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Unlocking the potential of Kansai companies

McKinsey Japan Kansai Office June 2018

Authored by:
André Andonian
Motohiro Hojo
Raymond Chan

Daruma dolls at Katsuo-ji temple, Osaka. The script character on the dolls means “victory” in Japanese.

Unlocking the potential of Kansai companies

Preface

The world is now facing change on a scale surpassing that of the Industrial Revolution. Today, such change is driven by several disruptive forces, including the growth of emerging economies, the disruptive evolution of technology, the increasing interconnectedness of the global economy, and the aging of populations across the world.

One intriguing phenomenon leading from these forces, especially as economies and markets around the world grow more tightly linked, is the gradual rise in importance of regions and cities rather than countries. In other words, regional and metropolitan attractiveness and competitiveness today hold increasingly greater sway than do the countries containing those regions and cities.

What does this mean for Kansai?

Fundamentally, Kansai leaders need to consider both the sustainable growth of the region as well as the international competitiveness of its cities. They should consider how Kansai can evolve, using its historical, cultural, academic, and infrastructural advantages to create a grand vision for the future, and make the bold moves required to achieve that vision. A worthy vision for the public sector and infrastructure related sectors, such as electricity, gas, transit, construction, telecommunications, and broadcasting, could be to establish a region that enables sustainable lifestyles, leading to improved core competitiveness and attractiveness throughout the region. The manufacturing and service sectors, by contrast, could focus on a vision grounded in global competitiveness, achieved by undertaking organizational transformations, productivity improvements, and growth investments in innovation and M&A.

The Kansai region and Kansai-based companies are on the precipice of tremendous change. The nature of the transformations required, and the urgency for undertaking them, resemble no other time in the region's history. Actions will require unprecedented levels of leadership, bold decision-making, ownership, and execution. We feel that McKinsey can help organizations take these important steps.

McKinsey & Company comprises more than 14,000 consultants across 60 countries worldwide, and has maintained a presence in Japan since 1971. In that time, we have supported Japanese corporations, government organizations, and nonprofits, including over 1,000 engagements since 2012. In recent years, we have enhanced our activities in Japan, which is among McKinsey's top priority markets, and in spring 2018 we became the only top management consulting firm to open an office in Kansai.

In this white paper, we propose transformation themes to achieve visions for Kansai such as those described above. We hope that this paper sparks deeper dialogue and collaboration between Kansai and western Japanese-based companies, government agencies, and academic institutions, and McKinsey.

André Andonian
Managing Partner, Japan

Motohiro Hojo
Co-managing Partner, Kansai Office

Raymond Chan
Co-managing Partner, Kansai Office

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Purpose: Unlocking Kansai's enormous potential

Kansai (defined, for the purposes of this paper, as the urban economic zone encompassing Osaka, Kobe, and Kyoto) is a global powerhouse in terms of economic might and population. The area has, over many years, amassed tangible and intangible assets, a rich talent pool, and organizations with real growth potential. As demographics and technology bring wave after wave of disruptive change to the world, the Kansai region and its companies face ever steeper challenges. This document puts forth several ideas for tapping Kansai's economic potential through stronger corporate performance.

The increasing importance of cities and regions, and Kansai's strengths

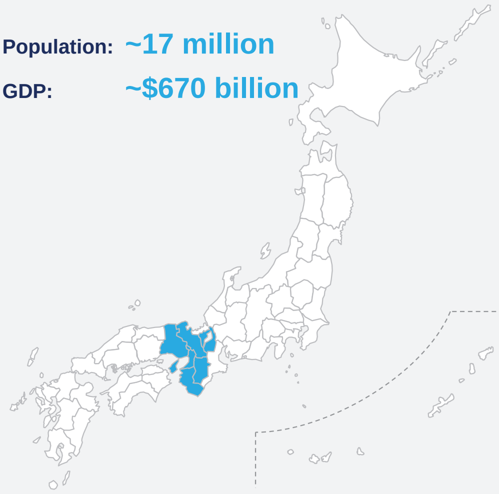
In recent years, the unit of economic activity has shifted from the country level to the regional and even city levels. In 2050, the urban population ratio will be above 80 percent in North America and Europe, and will jump from 48 percent (2014) to 64 percent in Asia. Worldwide, this translates to an increase in urban populations from 3.9 billion in 2014 to 6.4 billion in 2050. As one early consequence of this shift, we are already seeing the reputations of cities become increasingly detached from those of the countries where they are located. Various media also suggest that cities and regions need their own brands and strengths if they are to prevail in competition with other regions.

Exhibit 1. Kansai is one of the largest business centers in the world

Bold: Global top 20 both in GDP and population

Population: ~17 million

GDP: ~$670 billion



By GDP[1]		By population
Tokyo	1	**Tokyo**
New York	2	Jakarta
Los Angeles	3	Chongqing
Seoul-Incheon	4	**Shanghai**
London	5	**Seoul-Incheon**
Paris	6	Delhi
Kansai[2]	7	**Beijing**
Shanghai	8	Mumbai
Chicago	9	**Mexico City**
Moscow	10	**Sao Paulo**
Beijing	11	**New York**
Köln-Dusseldorf	12	**Kansai[2]**
Houston	13	Bangkok
Washington	14	Tianjin
Sao Paulo	15	Kolkata
Hong Kong	16	**London**
Dallas	17	Chengdu
Mexico City	18	Istanbul
Guangzhou	19	Buenos Aires
Tianjin	20	**Los Angeles**

1 PPP adjusted
2 Includes Osaka, Kyoto and Kobe

SOURCE: Brookings Institution "Global Metro Monitor" 2014; National Institute of Population and Social Security Research

The Kansai region is one of just a few globally to rank in the top 20 in both GDP and population (GDP 7th, population 12th; Exhibit 1). Historically, this region has been able to leverage unique strengths for its development, from Kyoto which boasts a rich history and is home to countless cultural treasures, to the commercial center of Osaka, with its Dojima Rice Exchange and its large textile, pharmaceutical, and consumer electronics sectors, to Kobe, whose maritime and shipping trade is among Japan's largest. This distinctive background and enormous economic scale continue to attract people and companies to the region.

The first "Top 100 Global Niche Companies," published by the Ministry of Economy, Trade and Industry in 2014, selected 25 companies from Osaka, Kyoto, and Hyogo (the prefecture where Kobe is located). Not only are there numerous top-flight companies that call Kansai home, but Osaka, Kyoto, and Hyogo have a combined total of 520,000 small and medium-sized enterprises (Tokyo, by comparison, has 440,000). The area is also a center of higher education with institutions like Kyoto University, Osaka University, and Kobe University. It seems clear that the talent development and economic ecosystem to support a healthy business climate in Kansai is already in place, and that Kansai-based companies have the assets and the potential to succeed.

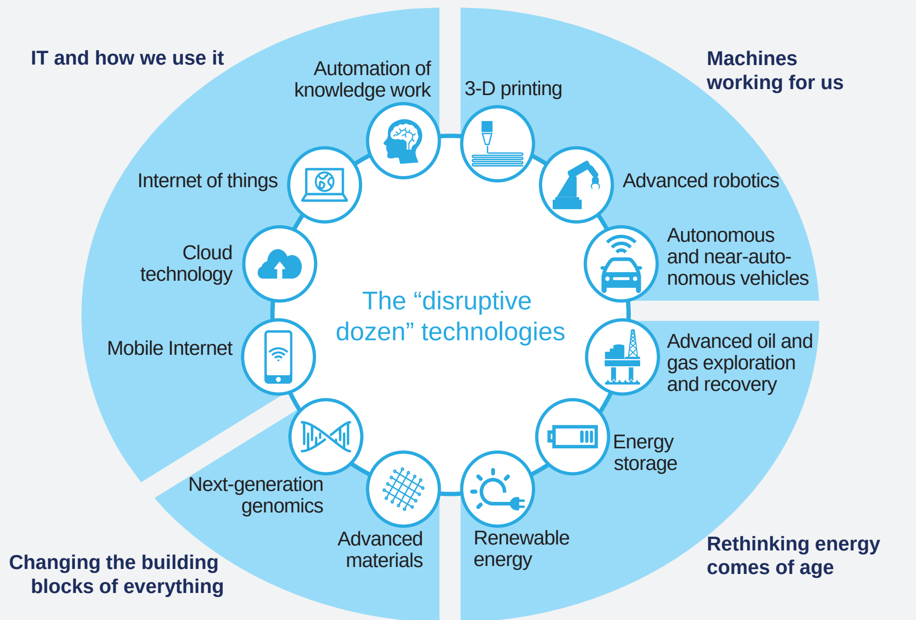
Disruptive global trends

In laying out our purpose for this paper, we noted the significance of disruptive change taking place today. Broadly, we see four disruptive trends exerting influence on a global scale.[1]

Disruptive trend 1: Growth of emerging economies

The United States currently has one of the world's largest urban residential populations at 250 million, but by 2025 China will be at three times that level, and India, double. Roughly around the same time, middle-class consumers, with a certain level of purchasing power, will account for around half of the global population. This represents a rapid rise in global purchasing power as well as a shift in its center of gravity toward emerging economies.

Exhibit 2. Twelve technologies have significant potential to disrupt



SOURCE: McKinsey Global Institute

1 Richard Dobbs, James Manyika, and Jonathan Woetzel, *No Ordinary Disruption: The Four Global Forces Breaking All the Trends* (McKinsey & Company, 2015).

Disruptive trend 2: Disruptive evolution of technology

The pace of technology advancement is accelerating, and the time required for new technologies to spread is declining. There are 12 innovative technologies that will have particularly disruptive impacts (Exhibit 2).

Disruptive trend 3: Increasingly interconnected global economy

From 1980 to 2013, the movement of goods and services among regions grew roughly six-fold from $1.9 trillion to $11.2 trillion. This is an indication of just how interconnected regions have become. Also, effects of local events now spread across the globe instantly, which indicates a new risk that interconnectedness also brings.

Disruptive trend 4: Aging of populations across the world

By 2040 in most developed countries, the elderly will account for one of every four people. A large decline in the working population is forecast for major economies; in Japan, the working population is expected to decline by 30 percent by 2050. Countries and regions need to respond to this trend on the institutional front with pensions and social security. On the corporate front, too, there is greater demand for services that address the unique needs of the elderly.

Implications for Kansai, and seven moves that Kansai companies can take

The top 200 Kansai companies by sales had average sales growth rates of 4.3 percent and a return on invested capital (ROIC) of 5.6 percent during the 2012-2016 period, both about three percentage points below the G7 average. In terms of productivity as well, the Kansai region generates approximately ¥4,700 in GDP per hour of work, 13 percent below the OECD average of roughly ¥5,400.

Investment and strategic actions for the future are also at low levels. Startups in Kansai captured only 6 percent of total startup investment in Japan. M&A activity tells a similar story: the ratio of company market capitalization[2] was 29.0 percent for the UK, 26.3 percent for Germany, and 21.8 percent for the United States during the 2005-2014 period. Kanto (the greater Tokyo region) was on a par with developed regions at 24.0 percent, but Kansai was only 12.7 percent.

The disruptive trends noted in the previous section could bring further headwinds for Kansai companies. Specific risks include:

- *Isolation:* Inability to keep up with latest trends, strategies, and management models as the rest of the world grows more connected
- *Lagging in technology*: Delays in startup investment, digitization, and adoption of new technologies
- *Shortage in human capital*: Inability to attract talent as competitors disrupt traditional ways of doing business across the value chain, with Kansai companies losing appeal as a consequence

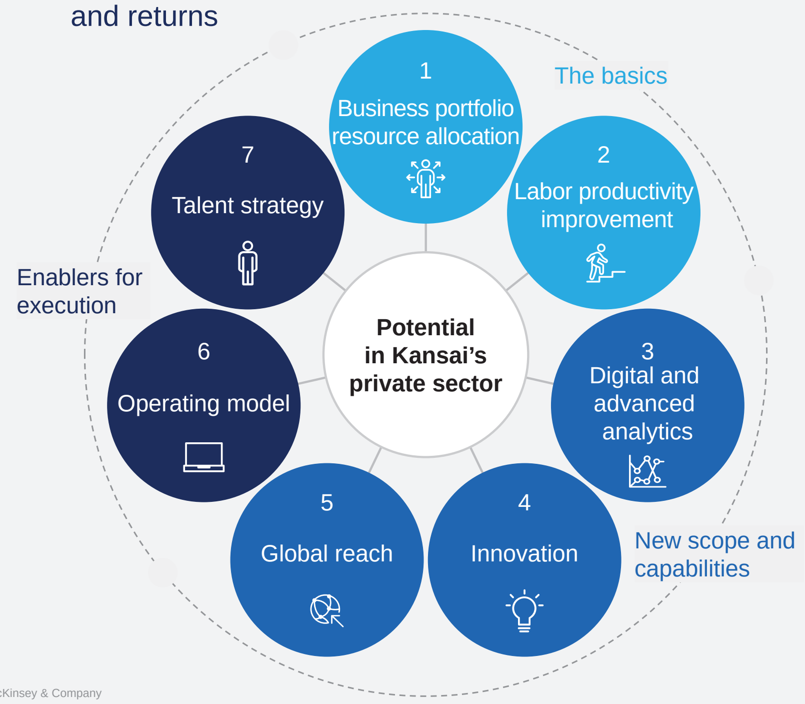
2 Covering the top 1,000 companies in the world by market capitalization as of 2004 (109 Japanese companies, of which 77 were in Kanto (Tokyo), 18 in Kansai, and 14 in other regions).

