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Future of Asia Podcast

Decoding the value and performance of corporate Asia

Corporations in Asia have grown in scale but lag behind the global average on profits, and the COVID-19 crisis poses new challenges.

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Companies in Asia will doubtless spend a great deal of time on crisis management, but they also need to look further out, planning how to deal with the challenges. In this episode, we discuss the capital paradox, decoding the Asian firm, what exactly is a resilient 21st century firm as well as provide a looking forward view in Asia. How can companies in Asia explore opportunities ahead and build capabilities to sustain long-term growth in a more volatile context?

Oliver Tonby: You are listening to the *Future of Asia Podcasts* by McKinsey & Company. I am Oliver Tonby, your host and chairman of McKinsey Asia. In this series we feature leaders from across the region to discuss the forces, the opportunities, and the challenges that are shaping the future of Asia.

Patti Wang: Hello and welcome to another episode of *Future of Asia Podcasts*. My name is Patti Wang and I lead McKinsey's research on the Future of Asia. The following episode is adapted from our recent interactive webinar session on decoding the values and performance of corporate Asia. I am joined today by three distinct panelists: Oliver Tonby, Senior Partner and Chairman of McKinsey in Asia; Chris Bradley, Senior Partner, Sydney office and leader of the Strategy and Corporate Finance Practice in Asia; and Jonathan Woetzel, Senior Partner and Director of the McKinsey Global Institute. Now I'd like to turn it over to Oliver who will be opening the briefing. Oliver, over to you.

Oliver Tonby: Thank you. Listen everybody I am absolutely delighted to have everybody on this webinar today. About one and a half years ago we set ourselves out on a campaign called the Future of Asia. The aim of the Future of Asia is to provide a better fact base for what's happening and what the future could look like in Asia. It's to provide a little bit more of a nuanced perspective on Asia overall. And then at the end of the day try to provide a holistic narrative. It is not all rosy. It is not all doom and gloom. So that's the aim of our Future of Asia campaign over the last one and a half years.

We are doing several chapters. We have already released the flows and networks chapter. We've already released half of the technology chapter. Today we're talking about Asian corporate ecosystem and performance. Coming later, we're going to release a paper on sustainability in Asia, and we're going to be looking at consumers across Asia.

That's the Future of Asia campaign. What we're doing today is double-clicking on trying to decode the value and the performance of corporates across Asia. These are the 5,000 largest companies in the world. 43 percent of those happen to be Asian. You're going to hear a few interesting things. You're going to hear that sadly there's been a significant reduction in economic performance, economic profits of companies globally, but also specifically in Asia. You're going to hear about increasing capital intensity. You're going to hear about [how] a large amount of the investments have gone into value-destroying sectors across Asia.

Even though you're going to also hear that there are pockets, even in some of the lesser performing sectors, there are some pockets of great performance. And you're going to hear about a corporate ecosystem that is frankly, more dynamic. Some would say tougher but certainly more dynamic landscape than any other parts of the world. And finally were going to try to draw from implications for companies from all of this.

With that short introduction let's get started. Let me hand over to Patti Wang who has been the leader of this corporate performance work that we have done. Patti, over to you.

Patti Wang: And like Oliver mentioned, first we'll be diving in to the capital paradox, followed by decoding the Asian firm, then diving into looking at what exactly is a resilient 21st century firm. As well as providing a looking forward view in Asia. Finally, we'll also make sure we leave ample amount of time for Q and A. So please make sure you use the Q and

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A functionality. I think that’s for it in terms of our opening. Why don’t we jump right in and start talking about the capital paradox. Chris, over to you.

Chris Bradley: Thank you. I’m going to introduce to you what we call the global 5000. That was the basis of our analysis. Luckily, we have a terrific database of companies and we’re able to understand the evolution of current global profit pools, one firm at a time.

These are companies that in 2015 to 2017 had more than $1.3 billion of revenue. 43 percent of these companies are Asian. If we look what happened in Asia, the big thing is revenue went from 30 to 39 percent of the world and invested capital went from 28 to 40 percent. In fact, of that additional $28 trillion invested capital out of one dollar of every two went to Asia. On that actually, one dollar in every three went to China. So we saw Asia playing a disproportionate role. At the same time the number of Chinese firms in the Global 5000 doubled to 900. But the number of Indian firms doubled, too, but to a smaller number, to 142. That’s the basis of our analysis. Which gets to the great mystery we are trying to solve, which is the mystery of disappearing profits.

Going back to 2005 to 2007, the economic profit in the world was quite healthy. Now let me just very quickly do a sidebar on economic profit because not everyone measures companies this way but we do. Economic profit is the amount of profit you have left over after you take your net operating profit, you take taxes away. But importantly you also deduct an amount for the capital that you employ. So we multiply the invested capital by the weighted average cost of capital to create what’s a quasi-return on capital that should be expected. Or, an opportunity cost of capital.

