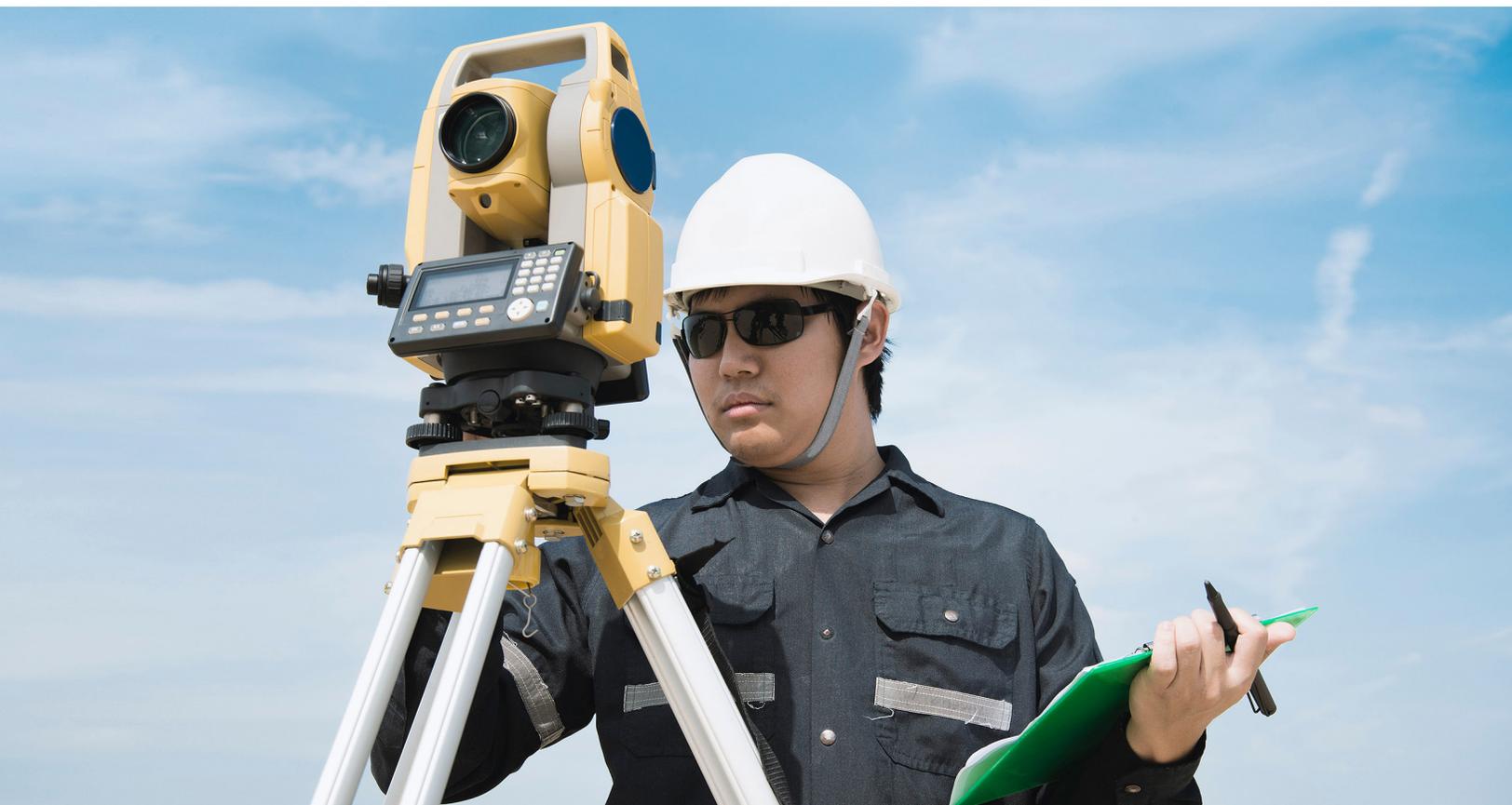


Getting the measure of corporate Asia

Over the past decade, Asia received half of all new investment in the global economy. Despite pockets of excellence, Asian companies have struggled to deliver strong returns on this influx of capital.