How should Kansai companies confront these risks and ride the wave of disruptive trends? Fundamentally, they need a holistic and objective understanding of the situation, and they need to respond with transformative moves that encompass the following objectives:

- *Reinforce the basics*: Review basic corporate strategy and resource allocation across businesses, and take proactive measures to improve productivity for the company as a whole
- *Expand scope and capabilities*: Expand the geographic range of markets, and achieve greater breadth of organizational capacity and technology
- *Support execution*: Drive fundamental changes in the organization's operating model, and rigorously execute on talent recruitment and training

Below, we offer seven overarching recommendations. Following through on each of these "bold moves" (Exhibit 3) will have an impact that can be termed truly transformative.

Exhibit 3. Bold moves by CEOs and management will drive performance and returns



SOURCE: McKinsey & Company

1. Optimize business portfolios and resource allocation

Companies need to examine the attractiveness of markets and their own core strengths to determine which businesses should be at their core, and which will serve as growth engines in the future. They then need to establish and update their business portfolios to maximize enterprise value and weigh market attractiveness and company strengths to clearly determine how to invest in or allocate resources across businesses.

In execution, management teams should focus on developing a common understanding, by closely examining the company's traditional core businesses and holding discussions based on clear strategy and facts. Creating an initial visual representation of the portfolio structure will help speed up the process.

2. Dramatically improve labor productivity

Roadblocks in productivity along the value chain should be clearly identified and structured, as should improvement opportunities. No areas should be held sacred in driving productivity improvements. Going beyond improving individual functions like production, sales, and marketing, companies should also address improvement opportunities with respect to coordination across functions, which is often difficult because of siloed operating models.

Companies must also freshly consider automating operations across the entire value chain, from development to distribution as well as corporate functions. Examples include completely automating the production process, creating advanced, automated services that address the needs of the elderly, and correctly leveraging new technologies in corporate functions so that automation brings high ROI. These efforts, combined, can deliver global levels of labor productivity.

3. Optimally leverage digital

Digital should be positioned clearly and boldly within the companywide strategy, steering the organization toward digitization. Digitization requires a different approach from conventional IT investments; it means fundamentally changing how business is conducted throughout the company, which requires a strong commitment from top management.

Digital should be used to trigger rapid changes, starting from areas most compatible with digitization. Cases where decisions based on data-centric insights led to success can be used to embed data-based decision making as the new norm.

Companies should also gather expertise scattered throughout the organization, integrate this data, and establish best practices while investing boldly in talent with digital expertise, and in capability building.

4. Proactively invest in innovation

The innovation of the future will involve completely reworking business models and building new ecosystems, activities that are different in nature from what has taken place in the past. Top management must make a deliberate effort to stay abreast of the latest technologies and trends and be sensitive to the seeds of innovation. Bold investments in research and development should be pragmatically executed by, for example, going beyond existing businesses and allocating a set budget for potentially risky areas like new, potentially disruptive technologies and basic research.

In addition to conventional approaches like M&A and joint ventures, companies must look to new external partnerships, including open innovation, and fully capitalize on ideas and technologies both within and outside their organizations. Accordingly, it will be necessary to create an organizational foundation that fosters innovation and cultivates both internal and external seeds of innovation. These seeds could take the form of a new innovation unit that is not managed according to the metrics and numeric targets of current businesses.

5. Evolve into truly global companies

Companies must articulate a bold scenario for globalization and seriously study the potential to move into unexplored regions. In addition to Southeast Asia, which is likely already on the radar, they should consider growth markets in India and other parts of South Asia as well as Africa. Personnel should be based on the ground to gain direct access to essential information and insights at the city and region levels.

In M&A, top management should share an understanding of integration strategies and plans, and the post-acquisition phase should be considered from the due diligence stage. Management must also define the roles of the head office and local subsidiaries, providing necessary governance, but delegating decision making authority to local people wherever possible, so that local subsidiaries have sufficient autonomy.

At the same time, talent capable of initiating globalization, including formulating business strategies and executing M&A, and growing businesses together with local people must be actively recruited, trained, and promoted.

6. Transform organization operating models

As the pace of change accelerates and the future becomes more difficult to predict, companies will need to change what have traditionally been rigid, hierarchical organizational operating models. Maintaining the focus on customer value while adapting to change means increasing the slimness (i.e., Leanness) and flexibility (i.e., agility) of the organization to improve both the speed and quality of decision making.

The "lean" operating model requires top management and employees in all units and functions to adopt a rigorous focus on the customer perspective. Whatever is irrelevant to customer value is eliminated as waste in an ongoing process of efficiency gains that also tackles waste stemming from lack of coordination across functions and units.

The "agile" operating model creates organizational structures that combine the "backbone" of unchanging strategic direction and common values that are maintained through changes, with the "flexibility" to shift resource allocation and reorganize teams to adapt to the environment. Certain units are more suited to the agile approach than others, and should be provided independence from rigid internal systems and decision making processes. These units can adopt the agile approach on a trial basis, create success stories, and with strong support from management, seek to spread the agile culture throughout the organization.

The "lean" and "agile" operating models are complementary. As a first step to transforming the operating model, we recommend choosing the approach that is the best fit for the company, and concentrating intensively on a single approach.

7. Ramp up the talent strategy

Companies should identify current talent within the organization, which will form the core of business growth, as well as the new talent required to implement future business strategies. A comprehensive talent strategy should be designed to attract, develop, and retain these people.

It is necessary for companies to clearly define what kind of people they require to implement company-wide strategies and ensure their success, including in new areas like cross-border M&A, innovation, and digital. Once target profiles have been defined, companies should move to flexible, effective recruiting activities. In doing this, they should utilize "people analytics," which applies machine learning and other advanced analytical methodologies to sift through complex data and improve the effectiveness of recruiting activities.

In the process of helping newly recruited talent develop skills and expertise, it is also necessary, from a longer-term perspective, to foster skills that will be required of future leaders. For leadership, practical, long-term, and encompassing areas such personal values should be designed. Companies also need clear HR evaluation systems that align with companywide strategy, fair evaluation criteria consistent with their systems, and tools to reflect evaluations in compensation and incentives. Having these factors in place will result in work that is more satisfying and motivating, thereby helping companies retain talented individuals.

Bold moves under the leadership of top management

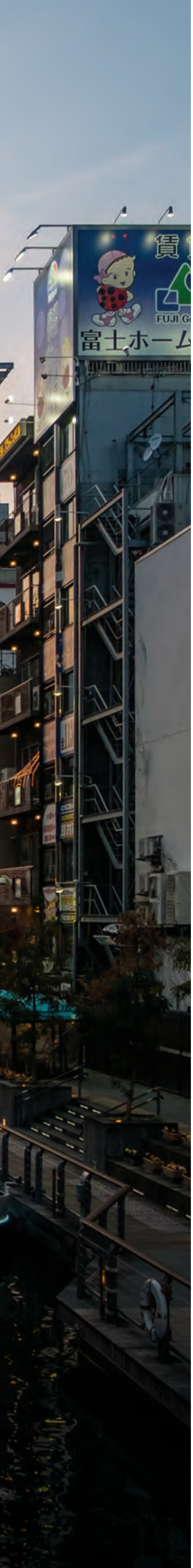
The seven bold moves outlined above are not simply tools or minor tweaks; they require the commitment of the CEO and the entire management team to succeed as strategic, transformative moves. The economic value generated by all companies[3] is concentrated in the top 20 percent of companies. Only 9 percent of companies in the middle 60 percent are able to move out of that group and into the top 20 percent. The ones that do engage in a repeated process of bold transformation.

Faced with disruptive changes, the Kansai region, with its unique history and culture and strong educational and social infrastructure, must decide how it wishes to evolve. Similarly, each company's top management must determine how their company will evolve within that context. They must also rigorously examine how their company will move forward on innovation and globalization to maintain and increase attractiveness. These questions should lead to bold actions that will improve company performance and, ultimately, make the Kansai region more attractive, stimulating further development.

We recommend this "transformative journey" based on our confidence in the potential of Kansai-based companies and the management teams who lead them. Through deep top management commitment and rigorous execution, Kansai companies, and the region as a whole, can both confront and embrace global-scale disruptive forces and reestablish a global presence. Kansai holds enormous promise.

3 The economic value produced by a company = net operating profit - (adjusted capital x weighted average cost of capital) = invested capital x (return on invested capital - weighted average cost of capital). Subtracting capital procurement costs provides an indication of a company's profit earned.

Dotonbori canal, Osaka.



1. Kansai's presence in the world

In recent years, cities and regions have supplanted countries as important units for measuring and evaluating economic activity and social trends. In Asia, for example, population shifts have led to an increase in total urban population from 32 percent in 1990 to 48 percent in 2014, and this figure is projected to rise further to 64 percent by 2050. In North America and Europe, more than 70 percent of the population was already living in urban areas by 1990, and as urbanization continues to progress, that ratio is projected to surpass 80 percent by 2050 (Exhibit 4). At the global level, the world had an urban population of 2.3 billion in 1990, 3.9 billion in 2014, and by 2050, around 6.4 billion people will be living in urban centers.

Exhibit 4. The world is seeing a dramatic population shift to cities

Percent of the population living in urban areas

		1990	2014	2050
Worldwide		43	54	66
Urban migration area	Africa	31	40	56
	Asia	32	48	64
Urbanized area	Oceania	71	71	74
	Europe	70	73	82
	Latin America	71	80	86
	North America	75	81	87

SOURCE: United Nations Population Division of the Department of Economic and Social Affairs: 2014 Revision of World Urbanization Prospects

Urbanization is concentrating economic activity in cities. McKinsey Global Institute estimates that over the decade from 2015 to 2025, the top 600 cities by population will generate 66 percent of the world's GDP growth. Even the way cities are perceived correlates less and less to perceptions held of the countries where they are located.[4]

4 Reputation Institute. 2017 City RepTrak. The Most Reputable Cities in the World.

Kobe Port Tower and Kobe Maritime Museum.

Kansai and its central cities have qualities and economic scales that offer undeniable potential

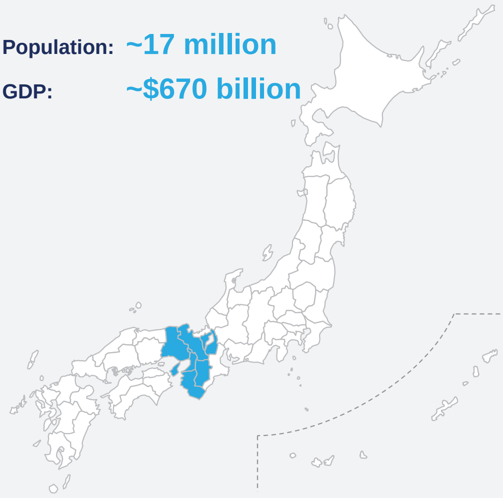
In this context, Kansai and its central cities have qualities and economic scales that offer undeniable potential. The urban cluster of Osaka, Kyoto, and Kobe already ranks in the global top 20 by GDP and by population (7th and 12th, respectively; Exhibit 5). Only a handful of other urban regions, such as Tokyo, New York, and London, can make a similar claim. Historically, Kansai has always been distinctive, and has leveraged its unique strengths to develop and grow. Noteworthy among these are the unparalleled historical and cultural assets of Kyoto, the commercial hub of Osaka with its Dojima Rice Exchange and robust textile, pharmaceutical, and consumer electronics sectors, and Kobe, which boasts one of Japan's largest trading ports. Its unique history and enormous economic scale continue to attract people and companies to the region.