In 2005 to 2007 we’re in a profit burn. The global economic profit pool was $726 billion. That meant companies were earning well above the cost of capital. But what you can see is 10 years later, that profit pool has all but disappeared. And so what we did was the Sherlock Holmes, what’s the detective story, where did the profit go?

The answer is, well, it didn’t go… North America is not the scene of the crime. They managed to maintain stable high economic profits. But you really see Europe and Asia were the cause. Asia nearly 50 percent of it there. So over this time the return on invested capital in China went from 11.4 percent to 6.8 percent. And in the rest of Asia, outside of China, went from 9.1 percent to 7.4 percent. So, we had this real deterioration of returns over this period.

The reason is capital intensity. The returns the company earns is a product of the earns and the turns. So the earns is about margin and the turns is around capital turnover. Let's just look at the bottom row, we'll get to the data later. The bottom row says that in this period, '05 to '07, to earn a dollar revenue, I needed 79 cents of invested capital. However, by the time I get to 2015 to 2017, to earn one dollar revenue I needed $1.08 of invested capital.

You might be saying, "Hang on a minute, isn't the big trend in the world the rise of tech and virtualization and software aiding the world?" Yes, and that's the great mystery. The reality is intense competition, constant rate platforming because of disruption, renewal of infrastructure, has caused the world to become more capital intensive. And it's not just because of urbanization of China, although that played a role. It's because in every sector the capital intensity has been increasing. And it's not just because there's more goodwill on balance sheet because of increased takeover activity, although that did grow faster. But the story's pretty simple. Invested capital over this period, globally, grew at 8 percent per year and revenue grew at 4.8 percent.

The story is even more intense in Asia. At the same time the net operating profit less adjust taxes (NOPLAT) margin went down from, this is profit margin, went globally from 8.7 to 8.4. So there was a small contraction in margins but nothing compared to the huge change in capital intensity. So if you wanted to explain where did the profits go? Globally, the answer is 87 percent capital intensity, 13 percent margins.

In China, interestingly, it is a bit more of a split story because while capital intensity is really increasing in China, the margins went down a little bit more there. So in China, it is about 60 percent of reduction in invested capital is because of capital intensity and about 40 percent because of margins. That's kind of the backdrop here. We've got disappearing profit pools driven by capital intensity.

But the decline in Asia has a more specific story. The first big thing that you have to take out of energy material because '05 to '07 was the very beginning in the peaking of our commodity prices as part of the super cycle, as China entered the world economy. What we saw over this 10 years is those profits all drained back as prices normalized. That's one adjustment. But even once we've done that, we've still got more than half of the picture left. And that's where we get to the other two lanes, which is capital allocation. Jonathan's going to go into this in more detail. But 74 percent of the new capital in Asia went to sectors that destroy value. In fact, it was 80 percent in China, while in the US the majority of capital went to sectors that create value.

And then in firm performance in Asia, we saw a deterioration of firm performance. What we see is there's basically slightly more representative firms in the bottom quintile of economic profits. So there's 24 percent of Asian firms are in that bottom quintile where of course you expect 20 percent. But there's also slightly less superstar firms. So 16 percent of Asian companies are in the top quintile of economic profit versus 20 percent globally. So there's slightly less superstars and slightly more troubled firms.

So we have done our Sherlock Holmes investigation but it's important to understand, where did this happen? This is largely a China story but nearly every geography suffered from some of the same fate. Japan did better than you'd expect it to given where its economy is going to because corporate sector there did a lot of hard work. India remained under the cost of capital but just given the amount of companies in the Global 5000 in India, that's not enough to move the dial so it's really China's story, particularly around the state-owned enterprises in China.

So that's the first action why I wanted to talk about the Capital Paradox. We've seen this explosion of investment, we've seen lots of growth. But at the same time, we've seen disappearing economic profits, as return on capital has converged below weighted average cost of capital. Thanks, Patti.

Patti Wang: Awesome. Thank you, Chris. Maybe if we open up to a couple of questions. The first one would be to Jonathan. Like Chris mentioned, when we looked at the country breakdown, China drives a lot of the economic decline. What do you think is some of the key differences or factors that would cause this phenomenon?

Jonathan Woetzel: Well, as Chris is pointing out, we have to divide this into the global industries like energy and materials, and from the local performance in the allocation that's going on within the country. So clearly a lot of what is going on is the role of those global sectors in a given economy and particularly in the Chinese economy then. But the question is that performance within the Chinese economy is also something that is driving the outcomes here. That has something to do with state enterprises and their leading role, particularly in more capital-intensive sectors, as Chris is saying, that in general we've seen more capital and less profit. That's really where the state enterprises play.

But I think there's also a positive side on this in that there are, as we'll see, some greenshoots to success even in the Chinese economy for as far as profits are going especially in knowledge-intensive sectors.

