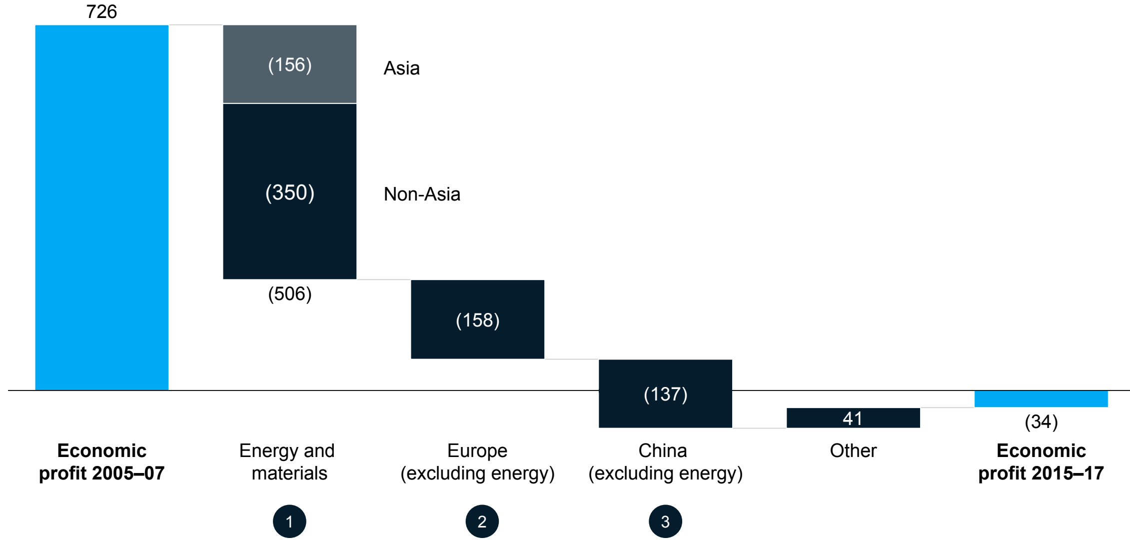
In just ten years, the energy and materials sector has turned from being a large contributor to economic profit to a significant source of economic losses.

The energy and materials sector is by far the largest reason for lost economic profit over the past decade, accounting for $500 billion of the decline. In 2005–07, the sector was a major generator of economic profit for companies. Ten years later, huge amounts of economic profit are being destroyed as oil and commodity prices fall, significantly damaging the performance of upstream oil and gas companies around the world.

Exhibit 4

The energy and materials sector, EU finance, and Chinese capital allocation account for most of the decline in global economic profitability

G5000 economic profit, 2005–07 to 2015–17, $ billion



Source: McKinsey Corporate Performance Analytics

This has not only been an Asian story. Indeed, Asia, Europe and North America each account for about one-third of the total economic profit lost in the energy and materials sector. One explanation of this is the cyclicality that naturally occurs in these markets. Instead of looking at a three-year average, if we take a longer period from 2005 to 2017, the average annual economic profit was $12 billion, compared with an average annual economic loss of $280 billion from 2015 to 2017 (Exhibit 5).