In this episode of the *McKinsey Podcast*, Simon London speaks with McKinsey senior partners Chris Bradley and Jonathan Woetzel about the growth of Asia's companies and how corporate Asia has pockets that are creating value. This episode is brought to you by the McKinsey Global Institute.

Simon London: Hello, and welcome to this episode of the *McKinsey Podcast*, with me, Simon London. It is no secret that the world's economic center of gravity has shifted decisively to the East. Before long, Asia will account for more than half of global GDP. But less widely understood is how this shift has affected corporate Asia—how Asia's companies have grown; in what sectors are they clustered; and, importantly, how they are doing in terms of value creation.

For an overview of corporate Asia, I caught up with McKinsey partners Chris Bradley, who is based in Sydney, and Jonathan Woetzel, who is based in Shanghai. Chris and Jonathan were actually together in Shanghai for this conversation, and I spoke to them from my base here in California. So, Jonathan and Chris, welcome to the podcast and thank you for joining.

Jonathan Woetzel: Glad to be here, Simon.

Chris Bradley: Thanks, Simon. Great to be here.

Simon London: You're both working on a project to get a clearer picture of the scale and performance of Asia's companies. Chris, why don't you start by describing the research for us and some of the key takeaways?

Chris Bradley: The way we looked at that was we compiled a database of the 5,000 largest companies in the world over two different periods of time, ten years apart. We looked between 2005 to 2007, and we looked between 2015 to 2017. We asked ourselves, "How's the composition of that Global 5,000 changed? What does that tell us about the geographic centers of corporate profitability?"

What we found was that Asia went from 28 percent of the world's capital base to 40 percent over this ten-year period. What that means is that more than

half of the growth—more than \$1.00 in every \$2.00 of new investment that went into corporates—actually went into Asia.

Most notably, it's China, which only had 429 companies in the first period but now has more than 900. What's even more startling is the average size of these companies. They've just gotten so much bigger because the invested capital, over that same period of time, in Asia has tripled.

Simon London: So, a vast amount of capital invested in Asia and a lot more Asian companies—notably Chinese companies—[are] now in the Global 5000. What about returns on that capital? If you look at corporate performance, in aggregate, of Asian companies, how are they doing?

Jonathan Woetzel: Well, in a word, not quite as good as the rest of the world; maybe that was a few words. The returns, on average, are lower than you would find in the EU [European Union] and certainly relative to North America. What's striking is the relative outperformance, if you want, in terms of invested capital and the underperformance in terms of economic profit. Over the past decade, big North American companies delivered 9.3 percent [in] annual ROIC [returns on invested capital]; Asian companies, 7 percent. And if you think about the overall economic profit, [it is] \$245 billion for North American companies, whereas Asian companies had economic losses of \$206 billion—in short, a fairly massive level of value destruction from Asian companies.

Simon London: Before we go any further, just make sure I'm clear on what the terminology means here.

Chris Bradley: The main two numbers we'll throw around to talk about corporate performance that get all companies on an apples-to-apples basis is return on invested capital, or ROIC, which is simply the net operating profit less tax, divided by the total invested capital of the company. The other measure we use is economic profit, which is a measure of how much profit is left after you deduct the cost of capital.

Simon London: Thanks for that. Sorry to be dense!

Chris Bradley: Now, it's not that all Asian companies are unprofitable; it's just that they're overrepresented among the companies that are unprofitable. For example, in the bottom quintile of economic profit globally, rather than having the 20 percent of companies that you'd expect, Asia has 25 percent of its companies down there. In the top quintile of economic profit, rather than the 20 percent of companies you'd expect, Asia has only 15 percent of its companies there. It still has substantial champions, extremely high performers, and—we'll come to it later—real pockets of value creation. There's just a drift slightly downward toward more companies that are destroying value.

Simon London: What do we know about why this is the case? What explains this overrepresentation of Asian companies in the bottom quintile of economic performance?