Oliver Tonby: Asia's standing in the world has changed. And it's clear that where the focus once was on how quickly the region would rise, the reality is now all about how Asia will lead. Keep listening to the *Future of Asia Podcasts*.

Patti Wang: Thank you, Jonathan. And maybe a question now to Oliver.

Oliver, what do you think are some of the ways that companies can respond to declining economic profit? Or what have you seen happen in the last years or so?

Oliver Tonby: Thank you, Patti. There are a couple of ways to answer. Let me first focus on before coronavirus in the recent months, because I think what we were seeing, I think companies were absolutely seeing this decline in economic profits. They were responding, and are responding, by two things. Number one, there's a continuous search for how to improve productivity and depending on which sector we're talking about. But using technology, using digital to improve the ongoing performance to reach more customers, e-commerce and so forth.

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–Oliver Tonby

So, one is the search for how to improve productivity. The other one is trying to find those new pockets of growth in adjacent industries and we're seeing that suddenly all companies are suddenly starting to look into adjacencies and crowding in to, for example, the e-commerce supply chain became very popular being a tech multiple industry. So as they look for adjacent sectors, look for growth.

I think now with COVID, those things have been intensified but COVID has added an extra measure, which is extreme uncertainty. We just do not know where the world is going, which scenario is going to play out. So I think companies are now really trying to step back and look at what we call Plan-Ahead Questions; which are the scenarios that are possible and what are the triggers and markers so that we know where we're heading and, therefore, that informs what we do.

Patti Wang: Wonderful. And we just had a couple more questions coming in. One around the capital allocation. And I think we'll talk a bit more about this in the next section with Jonathan. Isn't part of capital allocation to value-destroying sectors typical of required infrastructure bills of developing countries such as China? Maybe this is a really great question from the audience. And I think we'll get Jonathan, if you don't mind keeping this one in mind as you cover off decoding Asian performance.

Jonathan Woetzel: Yeah, well let's turn to that, Patti, and I'll keep that in mind. I wanted to sort of take this. We turned from a macro-economy what's going on and little bit from sector. I'll spend a little more time on sector but then let me turn to firms because I think there is message here overall about Asian performances. While one can look at the economy, why don't we all look at the sector. We shouldn't forget about what's going on at the firm level because that, in many ways, we think is the opportunity going forward is that firms will essentially be increasingly bucking the sector trend to deliver outperformance. But let's take this one step at a time.

On the first page following this, we can see that Asia essentially allocates more capital to value-destroying sectors. So the blue sectors are value-destroying, the black sectors are value-creating at the sector overall so it's pretty clear that the value-creating numbers are lower than the value-destroying numbers relative to certainly North America and relative to the world overall. That's indisputable.

Let's take another look. On the next page, as to where exactly that's happening. Here we can break it all down by sector, by country, within Asia and we start to get a bit more of a granularity about where is that profit going and coming from. Again, black is good. Where we can see, first of all, generally speaking, knowledge-intensive industries globally are more attractive in terms of economic profit and equally so in Asia. But there are some interesting standouts as we look at things like financial services. We look at China of course. The bulk of the profitability, economic profit, is in the financial services sector, which arguably, reflect the unique characteristics of that sector and how it is regulated.

And then we get in to a much more mixed territory whether it's consumer or capital goods, we start to see negatives. And then finally, with some exceptions, again we can see standouts in Southeast Asia, energy and materials in Japan around capital goods. There are pockets of exceptions. So, broadly speaking, we see on the far left, energy and materials globally, this has not been a good sector to be in as far as economic profit is concerned over this period of time.

Part of this is because, as you said, globally, something like energy and materials is a cycle, meaning that there is a long cycle and so when one looks at just a couple of years, one doesn't take the whole picture. So that is why we sort of would say anything that, because that you are heavily overinvested if you will in that sector, almost by definition, you're going to be underperforming the

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global averages because you are relatively overrated in those long-cycle sectors. That is absolutely their part. And that’s why we try to separate that out as far as doing, okay how does one fix Asia’s economic profit challenge?

So that’s all at the sector level but I think when we dug a little bit deeper and we try to look at firms, what we saw was, there is actually another story here. And on the next page we start to tell them, which is that where you play does matter. And so here again we have the sectors. But within each of the sectors, we show the distribution curve form from bottom quintile to top quintile. With the triangles representing the world average. This is where you can see that there is quite a span, and that top quintile performers even in a value-destroying sector such as energy and materials are able to create economic profit. And that view that is, I would say, the big opportunity for Asia is that as we see more firms moving to the top quintile, that creates the opportunity for the whole sector to move up.