Exhibit 5. Kansai is one of the largest business centers in the world

Bold: Global top 20 both in GDP and population

Population: ~17 million

GDP: ~$670 billion



By GDP[1]		By population
Tokyo	1	**Tokyo**
New York	2	Jakarta
Los Angeles	3	Chongqing
Seoul-Incheon	4	**Shanghai**
London	5	**Seoul-Incheon**
Paris	6	Delhi
Kansai[2]	7	**Beijing**
Shanghai	8	Mumbai
Chicago	9	**Mexico City**
Moscow	10	**Sao Paulo**
Beijing	11	**New York**
Köln-Dusseldorf	12	**Kansai[2]**
Houston	13	Bangkok
Washington	14	Tianjin
Sao Paulo	15	Kolkata
Hong Kong	16	**London**
Dallas	17	Chengdu
Mexico City	18	Istanbul
Guangzhou	19	Buenos Aires
Tianjin	20	**Los Angeles**

1 PPP adjusted
2 Includes Osaka, Kyoto and Kobe

SOURCE: Brookings Institution "Global Metro Monitor" 2014; National Institute of Population and Social Security Research

Companies with a deep history in Kansai, along with the region, itself, have the assets and potential to continue as leaders in the global economy and in society. The overarching theme of this report is how to raise the region's prominence given its many advantages, and more specifically, how to improve corporate performance and stimulate development of the Kansai economy from the perspective of corporate activities.

To-ji temple and five-storied pagoda, Kyoto. The temple is a UNESCO world heritage site.

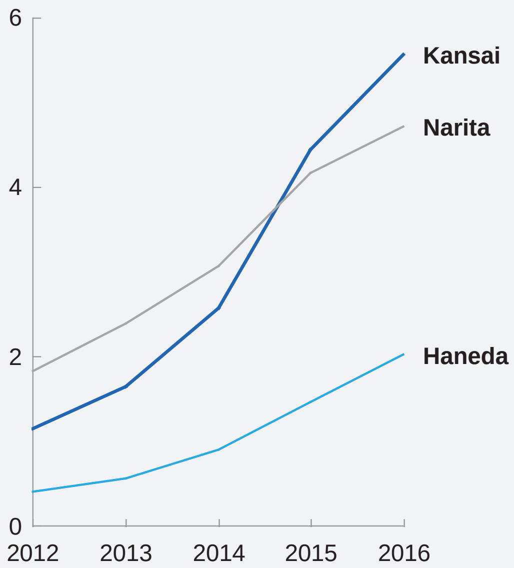
2. Kansai's strengths

Kansai has long been a center of Japanese culture and business. Kyoto was Japan's capital for 800 years beginning in the eighth century, and Osaka continued to be the center of business and commerce even after the capital moved to Edo (Tokyo). During the Edo period (1603-1868), Osaka was known as “the nation’s kitchen," and was blessed with all the conditions required to make it a center of commerce. These included the production capacity of the imperial territories around Kyoto, the excellent fishing ports and shipping routes of the Seto Inland Sea, and the seaports of Osaka Bay. The flourishing Dojima Rice Exchange was indicative of the region's status and prowess. Similarly, Kobe has maintained its position as one of the busiest trading ports in Asia. In 2016, it surpassed the Port of Yokohama to become the No. 2 trading port in Japan, recording its highest ever container handling volume in 2017.

Thanks in part to this traditional economic base and historical background, many of Japan's leading companies have originated in Kansai. The economic strength of postwar Kansai can be seen in its heavy industry players, trading houses, consumer electronics companies, and retailers, the concentrations of textile manufacturers and wholesalers along the quays, and the pharmaceutical companies and affiliated industries in Doshomachi. Of course, the region's industry is composed of more than just large companies: Osaka Prefecture alone is home to roughly 300,000 small and medium-sized enterprises, second only to Tokyo at 440,000. Adding Hyogo Prefecture and Kyoto, the number jumps to around 520,000.

Exhibit 6. Kansai is Asia’s new tourism hotspot

Tourists from Asia by airport of entry
Millions



“

Easy access from Asia - it costs only about $300 from China to Osaka

Convenience

Osaka, Kyoto, and Nara are all accessible in a single day

Many areas with traditional shops

Lively experience

More friendly and talkative shop-owners than in Tokyo, with a traditional mercantile attitude

Kansai has lots of local street food

”

SOURCE: Ministry of Justice, Bloomberg


Twilight view of Osaka and Kobe from Kikuseidai at Mt. Maya.

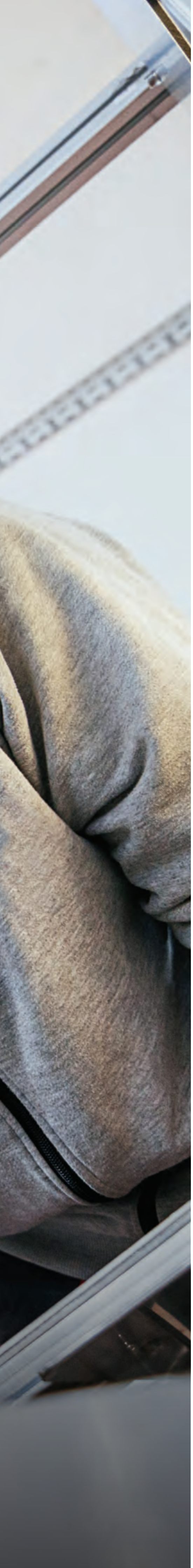
The first “Top 100 Global Niche Companies" published by the Ministry of Economy, Trade and Industry in 2014 included 25 companies from Osaka, Kyoto, and Hyogo prefectures

Kansai has a strong industrial structure, with a good balance across major industries, including food products, chemicals, steel, metal products, general machinery, electrical machinery, and transportation equipment.[5] The Kansai business makeup is unlike that of greater Tokyo or the Tokai region (Nagoya), both of which tend to be biased toward transportation equipment. In prefectural rankings of annual wholesale and retail product sales (2014), Osaka prefecture is second only to metropolitan Tokyo.

Another Kansai strength is its concentration of institutions of higher learning, such as Kyoto University, Osaka University, and Kobe University, as well as its corporate R&D centers and research institutes, such as Kansai Science City in Keihannna Hills, Kyoto Research Park, and the Kobe Biomedical Innovation Cluster. Perhaps thanks to this environment, the first “Top 100 Global Niche Companies" published by the Ministry of Economy, Trade and Industry in 2014 included 25 companies from Osaka, Kyoto, and Hyogo prefectures.

Easy access to and from Asia, primarily through Kansai International Airport, makes Kansai a convenient location for companies, and the ability to get around Kyoto and other major tourist destinations in a single day has helped Kansai's foreign visitor numbers to grow even more quickly than the number of foreign visitors to the Tokyo area over the past five years (Exhibit 6). Events such as the 2019 Rugby World Cup, for which Kansai is a qualifying venue, the 2021 Kansai World Masters Games, and development plans, including Yumeshima, designed as an integrated resort and world's fair site, and Maglev bullet trains are expected not only to further increase the number of foreign travelers, but to have an impact on the Kansai economy as a whole.

5 Kansai Keizai Doyukai, "Kansai Growth Strategy," March 2016.



3. Disruptive global trends

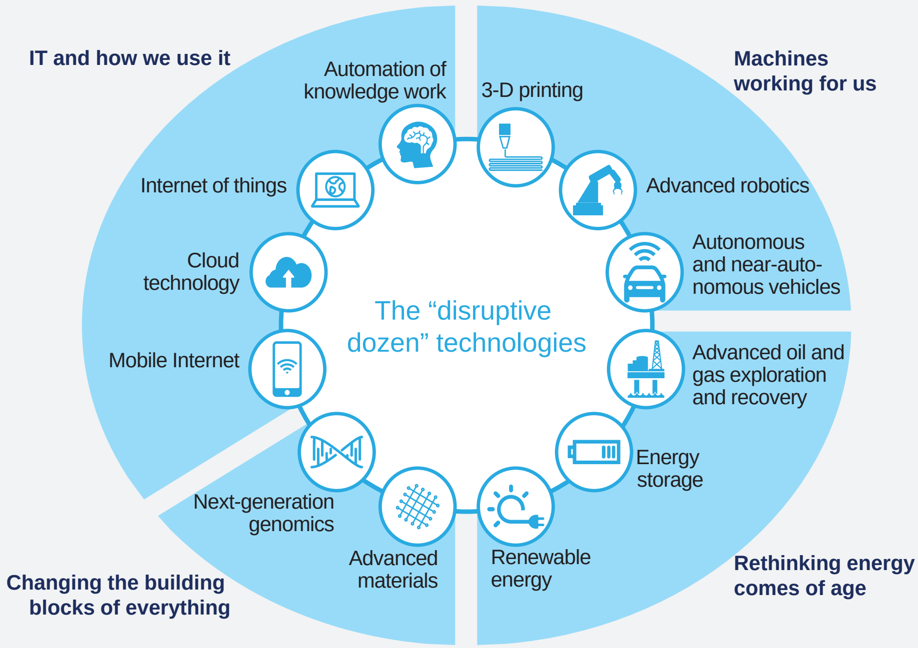
Shifting from the past and present to the future, we examine four major trends taking place: the growth of emerging economies, the disruptive evolution of technologies, an increasingly interconnected global economy, and the aging of populations across the world. The Kansai region will not be insulated from these waves of global change.

1. Growth of emerging economies

Urbanization is a global phenomenon, especially in emerging economies. China and India are moving along the same growth trajectory as Korea took 50 years before, but at far greater speed and with much more social upheaval. Over the past 30 years, the world's urban population has grown by an average of 65 million per year, and most of that growth can be attributed to the rapid urbanization of China and India. For purposes of comparison, the United States currently has an urban population of 250 million; by 2025, China's will reach triple that number, and India, double.

Urbanization, however, represents an increase in concentrated purchasing power (expressed, for our purposes, as GDP per capita on a country by country basis) as well as population. With per capita GDP growth in emerging economies that already have large populations, such as China and Brazil, we foresee a sharp global rise in total purchasing power. By 2025, in fact, we project that roughly half of the global population will have become “middle class” consumers with substantive purchasing power.

Exhibit 7. Twelve technologies have significant potential to disrupt



SOURCE: McKinsey Global Institute

2. Disruptive evolution of technologies

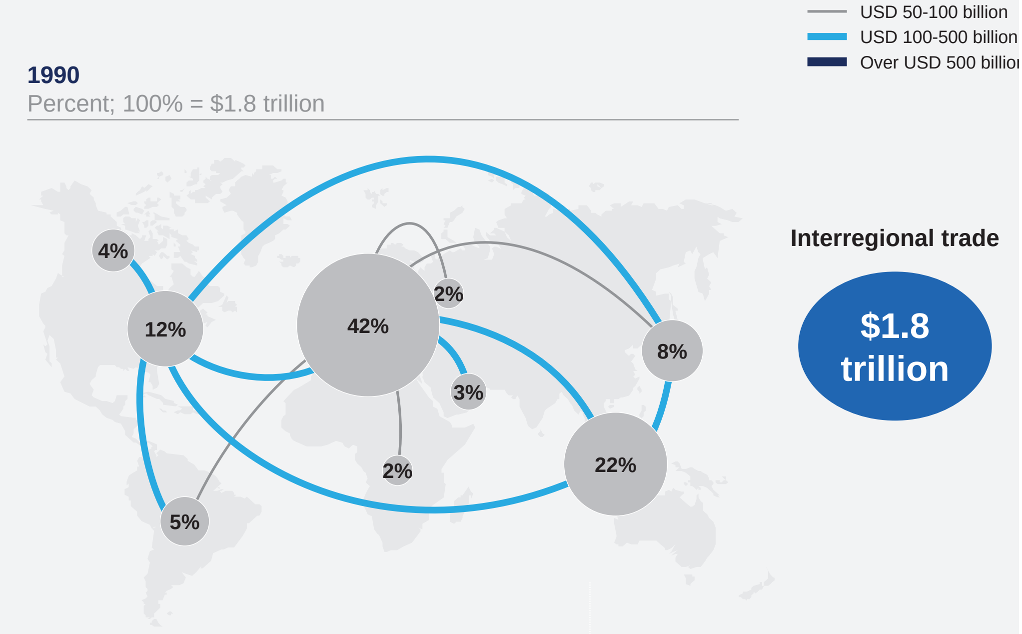
Technological advances have always brought disruptive change, but never with the speed we see today. In just the past few years we have witnessed the emergence of numerous innovative technologies (Exhibit 7), and the pace is only accelerating. Taking communications as an example, it took 115 years to go from the invention of the first telephone to the development of the first website, but only 16 years from there to the arrival of the iPhone. The span of time between the inventions of the printing press and the computer printer was 505 years. From that time to the development of 3D printers, 31 years.