Jonathan Woetzel: I think that [there] are probably at least three things going on here. Asia overall—I mean, because we're speaking, again, of a region with huge disparities—but, overall, it's still less developed, particularly in the higher-value-added, higher-technology, and higher-value segments of the economy, like technology and pharma, which do account for a substantial portion of the economic profit of North America. So that's underrepresented.

What's overrepresented are, let's say, domestic services—basically, construction, real estate, infrastructure, utilities—the things that one does at an earlier stage of economic development, and so it's very capital intensive in particular. Commodities like energy and metals and mining, which are also investment intensive, also tend to appear at earlier stages of economic development. Those two sectors are overrepresented in Asia, particularly in China. They account for the majority of the losses. If we look at the “troubled 200,” [we see] a lot of names like “XYZ State Construction Company” and “XYZ Highway Company,” plus “XYZ Raw Materials and Mining Corporation.”

Chris Bradley: If we just map it out by the numbers and we look at “Well, why is it that the US has a higher return on invested capital than Asia does?,” it breaks out pretty accurately that two-thirds of the gap is driven by capital allocation to different sectors. So there's more capital going toward lower-performing sectors. There's still a gap of one-third that is *within* sector performance and is lower inside of Asia. There's also a really important dynamic story because it's not just about where capital is now but where it's being allocated over time. Here I'd highlight a really big difference.

In the US, for example, over the last ten years there was \$6.1 trillion of new capital put into companies; that's net invested capital. Eleven percent of that went into sectors that earn below their cost of capital, so that destroys value. China, on the other hand, added almost \$10 trillion of invested capital onto its balance sheet—net invested capital—but 80 percent of that amount went into sectors that earned below their cost of capital.

What we've seen is this capital allocation drifting globally toward lower-returning sectors. I think, as Jonathan says, part of that is because there's a sector story that accompanies your S-curve of development. But there's also clearly something in there around capital allocation. By the way, the rest of Asia is better than China but not that much better.

In the rest of Asia, excluding China, 68 percent of the net new invested capital went into sectors that earned below their cost of capital. There seems to be something that's keeping America at the top economically, at least in terms of corporate performance, which is around being really strong in sectors that are higher returning—this is anything related to science, health, technology, and computers—while at the same time having economic systems that direct the marginal dollar toward better opportunities.

Simon London: Is there also something related to the balance of listed versus unlisted companies? Because we know that publicly listed companies tend to deliver higher returns on capital, and we

also know that unlisted companies—family-owned or state-owned enterprises—tend to play a big role in some Asian economies. I'm wondering if this is also part of the explanation.

Jonathan Woetzel: Yes. In that sense, our findings for Asia support the global finding or the global trend. Perhaps just more so that [in] listed firms, overall, the ROIC is substantially higher—globally it's 8.4 percent—than [it is in] unlisted firms, which would be 5.5 percent. That's a global number.

Asia looks very similar: 8.0 percent versus 5.3 percent. I think that that's absolutely true. The reality is that much of the unlisted firms—the majority of them, in fact—are in China. There's potentially a particular characteristic of unlisted firms in China versus elsewhere, but it's in line with the global trend. In fact, if we look at Chinese listed firms as a class, they had the same, more or less, ROIC as North America's.

Chris Bradley: What makes China really unique in this regard is just the scale of that unlisted sector. Just to put it in perspective, there's about \$12 trillion of invested capital in China overall, and a bit over half of that is inside of this unlisted sector, which is just orders of magnitude bigger than [it is in] most other countries. That's \$6.2 trillion of invested capital inside these unlisted Chinese firms; that's more than the entire capital base of Japan and India combined.

We've seen this massive global phenomenon. We call it the tsunami of capital that's hit China and, at a fundamental level, explains a lot of why the economic profit globally has gone, [since] ten years ago, from a fairly healthy \$726 billion to now, globally, being minus \$34 billion. Your average company is now earning below its cost of capital.

Jonathan Woetzel: I want to be careful, when we talk about flows and tsunamis and so forth, that, first of all, the Chinese financial system is relatively autarchic. It tends to stay by itself, and foreigners own less than 6 percent of the financial assets in the country. Whatever's been going on here,

it's been sloshing around pretty much inside the Chinese bathtub.