And it’s true across every one of these sectors you can see very substantial skew in energy and materials, in financial services, in knowledge-intensive sectors as well. You can get the sense of how many of the firms in that sector, relatively speaking, are creating positive economic profit. And it’s not an insubstantial number. You can see some sectors in Asia outperform, like financial services. Again, perhaps they have been more strict with their regulation. Also, in every other one that you can see. Even in the value-destroying sectors, there is a substantial share of firms that have generated positive economic profit.

So, how are they doing that then and who are those firms? As I was showing, that we’ve divided the world to get a better sense of who is making money and who is not. As you said this is the Terrific and the Troubled 200. For the Troubled 200, it becomes fairly clear that the sector effect is dominating. Apologies here, but the labels are switched, but we should note that here in the legend that the blue is so good. Let’s put it that way. That the blue is smaller for the troubled 200 than the black. But if you look at the Terrific 200, the blue and the black are basically equally down. Which means that within the Terrific 200, somehow, half of those companies have been able to get into the top 200 overall. Even though they were in a value-destroying sector, which is the interesting thing about Asian companies. Is that even though you are facing headwind, there is a way to succeed.

We can start to see what are some of those things. First of all, those top companies are, generally speaking, new companies. That is one of the most important sort of things that characterize, we think, Asian leaders, is that they thrive on competition. Here what we look at is the movement of the top quintile over a decade. How many of those top quintile companies that were there a decade earlier and how many of them were ones that had either dropped from the top or newly arising?

In North America, 53 percent of the companies that were in the top in this current period in 2015 to 2017 were also in the top, ten years earlier. So there was a lot of incumbency. As you look across Asia, that incumbency declines. That advanced Asia, China, emerging Asia, those companies that are in the top quintile in 2015 to 2017, they were not there before. So Asia is a very, very competitive environment, which means that that's how we see Asia's growth, driven by that competition. That is perhaps a standout characteristic of the environment in Asia that it supports and of course, its outperformance by creating turnover.

Specifically, what are those firms doing? On the next page, the ones that are actually beating the others to climb up that greasy pole to the top. First of all, they boldly reallocate resources. And I would say these are particularly unique to Asia. It's just that what we see is a lot more aggressive pattern in Asia than elsewhere. These are some of the characteristics that Chris has notably pulled out in our work *Beyond the Hockey Stick* as the moves that make a difference.

So here we see that for Asian companies, the top performers are 14 percent more dynamic in terms of the amount of capital expenditure that is reallocated across their businesses. That they definitely have a high rate of capital expenditure there versus the industry. That they're aggressive on productivity, whether it is labor or selling, general and administrative expenses (SG&A). Relative to the industry, they have much higher expectations for productivity improvement for their companies.

And finally, differentiation. In other words, their ability to develop and succeed in commercializing products that sets themselves apart in the market place. That they also do that much more successfully than their non-top-performing counterparts.

One last point is M&A, interestingly enough. This so far has not been one of the factors that have differentiated those top performers. That has not been a factor. But we think maybe going forward, this would become another lever for those top performers to carry out. So that's the story, that while across Asia at the sector level, we can see that there has been an allocation of capital or usage of capital, particularly in sectors which are value-destroying. Then, at the firm level of the market dynamic of competition has allowed a class of highly performing companies to rise to the top and to beat the sector average.

Looking forward, that's actually the big story. Back to you Patti.

Patti Wang: Awesome. Thank you, Jonathan. And maybe a couple questions building off of what you just mentioned. There has been a lot of companies that have been able to beat the odds of their sector. Specifically, within Southeast Asia. Maybe to Oliver, what are the oil and gas companies specifically doing in Southeast Asia that allow them to be profit-generating, versus the industry?

Oliver Tonby: Listen, I think that decade was particularly good for Southeast Asia, and oil and gas. I think that was the decade when oil and gasoline prices were still continuing to stay high, this is certainly compared to what they are now. These are companies that have been focused on that. They have not diversified too much, relative to some of the global companies that have diversified. I'm talking about, that were part of their portfolio into retail and into other sectors. So that turned out to be right for that period. They also have assets that have been reasonably depreciated, because remember we're talking about economic profit, which is a little bit complicated.

This was the perfect period for them. Now, big question is what happens going forward when we're now seeing a drive into renewable energy and so forth. So I think they are questions, looking ahead.

Patti Wang: Thank you, Oliver. And maybe over to Chris. So we put our investor cap on and look at the Asian market. What makes it so attractive? Why are investors continually interested in Asia?

Chris Bradley: Well, I think part of this increasing capitalization of the world prosperity and revenue just talks to the fact that there's a lot of capital around. And that talks to big and macro factors like reliable extraordinary low interest rates. And so there are a whole lot of macro factors, which, I think, talk to capital availability. Certainly when it comes to Asia, you have to differentiate between private capital and public capital. So public capital has different motivations and reasons, probably maybe a longer time horizon.