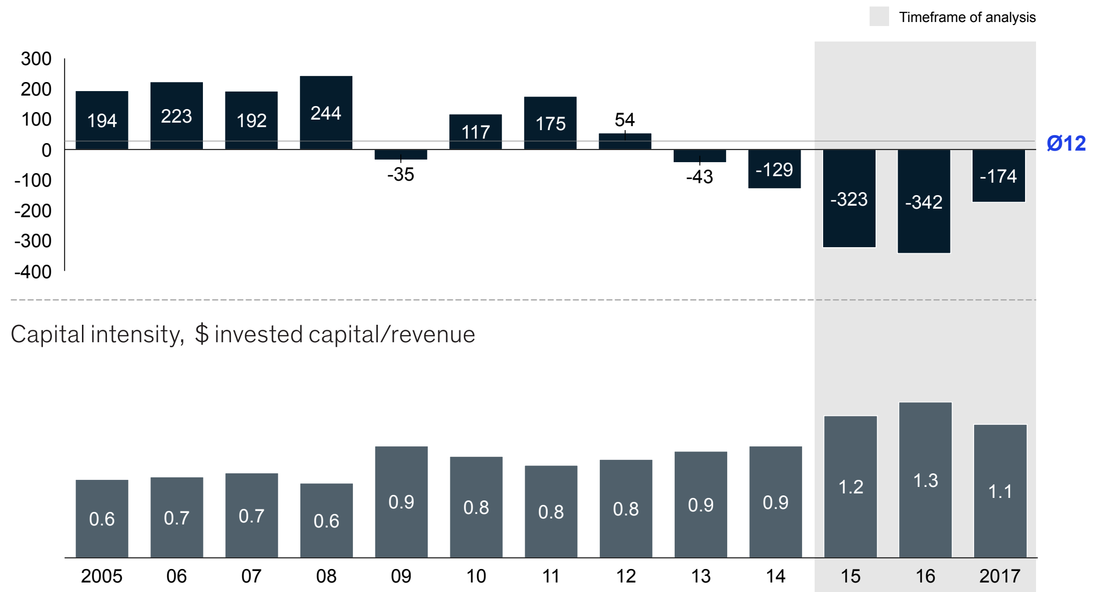
However, there has also been a historically significant supercycle, primarily driven by unprecedented capacity expansion to fuel China's development. At its peak (2006 to 2012), China's average capital expenditure, as a share of GDP, in the energy and materials sector was more than five times that observed between 2000 until 2005; this investment doubled again between 2012 and 2015. The average oil price was $110 a barrel from 2011 to 2014, but prices more than halved at the end of the supercycle in 2015. This made it far more difficult for players in the energy sector to grow revenue and profit. High capital investment coupled with lower revenue has resulted in exceptionally high capital intensity.

Exhibit 5

Increased capital intensity of the energy and materials sector has been a prime factor in recent economic profitability losses

Global G5000 firms

Economic profit, $ million



Source: McKinsey Corporate Performance Analytics

Europe's financial sector accounts for most of the region's destruction of economic value.

More than a decade on from the 2008 recession, many of Europe's banks have taken remedial action to restore their balance sheets and overall finances to some degree of health. However, financial services in the region are still destroying value—eroding 83 percent of economic profitability. In contrast, Chinese financial-services players have been generating positive economic profit (we will return to a discussion of Asian financial players later in this series of articles).

The average return on equity of Europe's commercial banks has been only 4.9 percent over the past five years, compared with the 7.9 percent achieved by US banks. This has taken its toll. In 2009, the United Kingdom and Western Europe together were home to eight of the world's top 30 banks by market capitalization; ten years later, only three European banks were left in that top 30.

China has allocated significant capital into value-destroying sectors.

Around the world, capital allocation has been drifting toward sectors that offer lower returns. This phenomenon is particularly marked in China. Over the past ten years, almost $10 trillion of capital has been invested in China, and 80 percent of it went to sectors that earned below their cost of capital. Domestic services sectors (that is, utilities, telecommunications, transportation, and real estate and construction) accounted for the highest share of investment at 45 percent, followed by capital goods (that is, machinery, automotive, chemicals, and fabricated components) and energy and materials at 19 and 16 percent, respectively. The rest of Asia outside China did marginally better with around 68 percent of net new invested capital going to sectors earning below the cost of capital.

Decomposing the sources of economic losses in China, we find that 57 percent of the value was lost in domestic services sectors, 41 percent in energy and materials, and 29 percent in capital-goods sectors (Exhibit 6).