Chris Bradley: Right, it's not a tsunami coming from somewhere else.

Jonathan Woetzel: Yeah, so [the] consequences of that mean it's also going to be largely visited on the Chinese economy. For the beginning of this period—postfinancial recession—we had a massive increase in debt and capital: debt went from 150 percent of GDP to somewhere closer to 250 percent. We've really never seen that kind of a rise anywhere else, so there was massive credit.

Truth be told, the last three years, the hangover is here, and we've been living through deleveraging in China for the last three or four years. That's stopped, but the expansion did definitely happen. Where it happened was in these, again, value-destroying, capital-intensive sectors of the economy. That's what took the cash. China's been spending about 9 percent of its GDP every year on infrastructure. Clearly, as the numbers show, those projects have not been returning their cost of capital.

Simon London: Chris, before we go on, I just want to pick up on something you casually dropped into the conversation. You said that the average big company, globally, is now earning below its cost of capital—or, less politely, destroying value. Is that just the impact, on the averages, of what we're describing here in Asia or are there other factors at work?

Chris Bradley: I think [it] reflects the fact that revenue growth is harder and harder to come by, and the world is becoming fundamentally more competitive at a time that the world is actually re-platforming itself. On [the] one hand, in the old world the global renewal of infrastructure [has] been long overdue and needed [but], at the same time, the production system of most companies is completely changing toward a different stack of technology. There's all these reasons why it's becoming harder to get incremental revenues at the same time that you're fundamentally having to re-platform businesses. Taken together, globally, ten years ago, you would need \$0.80 of invested

capital to earn \$1.00 of revenue, whereas today you need almost \$1.10 of invested capital to earn that same \$1.00 of revenue.

The other thing we know about the global balance sheet is that intangible assets are growing at about one-and-a-half times the rate of tangible assets. Even though tangible assets are outstripping revenue growth—so the hard, physical capital is growing faster than revenues—the intangible capital is growing even faster. While the global balance sheet, as I mentioned before, is growing at 8 percent per annum, the intangible part of that balance sheet is growing at 9.2 percent per annum. We are seeing more goodwill from more transactions, more intangible assets, but that doesn't explain the phenomenon entirely.

Simon London: Fascinating, and we should absolutely come back to that on a future podcast. For now, though, let's segue back to Asia specifically. Give us the good-news story. Where is value being created at scale in Asia? In what countries and in what sectors?

Chris Bradley: There's pockets of enormous value creation in Asia. If we just go by the numbers, we'd highlight that there's \$23 billion of accumulated economic profit in the Japan capital-goods sector, with companies like Hitachi [and] Mitsubishi Heavy in there. The South Korean IT sector, there's \$19 billion of economic profit in there, with companies like Samsung Electronics being an example.

The China IT sector, \$23 billion of economic profit in there, with household names like Tencent and Alibaba. Notably, actually, the Australian banking sector's in there, \$10 billion of economic profit. It's been a stable and notably strong performer over the time. Perhaps, controversially, there's \$62 billion of economic profit that's parked in China financial services. Financial services tends to be a patchy sector across the world in terms of value creation. At least by the reported numbers, China really stands tall there.

Simon London: We haven't mentioned India yet. How are Indian companies doing in aggregate?

Jonathan Woetzel: It is certainly, first of all, a growth story. It's appeared in the Global 5000 at levels much more significant than where it was before. So it's still relatively small, but it's on its way—150 companies today with real outperformance in pharma, in IT. On the other hand, [in] some sectors there is this issue of "How are we allocating capital and why doesn't it get a return?" Financial services stands out, as does the energy and materials sector; [I'm] saying these are areas where, simply, the sector has underperformed its cost of capital. I want to stress that there are still a lot of great-company stories here.

When we look at the actual new companies, many of them are newcomers out of India. There is a lot to be talked about—a similar story, perhaps overall, in terms of the level and rate of development in how capital is being allocated. [There is a] different role for the financial-services sector, perhaps, than in other economies, but [there's] growth and capital intensification, as we've seen elsewhere.