And at least in Asia, a correlation with more investment in sectors with top economics. If you take China, the part of China that's listed on the stock exchange and what has a private funding. The return on capital portfolio is really quite different and not too different than the US. We can see that importance of private capital in driving capital-allocation decisions.

I wouldn't know that when we look at an economic corporate landscape, that is today. When you buy a company, you are buying the next 50 years of economic profits as well. So, one needs to understand there is a mega trend in Asia. An emerging large middle class, an increasingly prosperous society with incredible panache for adopting technologies. You have got to remember, the investor is not just looking at today's profit but also the outlook for the future.

I think if you look at the stock market multiples, what you see is that stock market multiples in Asia are there. But actually, the US has the best of both. So the US has good stock market multiples, I believe, in growth going forward and excellent profitability today.

Asia has profitability today that's quite challenged and not very good multiples going forward.

Patti Wang: Awesome. Thank you, Chris. So maybe now we dive into the next chapter on building different firms. We've spent a lot of time talking about the client. I see lot of the questions coming in Q&A is now talking about how do we now move forward and how do we actually unlock the potential opportunity to create economic profit in Asia?

When we looked at this, there were two key levers and of course, being McKinsey we had to use some sort of an economic outlook on this. So what we have here is our different simulation.

Number one is in fully individual firm performance. The number two is also then looking at how do we allocate capital, what is the potential economic profit that we can unlock in the future? And what we found is that there's probably roughly around $440 billion to $620 billion in the large magnitude of profit that can be unlocked in the coming decades.

Now, when you actually pull in to these levers and if you break it down at a sector level, there are differences in which will be more effective. For example knowledge intensive, as we find Jonathan alluded to, knowledge-intensive sectors tend to be value-creating globally. But with this sector, it's more about investing and doubling down in this sector versus in other sectors such as domestic services and energy materials, this has been more about improving individual firm performance.

So why don't we spend the next little while talking specifically in giving you some ideas about opportunities at the sector level. The first sector that we are actually going to talk about is deep-diving into the value and knowledge-intensive PMP sector. On the next page, what we have here is, I'm talking about pharmaceuticals and medical products (PMP). So Asia today actually spends and accounts for 90 percent of global spending. It's actually the second-largest pharmaceutical market in the world. When you look at the economic profit Asian firms are able to capture, it is merely 6 percent.

And if we just take a step back and think about the world, who are these pharmaceutical companies? Asia does not come up on that list.

But our perspective here is that this will drastically change in the coming years and there's a great opportunity for Asian firms within pharmaceuticals in two specific ways. The first way is more traditional—what we see is China and advanced Asia, which is largely Japan, have an opportunity to compete like a traditional PMP firm. This means doubling down on R&D and then also like the BeiGene and Innovent Biologics, really launching innovative drugs.

Something that is even more exciting is if you actually look into areas such as emerging Asia, which is largely ASEAN and India, where they're leading is actually in digital and new innovative way to deliver care. And you would ask, "how is Asia or India able to lead in such a technology-advanced, R&D-intensive sector?" Well that's because within these developing countries there's actually more pain points to solve.

So for example in India, what we see is that there's one doctor for every thousand citizens. Versus in the US, there is 2.9 doctors per thousand. This then forces companies to be more innovative and potentially even leapfrog the traditional system in order to provide care for its citizens. And especially during the COVID-19 era where we saw is an emergence of telehealth as well as online pharmaceutical delivery really start to take root in a lot of these economies.

And if we take a look now at the second sector, which is consumers, I'm sure everyone's heard of Crazy Rich Asians. And you've heard that Asia is going to drive consumer spending. That is very much true. There is definitely the top percent that is going to drive luxury goods, but what's actually powering consumers in Asia is the growing middle class. And by 2040, we expect 40 percent of consumption globally to be in Asia. And today, within consumer goods, Asia already accounts for 40 percent. But we only, like pharmaceuticals, capture a very small percentage of economic profit.

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And what we see here as the opportunity is through four different kinds of emerging archetypes of firms and you might be very familiar with some of them, the Uniqlos or the Japanese and Korean cosmetics brands that are becoming Asian multinationals. But there's also a growing ecosystem of players like Alibaba, which are actually becoming a platform for a lot of the next generation, rising brands such as Feiyue and Gentle Monster. And a lot of it is actually supported by a wave of Asian culture. You've probably heard of K-pop or K-dramas, Korean dramas are also becoming very popular around young people.

And with the globalization of culture, it's also helping Asian brands build their brand abroad. And especially during COVID times, what we saw is a lot of consumer trends like contactless consumption or digitalization become the norm and these are very sticky trends that will continue on in non-COVID days as well.

And the third sector, we spoke a little bit about already is around energy and materials. This is a highly cyclical industry and because Asia actually is driving lots of demand, it today drives 44 percent of global energy and 70 percent of steel demand. This has been a very important sector that has driven a lot of the decline over the last decade especially given the end of this super cycle.