The time it takes for technology to spread is also decreasing. The telephone was in use for 75 years before there were 50 million users; radio, 38 years. By contrast, the Internet attained that level in just three years, and new online applications like Facebook and Twitter in less than a year.

3. Increasingly interconnected global economy

During the period from 1980 to 2013, the movement of goods and services across regions increased six-fold from $1.9 trillion to $11.2 trillion, resulting in ever more deeply connected regions, and adding new countries to international trade. The impact can be seen in the emergence of new trade centers like China and South America (Exhibit 8,9).

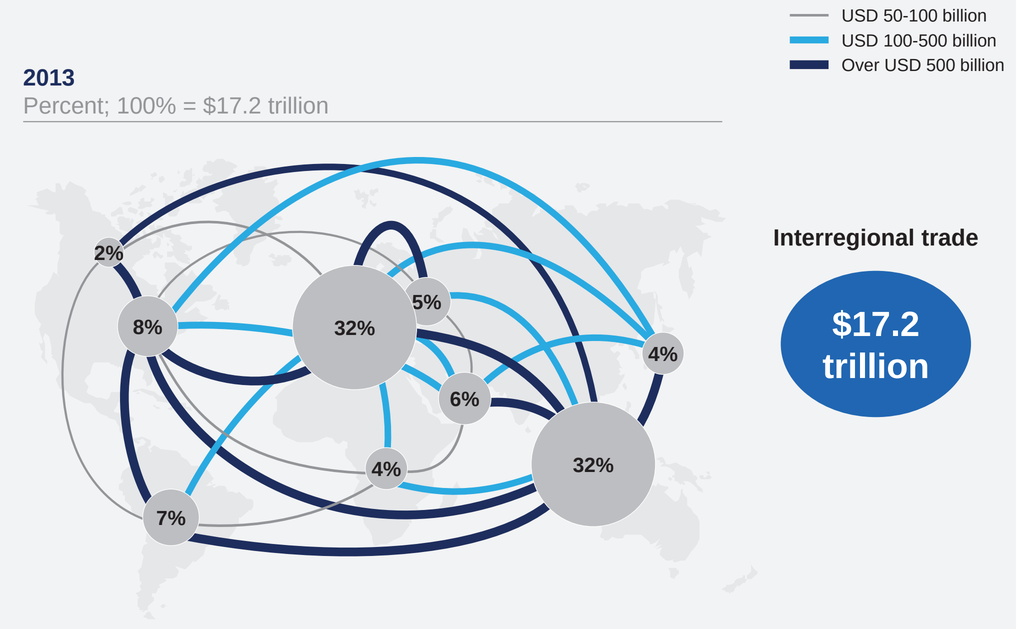
Exhibit 8. Global flows are becoming more interconnected



Note: Lines show trade flows between regions, figures in bubbles show participation in world trade

SOURCE: UN Comtrade; World Bank World Development Indicators; International Monetary Fund Balance of Payments; Telegeography; McKinsey Global Institute analysis

Exhibit 9. Global flows are becoming more interconnected



Note: Lines show trade flows between regions, figures in bubbles show participation in world trade

SOURCE: UN Comtrade; World Bank World Development Indicators; International Monetary Fund Balance of Payments; Telegeography; McKinsey Global Institute analysis

As the global economy has become more closely intertwined, regions and companies are increasingly vulnerable to the impact of global-scale changes. One example comes from correlation coefficients against oil prices, which were 0.33 and 0.36 for wheat and beef respectively during the 1980-1990 period, but rose to 0.97 and 0.82 for 2009-2014. Global share prices are also becoming more volatile. During the 1980s, share prices moved more than 3 standard deviations just three days per year on average. Over 2010-2014, that average grew to 10 days per year.

By 2040, one in every four people will be elderly across developed countries, including China

4. Aging of populations across the world

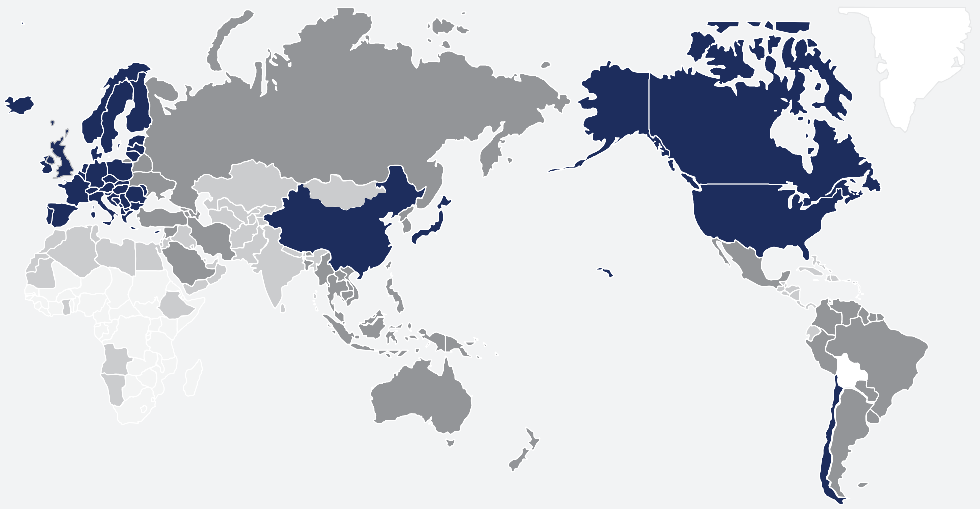
Populations continue to age on a global scale. By 2040, one in every four people will be elderly across developed countries, including China (Exhibit 10). By 2050, China's working population is expected to decline by 150 million, while the working populations of countries like Russia, Japan, and Germany are expected to drop by around 30% from current levels. In countries where sharp declines in the working population are expected, GDP growth is also set to slow, and policymakers need to consider ways to deal with this by, for example, encouraging the employment of the elderly and accepting greater numbers of immigrants.

Countries and regions will also need to adapt their systems to support larger numbers of pension and social insurance beneficiaries while providing services that address the particular needs of the elderly in areas such as mobility and mental and physical health.

Exhibit 10. By 2040, about one in four people in advanced economies, including China, will be 65 years old or older

n/a <5% 5-12% 12-20% 20-35%

Share of population 65+, 2040E



SOURCE: UN Population Division; McKinsey Global Institute analysis

Aerial view of the colorful foliage around Lake Biwa, Hikone city, Shiga prefecture.

4. Challenges facing Kansai companies and moves to address them

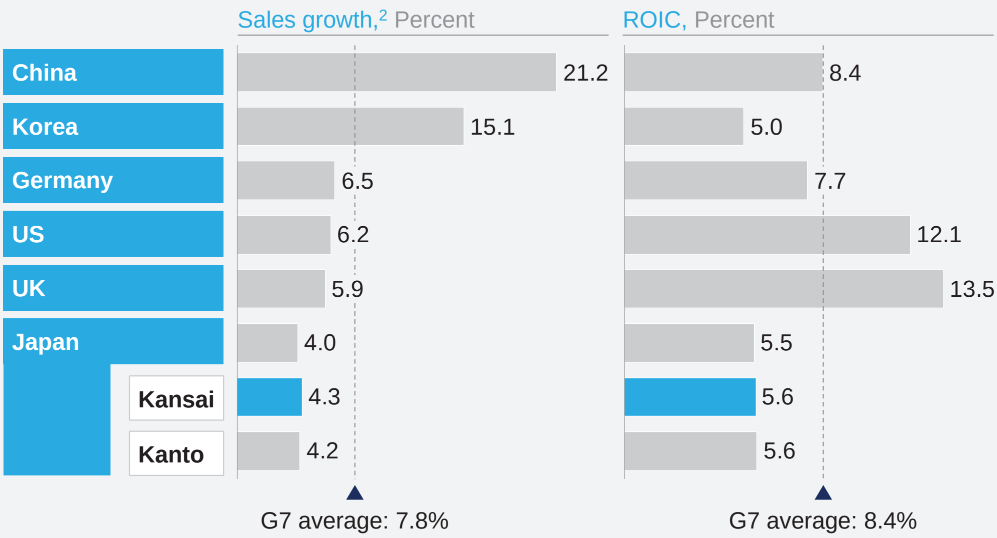
The challenges facing Kansai companies

Japanese corporate performances are largely stagnant, a fact as true in Kansai as elsewhere. Current performance shows a widening gap with other developed countries across growth, profitability, and labor productivity (Exhibit 11). Specific numbers help illustrate the stark picture:

- *Low growth*: The average sales growth rate in Japan is around three percentage points below the G7 average and 10 percentage points below the rates in China and Korea
- *Low ROIC*: ROIC is around three percentage points below the G7 average and six to seven percentage points lower than average ROIC in the US and UK
- *Low labor productivity*: Improvement potential in labor productivity is also noteworthy. Kansai's GDP per hour of labor is around ¥4,700, which is 13 percent below the OECD average of ¥5,400, and 35 percent below the US average of ¥7,300

Exhibit 11. Kansai companies have lower growth and profitability than global peers

Annual average sales growth and ROIC for companies by country,[1] 2012-2016



1 Sample company: Top 200 listed companies in 2016 sales in each market
2 Companies over 1,000% five-year average sales growth are excluded

SOURCE: SPEEDA

Three further threats from disruptions

Kansai companies largely have yet to land upon solutions to the disruptive changes noted in the previous chapter. Left unchecked, these trends put Kansai companies at substantial risk. Here, we highlight three specific risks for Kansai-based players to overcome or mitigate as the disruptive global trends intensify:

1. Isolation

As noted earlier, the global economy is increasingly interconnected with respect to flows of goods, services, money, people, and data. A McKinsey Global Institute survey ranked the United States third across these various flows, and China, seventh. Japan ranked 24th (Exhibit 12). On the flow of people, in particular, Japan was ranked 81st in the world. If Japan remains this disconnected from other markets, it will become increasingly isolated, even as the world grows ever more interconnected.

Exhibit 12. Japan has weak linkage with other regions

Ranking of connectedness with other regions 2014[1]

Rank	Country	Product	Service	Finance	People	Data
1	Singapore	1	2	2	12	6
2	Netherlands	3	3	6	21	1
3	United States	7	7	3	1	7
4	Germany	2	4	8	3	2
5	Ireland	32	1	1	28	9
6	UK	13	5	5	6	3
7	China	4	16	4	82	38
8	France	11	8	9	7	4
9	Belgium	5	6	33	33	8
10	Saudi Arabia	20	28	27	2	53
⋮						
24	Japan	15	20	12	81	20

1 Rank of participation as measured by flow intensity and share of world total; flow intensity represents the total value of goods, services, and financial flows as a share of the country's GDP

SOURCE: McKinsey Global Institute

Looking more closely at the Kansai region, we see that roughly half of all Kansai-originated exports go to just three markets: China, the United States, and Taiwan. There is substantial room to enter future growth markets, such as Africa and Southeast Asia. Kansai is especially lagging on Africa compared to China and South Korea.

Another indicator of looming isolation is M&A inactivity. Kansai companies show lower levels of M&A activity than their counterparts in Tokyo as well as other countries. Measured in terms of market capitalization of acquired companies divided by the market capitalization of head offices,[6] the UK was at 29.0 percent during the 2005-2014 period, Germany, 26.3 percent, the United States, 21.8 percent, and Japan, just 19.4 percent. Within Japan, Kanto (Tokyo) was at 24.0 percent, which puts the region on a par with developed countries, but Kansai was a mere 12.7 percent. This low number suggests that Kansai companies may not be sufficiently adapting themselves to the rapidly changing business environments around them.

2. Lagging in technology

There are gaps between Japan and other developed countries on investment in technology, and these gaps are only widening as time passes. In Kansai, startup company activities are low compared to those across Japan as a whole, and venture capital investment is below that of the Tokyo region. In 2006, total venture capital investments in Kansai accounted for 10 percent of all such investment activity in Japan, and that figure has dropped to just five percent in 2016. Going forward, Kansai can only maintain its traditional standing as a source of innovation if it endeavors to understand technology trends and makes bold investments in them.