Simon London: What about mergers and acquisitions involving Asian companies? What are the patterns and trends in M&A if you step back?

Jonathan Woetzel: What's striking is the greater share of the shift of transaction volume toward Asia. Asia has risen from, give or take, 16 percent of transaction volume at the beginning of the period to 31 percent at the close of the period. That's striking. As to what that transaction volume is, it's still largely East to East. It's transactions that are taking place within Asia and, mostly, domestically within countries in Asia. That said, the most rapidly growing portion of the whole thing is, if you will, East to West. That's growing at 8 percent over the whole period, so it shows that these Asian corporate firms are globally integrating. They're doing so a bit faster than perhaps might've been expected.

Chris Bradley: It's another special callout to Japan as well here too, which has particularly had the lowest share of M&A that's domestically focused. In fact, more than half of M&A in Japan is outbound. Newspaper headlines—stuff like

Takeda buying out Shire, for example—this is kind of happening all the time with Japan. As we see, Japanese companies both get a bit more confident but also get a bit more realistic about how to create value in a long-term deflationary environment.

Simon London: I'm conscious that we've been talking at quite a high level. Lots of numbers, trends, and so on, which is good, but before we run out of time, I want to make sure we bring it down to a level that's actionable. Chris, let's start with you. For executives or policy makers listening to this, what are the takeaways?

Chris Bradley: I think there's three things, Simon. The first one is this is a great reminder that the fundamental question that CEOs face in their strategy is where to compete. Because we see that, fundamentally, you can tell two-thirds of the story based on sector capital allocation. At a macro level, that means making sure the institutions are in place to get capital flowing to the right places. At a micro level, it means getting resource allocation right within a company.

The second message, I think, is this idea that Asia's overrepresented in the bottom-quintile firms—that set of firms that disproportionately destroy economic value. I think for policy makers and for CEOs in those sectors, there's really a question of “OK, what's it going to take? What conditions have to be in place to get to cost of capital here? What kind of industry rationalization, what kind of performance-improvement programs, do we need to really clean up that bottom quintile?”

The third one is, “Well, you know what? There's actually a lot of green spots in Asia. There's a lot of places where Asia is proving itself to be globally competitive. How do we double down on that? How do we make the greens even bigger greens?” I think there's some of the big takeaways that I would look at.

Simon London: Jonathan, anything to add there?

Chris Bradley is a senior partner in McKinsey's Sydney office. **Jonathan Woetzel** is a senior partner in the Shanghai office. **Simon London**, a member of McKinsey Publishing, is based in the Silicon Valley office.

Jonathan Woetzel: Yeah, I would certainly agree with Chris that the green spots for sure [exist]—I think that's what is interesting about this Asian environment. When we look at the top performers, Why are they there? What are the things that allow them, in this very skewed picture, to stay at the top and to rise to the top? That, I think, is an interesting story that we want to do more research on.

When we step back from the broader picture, I think it's clear that this is a region in transition. With that transition, there is [a] risk that we have a very substantial portion of Asian corporate economies, which are, let's just say, under water or they're paddling vigorously. There is a liquidity challenge for a lot of these companies that are not returning their cost of capital, and so their existence is fundamentally dependent on the willingness of the providers of capital to continue to do so.

That is a risk, and I think it's a macro risk, and it's one that every investor and every competitor should take into account, as they're operating in Asia. That said, this is a region in progress. We see that capital intensification being supported by and resulting in economic growth. Watch the space. It's going to be very exciting one way or the other.

Simon London: I think we are indeed out of time for today. Chris and Jonathan, I know you both need to run, but thanks so much for a fascinating conversation.

Chris Bradley: Thanks, Simon.

Jonathan Woetzel: Thanks. Thanks, Simon.

Simon London: And thanks, as always, to you our listeners for tuning in to this episode of the *McKinsey Podcast*. To learn more about this research and related topics, check out our Future of Asia page on McKinsey.com or, if you prefer, download the very splendid McKinsey Insights app.