But looking forward here, there is a lot of opportunities for Asia to unlock. Like Oliver alluded to, Asian companies are actually a spot within this cyclical industry, and where the opportunity here is in, potentially, renewables. And we already saw a lot of this happening in solar. So for example, between 2010 and 2018, the price and the cost of the solar photovoltaic (PVC) modules have dropped by 15 percent. A lot of that accessibility is actually created and generated because of Asian firms and Asian demand. And other things such as electrification is also going to be huge. China today is already the largest electric vehicle (EV) market in the world, and Korea is also committed in becoming a hydrogen economy. And a lot of these commitments to really drive more sustainable solutions is going to be a key area for Asia to play.

Maybe switching gears now, talking a little bit about real estate. I think real estate is a very interesting one because this is something we all have been spending a lot of time in—our urban homes and what we see here is urbanization is going to be a continued driver of what makes real estate very attractive in Asia.

By 2040 we expect nearly 3 billion urban population in Asia and this is the core group of people that will need to live in cities. And the ways that they're living in cities are going to change, not just because of COVID but because of a lot of underlining demographic changes. For example, there's going to be an increase in single-person homes especially in places like Japan and Korea. And this a drastic change to how Asian culture used to be. Asian cultures are known to have big families, you have your grandparents and grandchildren, everybody living in one house. But then, the switch to a more different way of living is going to cause different demands and requirements on real estate.

Something that is a rising trend because of COVID is also what you look for in your living space is now changing. With a shift toward working from home, your house becomes more than just a place where you sleep. There's requirements on making it a more work-appropriate space as well and these changing preferences are all saying that real estate companies will need to consider as they think about what their new services, as well as products, can be.

And lastly is a little bit on the financial sector. As Jonathan mentioned, when you look across the financial sector, there is a varying performance. In China, it actually does really well. This is one of China's highest performing sectors. Asia today is the largest regional banking market. However, we know that return on equity has been declining especially during COVID. But where we see Asia can really break through and I'm sure many of you have already felt this and use this everyday is digital banking. Whether it's Alipay or WeBank or Paytm that's coming from India, this is also a place where Asia has completely leapfrogged the traditional infrastructure of the Western society and introduced new ways of connecting people. These are high-level opportunities for Asian companies to think about.

If I may move, we're going to talk a little bit more about looking ahead but before we go there, maybe a few questions to the panel. The first one would be to Jonathan.

Jonathan, as you saw in the sector stories, a lot of the opportunities is actually around growth, is around globalization and helping Asian firms scale. What do you think some of the challenges will be for Asian companies especially given the current volatility in the market as well as the geopolitical situation?

Jonathan Woetzel: Well I think, Patti, that the growth challenge, first of all, is when we say globalization for Asian companies, the effort is still largely going to be first and foremost on Asia. Because that's where the growth is. So maybe we're talking actually more about regionalization. In that context, there are so many challenges. There are many Asias. We've identified four of them, from advanced Asia, to emerging Asia, to frontier Asia, to China, each has its unique characteristics. The first challenge is that companies from emerging Asia will have to address and rethink its approach when it gets to advanced Asia or frontier Asia and so forth. So there is certainly a challenge to rethink the model as one goes in to the very different operating environments.

The other challenges that I've sort of mentioned before is that in most of these top performing companies have relied much more on organic growth model than in an bolt-on acquisition or however you want to think about it, the inorganic approach. That will also be an effort. This will require a greater flexibility of approach, more attention to alliances and to making those things work. We know from our own research that there is no inherent reason why an alliance or a partnership could not be as successful as a wholly owned entity but it does take more work. There's just more to do. So that's where there is governance or information system. So those capabilities are also going to be challenges for Asian companies as they regionalize and they move in to the next level of their growth as top performing companies.

Patti Wang: Wonderful. Thank you, Jonathan. And I think a common question that is coming through our Q&A right now is how do you think about COVID and the effect of COVID on firms? So over to you Chris to talk about that.

Chris Bradley: Fantastic. So what we're going to do here is just transition a bit from a backward looking view based on economic profit, to a forward looking view based on what the capital market is telling us. And as you know, capital markets are basically, when they are repricing a stock, telling us what they think the future profitability that stock is so we can derive what the future looking probably is. The first point is more what's happening in the capital markets and the answer is well, there is a massive variation. So this chart looks a bit complex but what it does is take all the sectors and pull them above the axis. X is the average of the sector, you can see the difference of commercial aerospace at the bottom and healthcare supplies and distribution at the top is huge.

But we also showed how much variation is happening within the sectors, which is the bar which goes from the 10th percentile to the 90th percentile, and the block, which goes from the 25th to the 75th.