3. Shortage of human capital

We are also seeing changes in talent and capability requirements, largely as a consequence of new business models and approaches driven by digital natives and platform players who have a strong presence across the value chain and are causing tremendous upheaval to traditional value chains. To adapt to these environmental changes, Kansai companies need flexibility, robustness, organizational structures that promote agile decision making, and talent strategies that will enable them to prevail in the intensifying war for talent.

Taking a step back to look at Japanese demographics, the total population is expected to decline by 16 million during the period from 2015 to 2040, and the Kansai region population, specifically, by about 2.7 million. Focusing just on productive population, the Kansai region is projected to see a loss of 3.2 million people. The world, as a whole, is aging, but the Kansai region is at the vanguard of the trend, and will face serious labor shortages, contractions in economic scale, and increases in social security costs for the elderly. It is imperative for Kansai-based companies to begin adapting to the challenge they face in attracting talent.

6 Covering the top 1,000 companies in the world by market capitalization as of 2004 (109 Japanese companies, of which 77 were in Kanto (Tokyo), 18 in Kansai, and 14 in other regions).

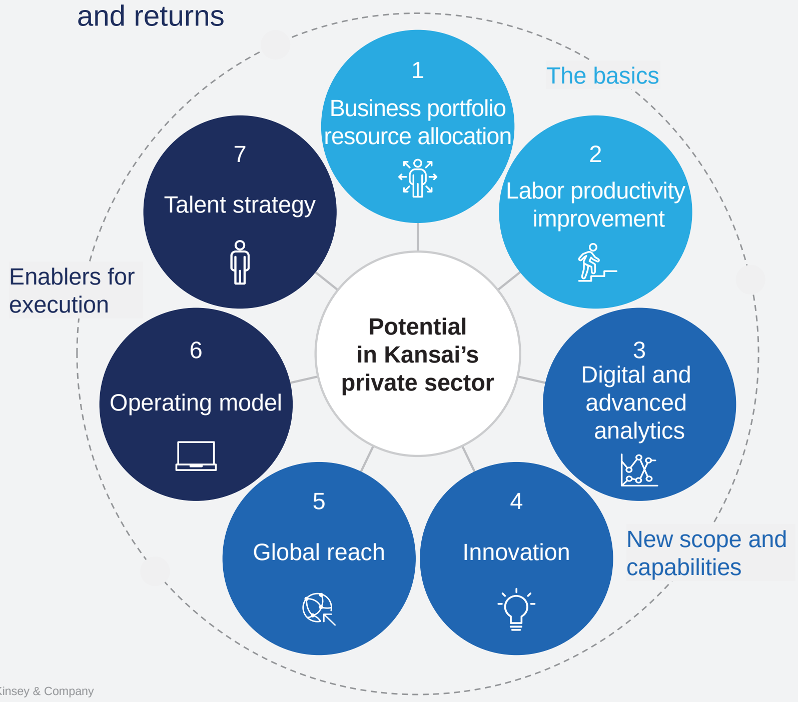
Proposed moves

The challenges facing Kansai-based companies are complex, and there is no silver bullet for any of the risks outlined in this chapter. Kansai companies need to take comprehensive action, summarized in three overarching themes:

- *Reinforce the basics*: Review basic corporate strategy and resource allocation across businesses, and take proactive measures to improve productivity for the company as a whole
- *Expand scope and capabilities*: Expand the geographic range of markets, and achieve greater breadth of organizational capacity and technology
- *Support execution*: Drive fundamental changes in the organization's operating model, and rigorously execute on talent recruitment and training

From these basic themes, we have distilled seven major moves for Kansai companies, and by moves, we mean actions that are much more than the adoption of tools or processes (Exhibit 13). They are deliberate steps to bring about transformative change. Each company will need a nuanced approach, adjusted for focus and emphasis as needed, that takes into account its particular circumstances (both internally and in the competitive and market landscapes where it operates) and its strengths and weaknesses. Actions should then be prioritized and rigorously executed.

Exhibit 13. Bold moves by CEOs and management will drive performance and returns



SOURCE: McKinsey & Company

1. **Optimize business portfolios and resource allocation**
   Work from a solid vision and strategy to rigorously organize around core businesses and growth factors to rebuild portfolios.

2. **Dramatically improve labor productivity**
   Use the latest insights and knowledge to overhaul approaches and value chain coordination, and achieve global-level labor productivity.

3. **Optimally leverage digital**
   Top management must take the lead in reorienting towards digital, clearly positioning digital within companywide strategy, and quickly taking action in the digital sphere.

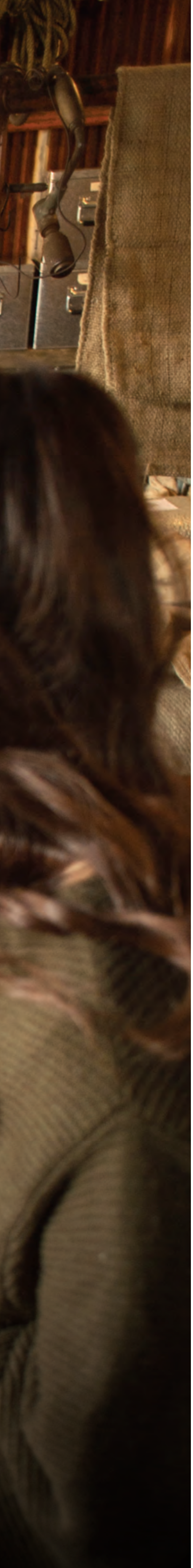
4. **Proactively invest in innovation**
   Create the seeds of "internal" and "external" innovation, not just in products, but in business models and processes.

5. **Evolve into truly global companies**
   Clearly define the roles of the head office and branch companies, move forward on international expansion in a way that makes best use of local talent, and maximize company-wide business value.

6. **Transform organization operating models**
   Switch from current hierarchical and moribund decision-making processes toward "agile" and "lean" organizations that are focused on customer value.

7. **Ramp up the talent strategy**
   Evaluate the existing talent who will be at the center of business growth, identify the new talent required, and formulate comprehensive talent strategies that will attract, develop, and retain these people.

The next chapter examines these major moves in greater detail.5.1 Optimize business portfolios and resource allocation.



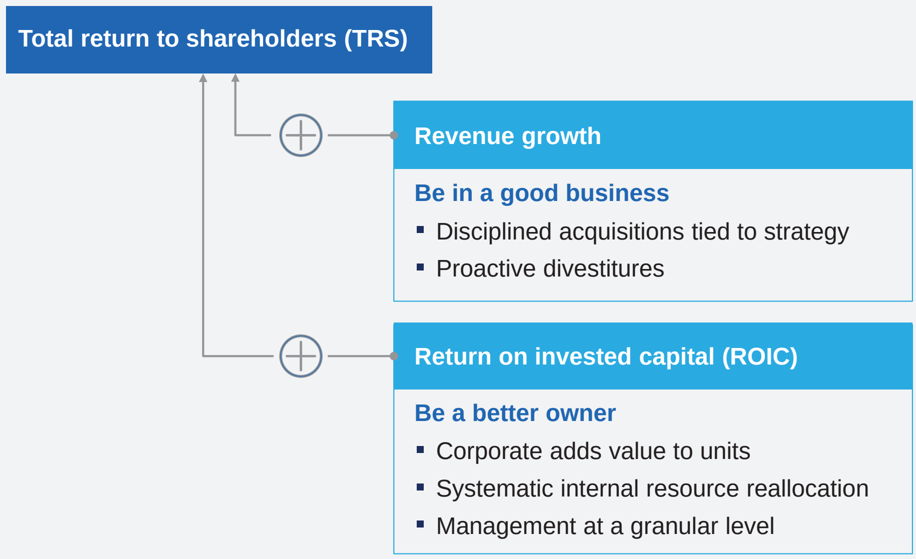
5. Seven major moves for Kansai companies

5.1 Optimize business portfolios and resource allocation

The importance of portfolio optimization in maximizing enterprise value

A management team's primary role is to ensure company sustainability and maximize its value by putting together an optimal business portfolio based on a company-wide vision and strategy. Growth and profitability are the key factors affecting sustainability and enterprise value. To maximize these factors, a company must position itself in the right markets and serve as an excellent owner of the business portfolio (Exhibit 14). "Right markets" are competitive environments where the company enjoys a tailwind of momentum. Excellent ownership involves leveraging a company's core strengths and investing appropriate resources in each market.

Exhibit 14. Companies should construct their portfolios to increase growth and ROIC



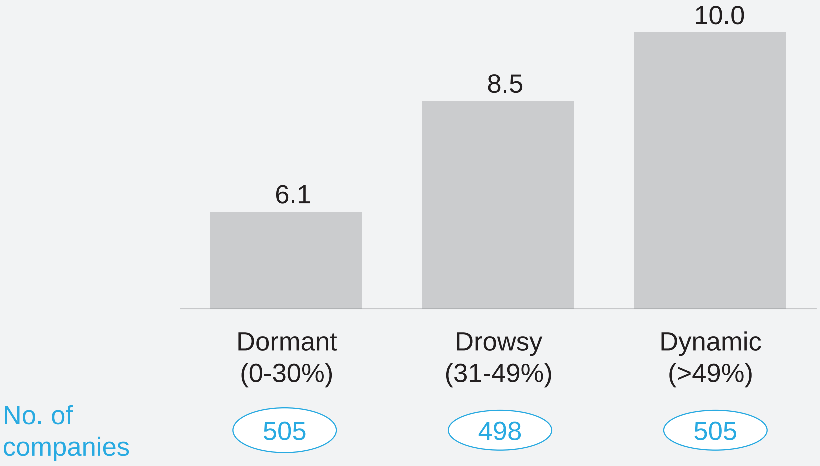
SOURCE: McKinsey Strategy & Corporate Finance Practice

In sum, optimizing the business portfolio is about focusing on core businesses, understanding markets and competitive environments, and making the most of inherent company strengths. In the optimization process, the company will make priority investments to maximize its strengths in the most attractive markets. If one of its businesses is in a low-growth market, for instance, a company focused on optimizing its business portfolio will likely explore options to increase margins; if the market is unattractive or unrelated to the company's strengths, the company is likely to consider exit strategies.

Sound and sustainable company-wide growth requires regular business portfolio reviews in light of current strategy, proactive acquisitions and divestitures, and, as a consequence of these activities, constant reallocation of resources. According to our analysis, returns to shareholders from companies that proactively reallocate resources are approximately four percentage points higher than from those who do not (Exhibit 15).

Exhibit 15. Companies conducting active resource reallocation have higher total return to shareholders

Median TRS CAGR[1] of companies by level of reallocation[2,3]
Percent; 1,508 companies; 1990-2010



1 TRS = Total return to shareholders. CAGR = Compound annual growth rate
2 Measures the share of CapEx that shifted between business units over the 20 years.
3 Assumes no dividends are paid out. For instance, a $10B dynamic reallocator would end up with a market cap of $67B vs. $33B for a dormant reallocator

SOURCE: McKinsey corporate strategy research program

Portfolio restructuring at a standstill in Kansai

While portfolio optimization and resource reallocation are key to improving enterprise value, cash on hand has continued to grow at Japanese companies over the past decade, which suggests they are not engaging in these activities. During the five years from 2012 to 2016, corporate retained earnings (excluding finance and insurance) increased by more than ¥100 trillion, from ¥304 trillion to ¥406 trillion. M&A activity – a primary form of resource reallocation – is particularly low among Kansai companies, which indicates a strong tendency to hold to traditional businesses and to avoid large-scale investments.

According to a recent survey, corporate managers cite increased sales and profits, and payout period, as the most important metrics when making investment decisions; for investors, however, the most important metric is ROI.[7] Clearly, when considering potential investments, it behooves top management teams to be far more sensitive to the expected increase in enterprise value that an investment brings.

7 Survey conducted by the Life Insurance Association of Japan, 2016

Many investors believe that Japanese companies, and particularly Kansai companies, should invest their abundant internal reserves in new growth. They are also applying more pressure, not only for investment results, but for the jettisoning of non-core and low-return businesses, making portfolio optimization and reviews of resource allocation the highest priority issues facing managers.

In point of fact, a McKinsey survey of Kansai corporate management teams found that approximately half considered “reallocation of strategic resources” to be important, but very few companies said that they had acted “boldly” in that regard.

Why do Kansai companies resist portfolio restructuring?