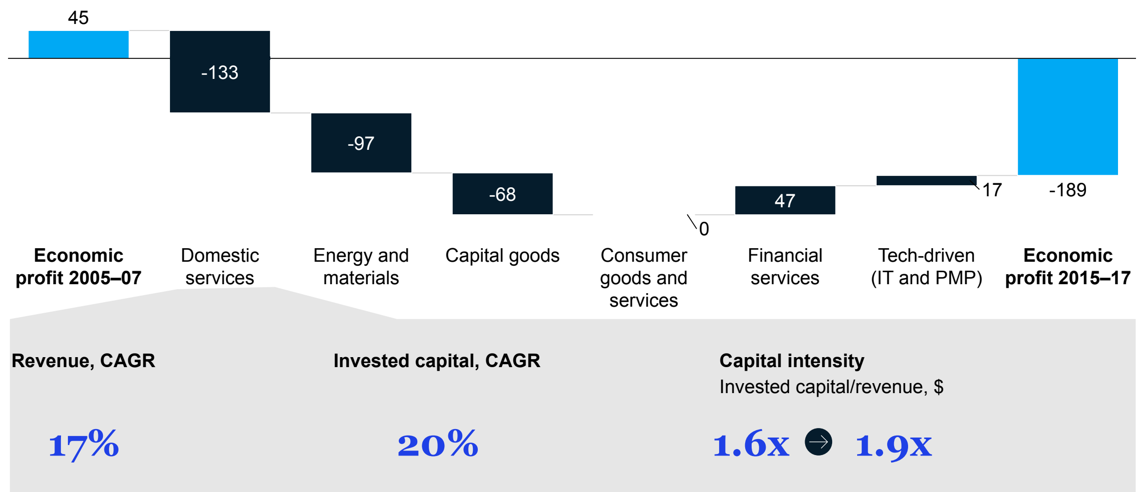
Although revenue from companies operating in domestic-services sectors largely plateaued between 2014 and 2017, invested capital increased by $1.7 trillion—a 9.1 percent compound annual growth rate from 2013 to 2017. This drove capital intensity to an all-time high of 1.9x in 2017.

The question is why? The answer partly lies in building the foundations for economic development. However, it is notable that a significant portion of capital is being invested on very large projects that have yet to return their cost of capital.

Exhibit 6

China's economic loss has been due to domestic services and capital-goods sectors as well as energy and materials

G5000 economic profit 2005–07 to 2015–17, $ billion



[1] Utilities, real estate, construction, transport, and telecommunications
Source: McKinsey Corporate Performance Analytics

5. However, pockets of economic-profit-generating excellence can be found in several sectors across Asia.

The picture is by no means negative across the board. Behind the averages, some Asian companies and sectors are performing exceptionally well. Pockets of significant value creation can be found in major countries and in varied sectors (Exhibit 7). For example:

— Japan's capital goods sector creates the most value in Asia with a performance comparable to its counterparts in North America and Europe.

— Financial services are highly profitable in China and in Australia.

— Technology-driven sectors, especially IT, create a great deal of value in China, Japan, and South Korea, and are improving as a source of value creation in India.

— Southeast Asia's energy and materials sector generates substantial value despite the sector's overall underperformance globally.

Countries have a competitive edge in different sectors. Japan and South Korea, for instance, lead in high-tech manufacturing, China has a host of dynamic new internet companies, and India gains most of its economic profit from its IT services firms. The breadth of the corporate ecosystem also varies. In Southeast Asia's energy sector, for instance, economic profit is being generated by only a handful of vertically integrated companies.

However, we recognize that EP is not the sole determining factor of top performing firms. Each sector has different industry characteristics and specific metrics to assess performance. Structural factors including regulations and competitive dynamics in specific countries and sectors can also create favorable conditions for companies.

In further articles in this series, we will look at the outperforming firms that are creating tremendous economic profit across different sectors in Asian economies. Among Asia's top 200 generators of economic profit, 60 percent are new faces and some of these have even recently joined the G5000 club. Interestingly, 32 percent of these top-performing companies operate in underperforming sectors in their home economies.