So just keep that in mind. We might have lots of different views about whether overall capital market response is correct or overheated or optimistic. But there's a lot of information in the variance in the slope of that curve and it's very unusual to see that much difference in that short period of time between sectors. It's really useful information.

So how we use that information is to infer what is the actual implied economic profits on the upside of this. On this chart, we've gone from the story from the early 2000s to today. That was the whole point of the presentation. We know the dotted line went from high economic profits down to zero. We also

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know from today’s presentation that the terrific top quintile lives in a very different world than the troubled bottom quintile of economic profit. That’s something we’ve established over a long period of time when we talked about a lot in our work on the power curve of economic profit.

What this chart does, it compares that time trajectory and then this number LTR at the end. That’s the long-term implied profit by current market valuations. And here’s the really surprising thing. Well, it’s no surprise that overall valuation is the same that the profit pool’s on the shrinking end by –$352 billion. But what the real surprise is actually says the best companies are expected to get better. But it’s the worse companies are expected to get a lot worse. And that’s why we call this the great amplification.

The astute among you might notice a slightly different pattern around the time of the global financial crisis, where the top quintile also took a hit. And what we see in Asia, similar pattern, we’ve already seen in Asia that more difficult trajectory of economic profit. But the difference in Asia, I think, is the top quintile is slightly less of a jump up, but I think that’s about sector exposure in some of these mega winners in big tech, big pharma. But we also seen the bottom quintile, some of the more difficult sectors like banks, real estate, more exposure to those sectors in Asia.

So what of that? I’ll get there very quickly. Well, two things. First of all, the COVID is an unlocking, not a new trend in forces, but a release of forces that have been pent up a long time. Think more like an earthquake, there’s a fault line, there’s pressure against it. This event happens and you get an explosive issue of force. And so, we see from 2007 to 2017 quite a clear trend on which industries are losing economic profit, which ones are gaining.

The surprising thing here is when you look at the implied profits in the market. What the market is saying “Hey, more of the same.” There’s no U-turns here, there’s only acceleration.

On Asia, it is the same story by the way if not more exaggerated. So, no different in Asia.

And sorry, I will make one more point before that. We also looked within sectors. And when you look within sectors, another factor is happening; is that the best companies in the sector are actually doing pretty well. So the top quintile of companies within a sector in half of the sectors are actually doing better.

But in nearly every sector, is doing a lot better than the bottom quintile who is doing worse. So there's two big distortions, two big accelerators, two big amplifiers. One is difference in the sectors that were on the mega trend and not on the mega trend. That increase, no new mega trend, it's just amplification, just acceleration.

And within sectors, there's a big flaw to quality. In fact, you can see when you look at the mark, the firms and the groups of firms that are doing well at the top. They tend to have future-ready, resilient business models. And the firms within sectors that are struggling tend to have more asset-intensive, more legacy-based business models.

So we think that's a very important message coming out of COVID that it's not so much about a one-off health crisis. But it's about quite a radical, dramatic acceleration of bringing forward the future in quite a shocking way.

Patti Wang: Wonderful. Thank you, Chris. And then we're actually going to do a quick time check. We have about ten minutes left. And then Oliver is going to quiz us off and will leave a couple of minutes at the end for a few Q&A.

Oliver Tonby: What does all of this mean for companies across Asia? Now, this is difficult to summarize because I know this ended up being too high a level as opposed to for particular sector, sub-sector in a particular country. But, the five things to point out, let me use a slightly different language than what's on here.

But number one, talking about building your resilient firm for the 21st century. This is about the new ways of working, new business models. There's a premium on taste, a premium on innovation, a premium on collaboration. We talked about and we see the rise of ecosystems. We see the rise of platforms. There are new ways of collaborating and competing at the same time. We see an increase in taste and importance of R&D within Asia that there's an underspend in R&D. We've didn't talk about it this time but we do see that. So this is about new ways of working new business models that is part of being resilient for the 21st century.

Number two is leveraging technology to unlock productivity. I would even broaden that it's technology and we're seeing digital, digitalization especially during the COVID time. I'm sure you had seen some of the research in the US that took ten years to go from 6 to 16 percent of online retail penetration. And it took 8 weeks to go from 16 to 26. Ten percent increase in ten weeks that previously took ten years. We're seeing that everywhere also in Asia. So leveraging technology, digital to unlock productivity, new ways of reaching your customers.

The third one is bolder portfolio moves, but even before that, portfolio assessments. Are your businesses, your sub-segments, future-proof? Because there are several trends and we saw that Chris presented is that many of the trends we've seen for a long time are being amplified and accelerated these days. So therefore, what does that mean for your capital allocation? How do you find those pockets of growth, going forward?