Based on projects we have conducted, and our discussions with management teams, we see a number of organizational factors behind the failure of Kansai companies to adequately reorganize their portfolios and reallocate resources:

- *Clinging to precedent*: The budgeting process assumes that the previous year's levels will be maintained, and initial goal-setting tends to be risk-averse due to rigid HR systems and annual evaluations. As a consequence, business structures are maintained from year-to-year.

- *Resistance to business exit*: Gaining management team consensus on exit decisions is challenging. Part of the difficulty is relationship based and cultural; exiting a business may be conflated with abandoning friends and colleagues. In addition, managers who helped launch the business now slated for divestiture or exiting may be in positions of influence in the company today, as auditors, directors, counselors, and may be inclined to preserve their “legacy.”

- *Difficulty shifting from core businesses*: Companies often fail to adequately understand their true strengths which can, inhibit bold changes; core businesses become confused with core strengths, and maintaining the business itself becomes the goal rather than enhancing and leveraging the strengths.

McKinsey’s survey of Kansai corporate management teams found nearly 50 percent responding that there were internal practices and unwritten rules constraining the reallocation of resources, and managers also perceived working-level resistance from current businesses and internal systems.

These survey findings lead to the conclusion that there is tremendous untapped potential for Kansai-based companies to leverage their growth businesses and core strengths for much bolder reallocation of strategic resources, resulting in enhanced enterprise value and happier investors.

Steps in optimizing portfolios and resource allocation

What specific moves can Kansai companies make to optimize their portfolios and boldly reallocate resources? The basic framework consists of four steps.

Step 1: Articulate the strategy and set clear goals

Clarify the company strategy and vision, and the direction for improving enterprise value. There must be a top-down decision on how to organize the business portfolio and reallocate resources to achieve the strategy and vision. Goal-setting should go beyond simple metrics such as sales, profits, and other typical components of performance evaluation to leverage multifaceted data such as total shareholder return (TSR), investor performance evaluations, and clear visibility around how much cash is generated.

Step 2: Analyze the current portfolio and resource allocation

Review and rethink the market and competitive environments, and accurately identify the growth potential and competitive advantages of the current portfolio. Having done that, managers have a number of different analytical methodologies at their disposal. They can, for example, divide businesses into detailed cells to analyze results and business metrics on a cell by region matrix, or forecast ROIC and sales growth rates based on EBIT growth and future trajectory. In addition, managers need to identify current business resource structures and present their findings in a visual format for each business unit to arrive at a comprehensive evaluation.

Step 3: Evaluate resource allocation for the new business portfolio

To optimize the business portfolio, managers will first need to assess which businesses contribute to value creation by studying the growth potential and costs of current businesses and the options for improving capital efficiency. That done, managers need to verify the growth potential of divesting from or otherwise exiting non-core businesses and building new growth platforms.

Step 4: Formulate a resource allocation plan for the new portfolio

In developing the new resource allocation plan, the management team should explicitly state how growth rates and profits will change as a result of the portfolio changes, and what levels and types of resources are needed. As stated above, business portfolios and resource allocations are fundamental outgrowths of the overarching strategy, and require a top-down decision.

Challenges to execution and implications for Kansai companies

The steps for portfolio restructuring may seem straightforward – and conceptually, they are – but achieving real improvement will likely require a great deal of courage.

For example, there are constraints on the resources that can be invested. Even assuming that there is a new priority investment target that current the input of strategic resources, those resources may already be allocated to current businesses. As such, the first step for managers will likely be to start pulling these resources away. That may not be very difficult for things like capital investment where it is relatively easy to switch focus, but human resources, for example, are not so easily converted, and managers may face problems in investing the time and additional money required to build skills and convert human capital. Another challenge will be in aligning with business and unit leaders, who face near-term targets, about the reallocation of resources from a longer-term perspective.

Kansai CEOs and management teams will need to make tough overall judgments about their company's future from a long-term perspective, and exert strong leadership and decision-making if their companies are to implement changes in business portfolios and resource structures. Particularly for companies in the Kansai region, the following points could play an outsized role:

- *Prioritizing the core businesses*: Mere tinkering with portfolios on a business by business basis will not get the job done. Rather, emphasize the reallocation of resources within core businesses. Traditional core businesses tend to be tied to past practices. It is especially important for managers to constantly review their approach and sensitivity to technological advances, new platforms, and changing customer behaviors and needs that could destroy core businesses.

- *Aligning management team awareness*: Clearly articulate the vision and strategy, and provide visual assessments of current businesses so that issues and management team discussions are fact based and foster a common understanding. High quality discussions and transparent information are essential for accurate decision making about portfolio restructuring.

- *Quickly visualizing the existing portfolio structure*: Analyzing the profitability of individual businesses and changing decision-making mechanisms are time consuming activities that require substantial data and preparation. Before going down that road, use information readily at hand to categorize businesses by growth potential and profitability, even if very roughly. This quick exercise often helps to identify biases in the company's portfolio, and areas of distortion in resource allocation. After developing some hypotheses, the management team can then move forward efficiently on analyses and studies that yield greater detail and insights, leading to faster decision making.

Keep in mind that the goal is not portfolio change and bold resource reallocation for their own sakes. Efforts must link back to the business strategy and vision, and must help improve enterprise value. It is incumbent on managers to be prepared to shift their mindset as needed, and think about whether their company's business portfolio is optimized from the perspective of investors.

5.2 Dramatically improve labor productivity

There is much greater potential for labor productivity improvement in Japan than in other developed countries, and this is as true for Kansai as for other regions. As we saw in Chapter 4, Kansai's per-working-hour GDP is approximately ¥4,700, or 13 percent below the OECD average of ¥5,400, and 35 percent below the United States' ¥7,300.

While it may be a generalization, it is reasonable to assume that most Kansai-based companies have significant opportunities to improve productivity by identifying and tackling impediments in the value chain.

At the business unit level, the greatest challenge is likely work processes, which continue to be stubbornly dependent on people rather than organizations. This is not just limited to the production floor, but also in sales, marketing, and administrative work, where the tendency is to rely on experience-based insights and "expert" techniques. Doubtless, there are cases whereby expert techniques are, themselves, the source of a company's value. Nonetheless, companies should consider ways to improve the work processes dependent on the expertise to ensure both that the knowledge is not lost and that it continues to be developed.

There would also seem to be problems with coordination among production, sales, marketing, and other functions. Units are organized as silos, and in many cases, processes have not been optimized to allow information and communication to flow. One example would be a lack of coordination between the inventory management process in production and the demand forecasts of sales. Ideally, there should be a balance between stockouts for individual products and inventories as a whole, but stock imbalances are common, resulting in increased production line loads to respond to emergency needs for out of stock products, returns due to delivery delays, and increased storage costs for inventoried products.

In this section, we examine the improvement opportunities in Kansai company labor productivity from two perspectives:

1. Structure of the productivity bottlenecks in the value chain and visualization of improvement opportunities

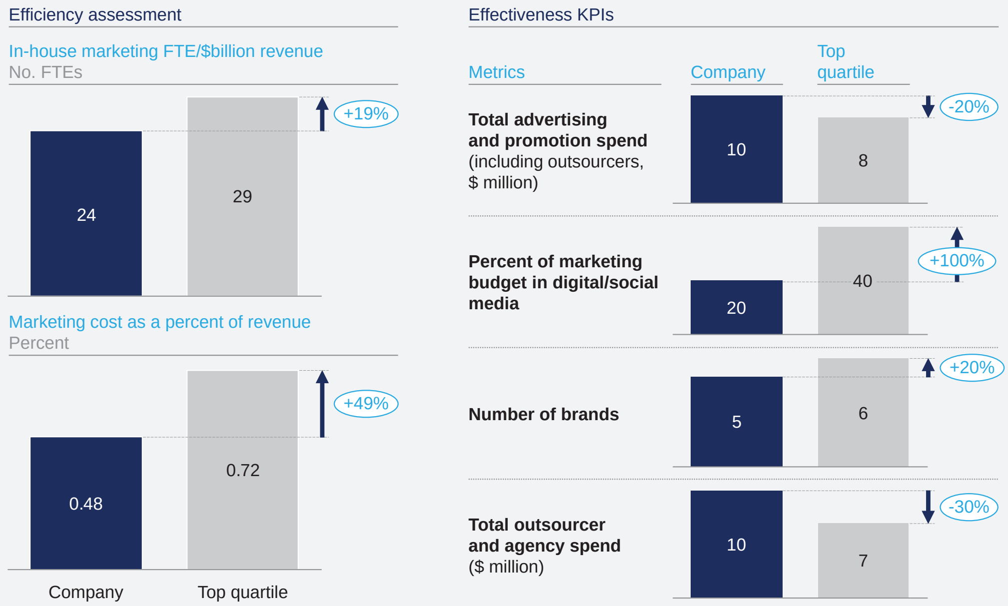
2. Automation of value chain-related operations (from development to logistics) and corporate operations

We conclude by examining the implications for Kansai companies, which center on adopting up-to-date approaches and aspiring to global top-tier labor productivity.

Structure of the productivity bottlenecks in the value chain and visualization of improvement opportunities

In the diagnostic phase, where improvement opportunities are defined, the goal is to use top-down benchmarks to identify improvement potential at the level of individual expenses, regardless of whether those expenses are direct or indirect. Top-down benchmarks refer to full-time equivalent (FTE) headcount, cost per unit of production volume, yield, lead time, and other performance metrics that can be compared against competitors to identify improvement potential. For example, McKinsey's corporate and business functions (CBF) tool is a benchmarking tool specifically for indirect units, to diagnose advertising and promotional expenses (Exhibit 16). The tool compares FTEs and advertising and promotional expenses for unit sales, indirect units, level of outsourcing, and other factors against those of competitors.

Exhibit 16. Benchmarking for marketing (example)



Summary | **Opportunity to boost digital and social media spend as compared to peers** | **Opportunity to reduce total advertising and promotional spend by 20% compared to top quartile**

SOURCE: Company data submission, McKinsey CBF Practice

Next, we consider bottom-up accumulation of productivity improvement ideas. The priority here is on areas with high improvement potential, and the goal is to identify specific improvements. Team members should be encouraged to propose bold, sweeping ideas rather than to narrow the scope by critiquing an idea as unrealistic or "not the way we do things." At this stage, units evaluate ideas in terms of risk and feasibility for the unit itself, and beneficiary units also evaluate the idea's effectiveness and impact.

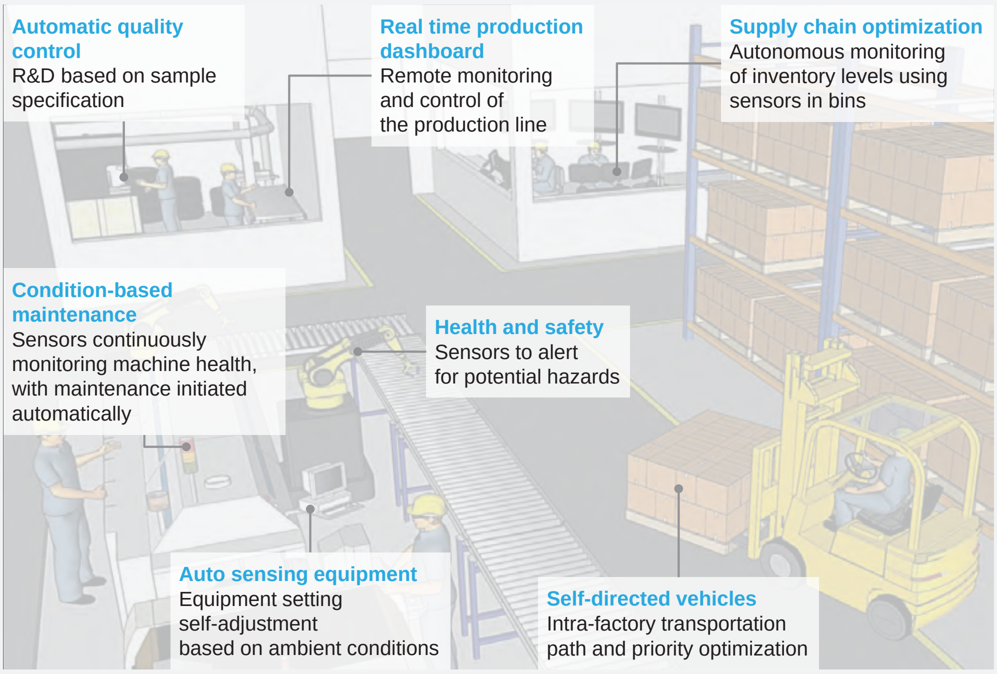
Once ideas are selected for execution, the implementation is managed individually, and impact is rigorously measured. To this end, a formal, efficient progress management system is critical for tracking progress so that initiatives are not lost with transfer of ownership. Once an idea has been evaluated by a unit or organization and the decision has been made to go forward, it is necessary to set an execution deadline and realistic steps to follow, with a clear action plan added to the progress management system. Then, about once every week, execution is summarized, and any issues are discussed and addressed.