Exhibit 7

There are pockets of excellence in Asia

Performance based on average economic profit created in 2015–17, $ billion

Economic profit creation
$billion
-170 220

	Energy and materials	Domestic services	Capital goods	Consumer	Financial services	Tech-driven (IT & PMP)	Total
North America	-82	-6	32	78	3	220	**245**
EU	-56	-33	31	45	-59	49	**-23**
Rest of world	-34	-14	-8	-0.2	4	1	**-51**
Asia	-112	-161	-44	5	43	64	**-205**
China	-88	-125	-64	2	62	24	**-189**
Japan	-6	-5	23	3	-17	12	**11**
South Korea	-4	-13	-1	-0.3	-1	19	**-1**
Australia and New Zealand	-5	3	0.1	1	10	1	**9**
Singapore		-7	-1	-1	1	2	**-6**
India	-14	-12	-0.4	-0.1	-15	6	**-36**
Southeast Asia	5	-1	-2	1	3	0.4	**6**
Total	**-284**	**-214**	**11**	**128**	**-9**	**334**	**-34**

Note: The purpose of this exhibit is to showcase economic profit. It is not meant to be used as a means to pit sectors against each other for comparison. The exhibit shows a three-year snapshot of economic profit performance and may not capture the cyclical dynamics of several of the industries. Given the nature of the financial services, its economic profit is calculated differently using equity to calculate capital charge. The financial data used here reflects numbers that are publicly available based upon accounting practices accepted by each geography.

Source: McKinsey Corporate Performance Analytics

6. The opportunity—Asia could unlock $440 billion of incremental economic profit from two major levers: turning around troubled companies and capturing companies' latent potential to create more profit champions.

At the firm level, Asia appears to be an extremely competitive environment, which may go some way to explaining the low margins. *Strategy beyond the Hockey Stick* introduced the economic profit "power curve", and demonstrated that the bottom and top of the power curve are what really matter because this is where most value is created and destroyed. In the middle of the curve is the broad flatland where the majority of firms do not create or destroy economic profit. We looked at all the companies in the G5000 and mapped them on the power curve by country and region.

For Asia, we looked at two groups of Asian companies: the "Terrific 200" that have the highest economic profit in the region and account for one-quarter of global economic profit creation in the G5000; and the "Troubled 200" with the lowest economic profit that account for one-third of the global destruction of value. To reverse global economic profit destruction, more of the Troubled 200 need to move up the corporate "power curve" and the Terrific 200 need to stay where they are.

Turning around troubled companies and unlocking the latent potential of champions are both likely to prove challenging. Over the past decade, only 54 percent of Asian companies have lifted themselves out of the bottom quintile of all companies, compared with 61 percent of North American firms. Only 49 percent of Asian companies have maintained their position in the top quintile against 61 percent of their North American counterparts. Chinese firms have found it even more difficult. Only 44 percent of these firms remained in the top quintile, and only 37 percent have left the bottom quintile.

If Asia were to match the power curve distribution in North America, it could create additional economic profit of $440 billion—a substantial prize. To capture this, 187 Asian companies would have to move from the bottom to middle quintiles to create $180 billion in economic profit, and 255 companies would need to move from the middle quintiles to the top, generating $260 billion in economic profit. In short, if about 200 companies are turned around, and another around 250 companies in the middle quintile unlock even more economic profit creation, Asia would not only be the region with the largest representation in the G5000, but also that group's largest generator of profit.

The increasing scale and global prominence of Asian companies has generated a great deal of interest around the world but diving into the details reveals that looking at scale and global presence alone does not paint a full picture. Look more closely, and we find that capital-intensive Asian companies are not necessarily generating economic profit; this may not be sustainable in the long-term. The big question is how corporate Asia can turn around its relatively poor recent record and capture a greater share of the global economic profit pool.

We will explore this question in the rest of this series of articles, which will map value in Asia, and look in detail at companies—and sectors—that are either destroying or creating value as we try to discern a path to more sustainable economic profit creation in the future.

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