The fourth one is around, I would call it more broadly organizational ability, maintaining momentum, agility. How does your structure change? How do you keep decision making, something we've seen in the past few months is the speed of decision making across all companies, all countries has really picked up. How do you maintain that speed of decision making and the agility? How do you build the modern skills that are required to deliver on the technology the digital and what have you that we just talked about. And then finally, the plan-ahead teams, this is around how do you deal with some of the uncertainty, the scenario that my colleague Chris Bradley on here has beautiful quotes that I've heard.

This COVID era is like we're in the middle of a long, dark tunnel. We do not know how long that tunnel is and we do not know what it looks like on the other side of that tunnel. That has pretty profound implications for businesses, for companies so setting up scenarios, knowing what the trigger points are when you act so that you know that you're going this way instead of that way. What used to be done in yearly budgets is now quarterly budget. So the whole way of planning ahead and the whole way of managing the company changes.

These are five implications that we see for companies that are, in summary, at the high level. Thank you.

Patti Wang: Awesome.

Oliver Tonby: Back to you, Patti.

Patti Wang: Awesome. Thank you Oliver. Maybe before we dive into a few more Q&As, let me answer a few questions we've got. The first one's about domestic services. What we mean by domestic services is actually an inclusion of sectors such as utilities, construction, real estate and a lot of transportation and that we've grouped together into domestic services.

Another question here is, as we were presenting the sector story, we talked a lot about how Asia often accounts for huge portions of demand but small portions of economic profit. There are varying reasons why each factor has occurred in each sector. For example, in consumer goods, it's the lack of representation. The focus on domestic markets, for example, within Asia you have a lot of these foreign companies also coming into Asia and making their profit and their fortune on Asian demand. But that profit is then allocated back to the North American or European headquarters.

Maybe a question over to Oliver. You've talked a lot about economic profit. As we're moving into this new age and even as COVID has showcased, running a firm in the future is a lot more than a possibility. How does purpose and other factors come into play here?

Oliver Tonby: Thank you. That is an extremely important question and comment, Patti.

I do think we have now focused on economic profit, I do think that what we've seen in the last two years is that the broader topic, broader purpose is as important, becoming as important. We've seen that it's a global phenomenon. We've seen that here in Asia. We've seen an awakening on sustainability. For those of us that were in Davos this year, by far the most discussed topic was sustainability. There has been a shift in talking about it to actually companies wanting to drive for impact on sustainability and it's coming from consumers. It's coming from employees in the companies and it's coming from investors.

So I think the broader topic of purpose is very important. Sustainability is one part of it. COVID was another awakening that we've seen now that all parties, all companies need to chip in and lead from the front in the fight against COVID and then the economic recovery. That's another driver of purpose. And I think now, over the last couple of weeks, we've also seen that companies are expected to play a more active role in the fight against discrimination.

So I think purpose has come to stay as something that is even more important than it was historically for companies. I would say that in many companies that I know, that I serve across Asia actually have been on broader purpose for quite some time. I'm happy to see that this is now becoming a global phenomenon.

Patti Wang: Wonderful. Thank you, Oliver. And maybe to close us off here, Jonathan, we talked a lot about corporations but what can policy makers do to also help to accelerate the growth of Asian firms, both profits as well as on purpose?

Jonathan Woetzel: Well I think one of the big lessons again, as evidenced in COVID as well, is the capacity of governments to work cooperatively with the private sector. And so to this sector, this time around, it was very clear that the private sector stepped up but to respond to those social and societal challenge, but that was enabled by effective collaboration with the public sector.

So governments and policy makers obviously should, in that sense, continue to have high expectations of the economic performance of their private sectors and to hold them to account in that sense. Sort of like probably keeping the pressure on competitive intensity that's led to top firms in Asia growing and being successful while ensuring that the environment in which the firms compete is supportive of those competitive firms rising to the top. Providing and investing in human capital, ensuring that these long-term investments see through-cycle infrastructure that needs to be built as they put in place, and providing access to marketplaces, of course, across Asia so that the top performing firms can grow and mobilize and introduce innovation to all of those literally hundreds of millions of Asian consumers and companies waiting for improvements and hungry for new products and services.

So that's, in a sense, is a continuation of the same polices brought forth into this new post-COVID context.

Patti Wang: Wonderful. Thank you, Jonathan.

And I believe we are right on time. So thank you everybody for joining us from around the world across different time zones today to talk about the performance and decoding of Asian corporates. And thank you, panelists, for joining us today as well.

Oliver Tonby: Thank you, Patti.

You have been listening to the *Future of Asia Podcasts* by McKinsey & Company. To learn more about McKinsey, our people, our latest thinking, visit us at mckinsey.com/futureofasia or find us on LinkedIn, Twitter, and Facebook.

Oliver Tonby is the chairman of McKinsey Asia and a senior partner in the Singapore office; **Jonathan Woetzel** is a director of the McKinsey Global Institute and a senior partner in the Shanghai office, where **Patti Wang** is a consultant; and **Chris Bradley** is a senior partner in the Sydney office.

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