It is also important to consider efficiency across functions. For example, in operations involving multiple units where a lack of coordination results in returns and do-overs, the first step is to limit the losses from inefficiency by deciding in advance on objectives, individual responsibilities and roles, and procedures. In our experience, rigorously adhering to this approach results in a 20 percent workload reduction measured as payroll expenses. The excess labor that results can be reallocated as appropriate.

Automation of value chain-related operations (from development to logistics) and corporate operations

The use of industrial robots, IoT, machine learning, AI, and other technologies to automate business processes can be expected to dramatically improve labor productivity. There is space for automation in almost any process, but there are three areas in particular where improvement potential seems especially high for Kansai companies:

Exhibit 17. Various IoT applications in use in manufacturing plants

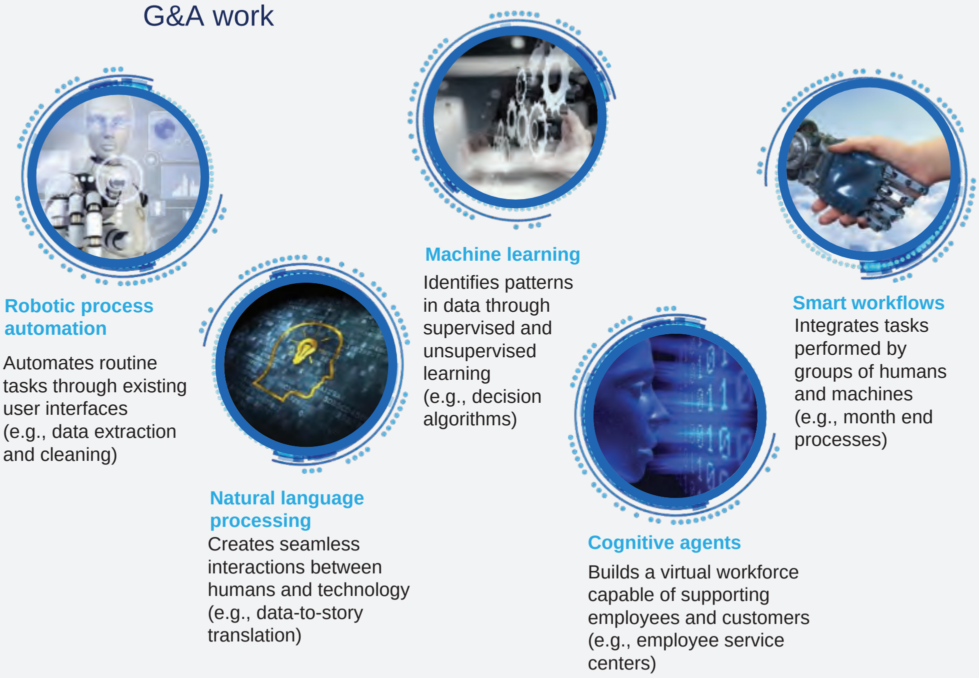


SOURCE: McKinsey & Company

- *Production processes*: Manufacturing production lines have already installed assistance robots (robots that make the work of human beings safer and more productive) and collaborative robots (robots that learn detailed gestures and patterns from human movement, have sensors and other safety measures that enable them to work safely alongside human beings, and can substitute for or collaborate with human beings on complex work). The Internet of things (IoT) can also be leveraged to gather production line data for sharing among machines, further refining production processes. The automotive industry and other areas of manufacturing are already introducing advanced technologies, and there are efforts underway to automate ordering, inspection, and transportation within warehouses and other areas outside the production line. The plants where these advanced initiatives are taking place have seen an acceleration in their PDCA cycles thanks to the data harvested from production lines, and the development of new, next-generation automation technology.

- *Service operations*: Progress is being seen in the automation of service operations, both for companies and individuals, and there are expectations for labor productivity improvements in areas like medical institutions and consumer services. One example is a large US retail company where sensor products are used to confirm product prices, shelf lives, and stockouts, reducing payroll expenses for shelf inspection by 50 percent. Though on a smaller scale, there are also examples of robots being used in customer services in the food and beverage and travel industries (Exhibit 17).

Exhibit 18. Five technologies are expected to enable further automation of G&A work



SOURCE: McKinsey & Company

- *Corporate operations*: Most expense calculation, data input, and other administrative work can in the future be automated with machine learning and AI secretaries. There are already many startup companies developing these services, and all basic technologies for the automation of indirect operations are rapidly advancing (Exhibit 18). For example, a European telecoms company successfully automated 15 core processes (e.g., credit screening, order processing, ID issuing), accounting for 35 percent of all indirect operations. Introducing 160 automation programs has produced ROI in excess of 600 percent over three years.

Implications for Kansai companies

By clarifying the productivity impeding factors in the value chain and using this information to rigorously execute on the basics of operations improvement, companies can look forward to steady improvements in margins. The first step is to begin working from things that are achievable right now, bearing in mind the following imperatives:

- *Examine every area*: Question all current approaches to doing things, from diagnosing improvement potential to monitoring activities, and ensure that absolutely nothing is overlooked. The commitment of the management layer is essential to ensure comprehensive analysis.

- *Hold nothing sacred*: It is important that nothing be "off limits" when diagnosing and making improvements. That includes the craftsmen-like skills on the production floor that are the province of individuals and would seem not to have any room for improvement, to existing suppliers within the group where there may be resistance to switching.

- *Revisit vertically-oriented operating models*: In many cases, problems in the coordination of the existing value chain (i.e., lack of coordination and communication between functions) become impediments to improving working-level processes. Rather than accepting the "reality," view it as an additional focus for process improvement.

The next step is to consider how technologies can be leveraged, in other words, how to automate. The Kansai region has numerous advanced technology-oriented companies, from robot manufacturers and software developers to the companies that use them, and the region is well positioned for automation. Nonetheless, according to a 2016 survey by the Japan Machinery Federation, while the majority of manufacturing companies had industrial robots installed, very few other sectors did. When it came to indirect operations and service operations, automation was still in its infancy.

For Kansai companies to achieve a higher level of automation, CEOs and management teams need to articulate a long-term vision and exert decisive leadership. Automation is, of course, a major investment. Not only are there high startup costs, but in most cases staffing will also need to be reorganized, so it is imperative for top management to be deeply committed to the project and to view it as a source of medium and long-term profit. In addition to a steadfast commitment, top management should implement automation with the following in mind:

- *Automate throughout the production process*: Progress has already been made on production line automation, but in many cases, may still be locally operated, and limited. Companies need to leverage technology to achieve the next generation of automation by using data collected from robots, optimizing the entire production line, and achieving better linkage with companywide digital platforms.

- *In service operations, look to the latest examples*: Sectors such as healthcare, retail, and food and beverage may already be exploring the potential to automate service operations in areas such as reception, ordering, and payment. In the Kansai region, the elderly are a particularly important customer segment. As such, interfaces and operations must be carefully designed to reduce the manual work required for servicing customers if desired productivity gains are to be achieved. As populations age around the world, service operations automation, which is still a relatively young field, presents an opportunity for Kansai companies to become leaders.

- *Use new technologies correctly when automating corporate operations*: Companies must carefully study not only which processes can be automated, but which of them should be. At present, the highest ROI is generated in work that has large volumes of processing and is suitable to algorithms. The scope of potential application will only widen as basic technologies advance, making it important for companies to form their decisions on the most up-to-date information available.

Disruptive changes, as we have said, are taking place at a global level, and for Kansai companies to survive and thrive in this environment they will at the very least need to raise their core performance the to global standard. Businesses in the Kansai region, many of which face lingering problems due to older, traditional structures, have an opportunity to leverage the technologies that are triggering disruptive change and use them to quickly raise productivity to global levels.

5.3 Optimally leverage digital

Data is changing the world dramatically. By 2020, estimates suggest that 21 billion devices will be connected through the Internet. Around 90 percent of the world's data today has been created just in the last two years. Connectivity and data volumes, alike, have recently seen exponential growth.

Given the ubiquity of the term "digital," it is important to clearly define what we mean. We define digital as 'technology that brings together cross-cutting insights from business and technology trends to help develop a strategy, design a complete, functional transformation, and develop new propositions and businesses.' To maximize economic value, digital should be coupled with advanced analytics, which draws on the increasing volume, variety, and velocity of data to provide new insights for organizations and enterprises of all types.

Digital and advanced analytics, if handled correctly, can create a transformational impact on company performance. It is estimated that digital and advanced analytics can, depending on the industry, capture 20-40 percent of revenue if fully utilized (Exhibit 19). The future of companies hinges on adapting to these two factors.

Exhibit 19. Substantial impact from digital is expected across industries

Industry	Degree of digitization Percent	Current revenues at risk over the next three years Percent
Telecommunications	24%	44
High tech	36%	41
Media and entertainment	34%	39
Retail banking	24%	34
Other financial services	26%	33
Professional services	20%	30
Retail	19%	29
Insurance	17%	28
Healthcare systems/pharmaceuticals and medical products	18%	27
Travel, transport, and logistics	19%	27
Automotive and assembly	16%	25
Consumer packaged goods	12%	16

SOURCE: McKinsey Global Digital Survey

What digital can do

Digital provides significant opportunities to companies across the entire value chain. Broadly, it can be broken down into product and service development, marketing and sales, and productivity improvement. More fundamentally, digital can also transform business models.

1. Product and service development

Digital has transformed product and service development cycles and approaches. Digital product teardowns offer a deeper understanding of the interaction of different product components and design and feature elements at the development stage. Advanced simulations can predict how customers would react to certain elements of products and services, resulting in improved product and service design.

Digital also provides direct, fast insights into customer behaviors and experiences. With rapid development-testing-feedback data capture and analytics, a product or service in development can adapt to genuine customer needs in real time. These digital applications can reduce development costs by 20-30 percent, development time by 20-50 percent, and manufacturing and assembly time by up to 50 percent. They can also increase market penetration through better prediction of customer needs.

2. Marketing and sales

Sales effectiveness can significantly improve through advanced analytics used to predict the best mix of sales strategies, including advertising targets, promotional media, and resources to invest in. In B2C, consumer data across different dimensions is integrated, and product and service providers can leverage the information to maximize sales. Even in B2B, data is integrated, and sales and procurement networks are simplified without intermediaries. Platform players, such as Amazon, have leveraged digital to significantly streamline marketing and sales activities, and even more so for small to midsized businesses.

Digital enables a seamless customer experience by allowing companies to interact with their customers through multiple online and offline channels beyond physical stores, which used to be the only touchpoint. Companies unable to use online channels are disappearing from the market at an increasing pace.

3. Productivity improvement

Digital has also improved productivity across many industries. For indirect cost, digital applications can automate customer services such as in call centers or at retail bank branches, which were once thought difficult to replace. In manufacturing, companies can optimize cost through predictive manufacturing systems, digitally-enabled robotics, and 3-D printing.

4. Business model transformation

Finally, digital has enabled companies to entirely transform their business models. Evolving digital companies explore new business areas, utilize new channels to reach customers, and offer new products. One distinctive example is platform companies who own multiple businesses and have direct access to end-consumers without intermediaries. Platformers create ecosystems that enable interactions between producers and consumers, and leverage customer data gathered directly to generate more value. Here, we highlight a couple of especially active industries in digital, pharmaceuticals and advanced industries.

Pharmaceuticals

In the pharmaceutical industry, digital can be used for numerous applications, including drug development, multi-channel physician engagement, sales force analytics, commercial spend optimization, and improved medication adherence. In our interactions with one specialty pharmaceutical player, we helped to analyze historical sales performance data breakdowns across multiple potential growth drivers, including sales frequency, account acquisition patterns, and sales representative skill sets. Our advanced analytics led to unconventional insights. For example, we found that nearly all growth came from new account acquisition and more than one visit per month did not increase sales for established accounts. Based on these insights, the sales force training and incentive structure was redesigned, leading to an improved conversion rate of accounts from 40 percent to 75 percent, reduced time to conversion from 10 months to 7 months, and an overall sales increase of more than 15 percent.

Advanced industries

In advanced industries, digital applications in operational improvement have delivered significant impact. Real-time performance management is one of the applications where installation of sensory devices enables performance tracking and real-time transmitting to smart applications. Installation of sensors, cameras, and other monitoring helps to provide real-time transparency regarding performance KPIs, such as overall equipment effectiveness (OEE), breakdowns, and minor stoppages. This information can then be transmitted instantaneously to large digital performance boards or remote devices to define improvement actions and set priorities to fix issues. No manual data entry is required, so operators can focus on value-adding activities.

In the case of a major manufacturing site, real-time performance visualization was deployed on four 24x7 production lines, training was provided to all workers and managers, and output was integrated into performance huddles. Not only did data transparency create healthy competition among participants, but also the OEE improved from 50-55 percent at baseline to 70-75 percent, resulting in a $20 million revenue increase.

Japan and Kansai companies on digital

Based on the proven impact achieved through digital, companies are accelerating digital transformation globally. Japan, and Kansai companies in particular, seem not to have yet taken decisive action.

According to a survey by the Ministry of Internal Affairs and Communications in 2013, IT investment amounted to 26 percent of total capital investment in private industry in Japan, compared to 39 percent in the United States. Furthermore, the “White Paper on Manufacturing Industries (Monodzukuri) 2015” revealed that only 19 percent of major Japanese companies utilized big data, as opposed to 73 percent in the US.

In a survey by the Japan Machinery Federation in 2015, 84 percent of executives at Kansai manufacturing companies responded in the affirmative to the statement, “the company has rich data but is not using it.” The biggest issue they face, according to the same survey, is lack of talent in data analysis. Major Kansai-based players in industries such as retail, automotive and assembly, high-tech, and healthcare have a tremendous opportunity to capture value through digital. Moving decisively to become digitally driven is, like it or not, a prerequisite to competing against global companies in today’s connected market.

Becoming digitally driven

To become digitally driven, companies must change their mindsets and approaches to digital. Our global experience has given us insight into six key lessons that top managements must embrace as part of a successful digitation journey:

1. *Make it a business opportunity, not a technology problem:* Integration and adoption happen through engaged (and up-skilled) business leaders and frontline personnel. They should feature heavily in the composition of the digital and analytics teams.

2. *Focus on bottom-line business impact:* All effort should be anchored on at most two or three priority use cases that will create disproportionate value. Understanding relative value at stake across the business and a laser-like focus on capturing the value are critical.

3. *Establish an innovation backbone, not a command and control center:* A center of excellence (CoE) can bundle scarce talent and core technologies, but is not a centralized "function." The CoE should create platforms (e.g., a data lake, analytics and algorithms, digital excellence, training) that unleash innovation at the front line.

4. *Don't "boil the data lake":* More, better organized data is not a bottleneck to getting started. One typically needs around five percent of data organized to start – the rest should follow priority use cases.

5. *Don't fall into the "pilot trap":* Move fast – create material value in 12 months, not in 5 or 10 years. Scale priority use cases quickly, kill experiments that are not working, and establish quarterly milestones.

6. *Orchestrate the transformation:* Put a premium on leadership and reset aspirations – an aspirational, committed, and engaged leadership team that can rapidly integrate across the business is critical.

For Kansai-based companies, while a comprehensive digital strategy should be established, we further recommend six focused actions to accelerate change:

1. *Drive a bold vision:* Successful transformation into a digitally-driven company requires a bold vision. Digital transformation cannot be done with a half-hearted commitment. An aggressive, overarching vision articulated by the senior-most leaders is imperative for driving change.

2. *Commit to digital with passion:* A company will not be successful in digital transformation without a strong leader who is passionate about digital and truly believes in its value. A leader should clearly communicate the commitment throughout the company to make it real.

3. *Start small:* Trying to change everything at once does not work, especially for companies with a long and proud legacy. Focus on one branch, one division, or one project first, using digital "champions" to drive the effort. Achieve a success case, however small. Followers naturally become active supporters for rollout.

4. *Drive decisions using data*: In the digital era, business strategy should be based on and validated by data and analytics. While experience remains important, business decisions should be driven by contemporary evidence. In the ever instantaneous and volatile business environment, a knowledge base from the past would become stale very quickly.

5. *Aggressively invest in digital talent*: While we acknowledge digital talent is in high demand, we believe Kansai-based companies can tap into the digital talent market through a focused but broad-based effort. Focus on digitally savvy and digital native students congregating in the Keihanna area. Consider collaborating with universities to tap into potential talent pools, and even use competitive packages to pull in talent from startup companies in Tokyo. Heavily invest in developing that talent once acquired. Such investments would deliver a high ROI in the long run.

6. *Leverage internal best practices*: A major issue facing Kansai companies is disconnected internal systems (e.g., customer databases) across regions and departments. Companies should leverage their internal knowledge to improve their IT infrastructure and systems. Usually, the talent and capabilities exist, but are underutilized (e.g., within acquired foreign subsidiaries). These efforts would lead to an accumulation of digital assets and knowledge within the company.

5.4 Proactively invest in innovation

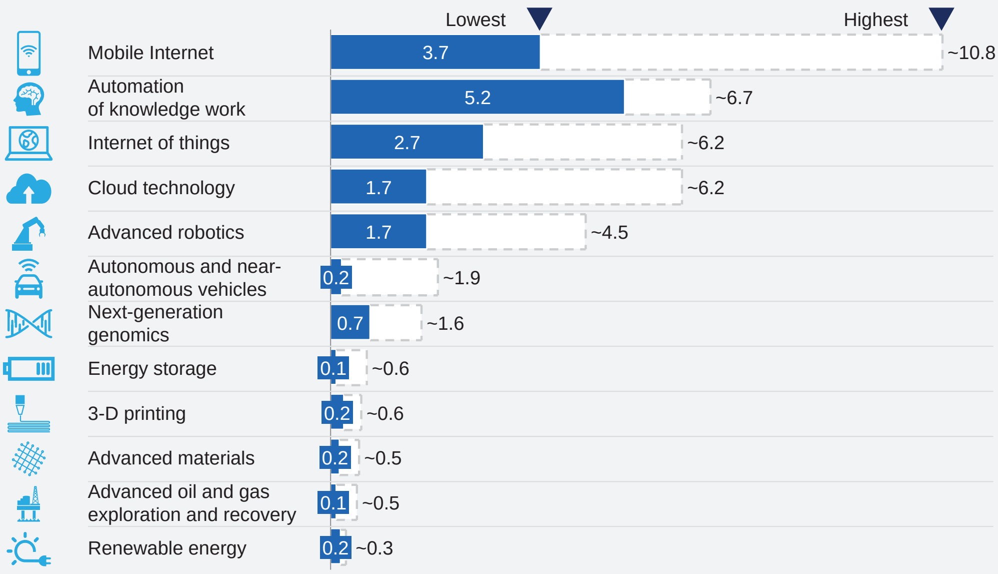
Changes in the nature of innovation

Ever since the Industrial Revolution, innovation has been a source of economic growth, and over the past 20 years, its speed has only accelerated. We think the next 5 to 10 years will be particularly important in the development of technology. The McKinsey Global Institute estimates that advances in the 12 most disruptive technologies will have an economic impact of $17-40 trillion per year in 2025 (Exhibit 20).

Exhibit 20. Without investment and commitment to innovation, companies will miss out on the disruptive technology trends

Estimated potential economic impact of technologies from sized applications in 2025, including consumer surplus

USD Trillions; annual



SOURCE: McKinsey Global Institute analysis

The accelerating evolution of technology has been a catalyst in changing the nature of innovation itself. While innovation used to be associated with the development of new products, today it also encompasses new business models and ecosystems. Digital technologies bring together different businesses and consumers from across the globe, making it possible to develop new business models.

One success story in identifying and exploiting change comes from the "BAT" (Baidu, Alibaba, Tencent) group of leading-edge companies. These companies have used digital to change the entire value chain by building a comprehensive ecosystem that includes everything from customer contacts to indirect units. Their rapid expansion has become a threat to more traditional companies in their business areas.

The Alibaba Group, for example, began as an e-commerce player focused on the Alibaba.com B2B market, but then moved into the Alipay payment business, which is particularly strong in mobile, and went on to add a financial services business that features online screening based on personal data. Following a very different path, Tencent used the "WeChat" social networking service as a customer experience platform from which to expand into payments, finance, entertainment, and search engine services.

Stagnation at Kansai companies

The Kansai region and Kansai-based companies were at one time a source of revolutionary products and a leader in global innovation. Consider Sharp's "CS-10A," the world's first calculator, developed in the 1960s, Nissin Food Products' instant ramen from the 1970s, and Nintendo's "Family Computer" home videogame machine from the 1980s.

In recent years, however, the region seems to have lost its way as an innovator. Looking back over hit products chosen by Nikkei Trendy magazine during the 1990s, almost half of the hit products in Japan originated in Kansai; over the last decade, that ratio has fallen to around 20 percent. The stagnation is not merely in products – innovative business models also seem to be lacking.

One recent indicator of this torpor is Clarivate Analytics' "Top 100 Global Innovator Award" from January 2018, which included 39 companies from Japan. Kansai-based companies, however, accounted for not even a quarter of the Japanese contingent.

Exhibit 21. How we measure innovation: the eight essentials

		Key questions
Clear vision and strategy	1 **Aspire**	Do you accept innovation-led growth as absolutely critical, and do you have cascaded targets that reflect this?
	2 **Choose**	Do you invest in a coherent, time-risk balanced portfolio of initiatives that are resourced to win?
Bigger and better ideas	3 **Discover**	Do you have actionable and differentiated business, market, and technology insights that translate into winning value propositions?
	4 **Evolve**	Do you create new business models that provide defensible, robust, and scalable profit sources?
Fast and effective scale-up	5 **Accelerate**	Do you beat the competition with fast and effective development and launch of innovations?
	6 **Scale**	Do you launch innovations in the relevant markets and segments at the right magnitude?
Mobilized organization	7 **Extend**	Do you win by creating and capitalizing on external networks?
	8 **Mobilize**	Are your people motivated, rewarded, and organized to repeatedly innovate?

SOURCE: McKinsey Innovation Practice

One of the causes of this relative decline in innovation is a failure to grasp the changes that are taking place around the world. Many players in Kansai continue to see innovation as something that their research and development units are responsible for, which eventually leads to new products. In a McKinsey survey of Kansai companies, expanding innovation was considered a top priority, but very few companies said they were actively working on it. As the nature of innovation changes, Kansai-based companies are finding it difficult to leverage their traditional strengths.

Four essential actions for innovation

So what should Kansai companies do? It is not a simple matter to target innovation and “make it happen.” Innovation requires the proper soil; it will be necessary to adapt the nature and structure of companies so that they are able to capitalize on both "internal" and "external" innovation.

McKinsey has identified eight common aptitudes of innovative companies (Exhibit 21). Companies possessing more of these aptitudes will be more successful at generating innovation-driven growth.[8]

We have selected four factors that, in our experience, are most important for Kansai companies to build the right aptitudes to successfully innovate.

1. Top management must improve its own sensitivity to innovation

Innovation, in the sense of departing from existing businesses and creating something completely new, requires top management to make even more of an effort to directly identify and follow the latest technology and market trends and become more sensitive to the seeds of innovation.

When top managers meet directly with people at the cutting edge of innovation, it produces innovation initiatives, and can lead to investment decisions and partnerships. The success stories go beyond managers simply participating in tours and sharing perspectives. Rather they are involved in direct discussions and debates, and use the stimulus that comes out of them to lead their businesses. For example, McKinsey holds a boot camp that lasts several days, in which top managers from companies across many sectors are invited to Silicon Valley, where they engage in intensive discussions with local startups and venture capital firms. We have conducted more than 50 boot camps over the past three years, and they have led to numerous investments, partnerships, and successful innovations.

2. Rethink attitudes toward research activities and investment allocation

Companies need to view the scope of research and development as something that goes beyond the framework of existing businesses and allocate a specific budget to seemingly unrelated technologies and basic research. One way to do this would be to allocate 10 percent of research and development investment to high-risk/high-return areas with the potential to create new markets.

8 McKinsey Quarterly, "The eight essentials of innovation," April 2015.

Top managers can improve the precision of high-risk research activities if they are able to articulate concrete directions for research activities, and how those activities relate to their long-term strategy for the company and its strengths. It is crucial, however, that this communication takes place in parallel with the efforts described in item 1 above.

3. Explore new kinds of external partnerships

In addition to traditional approaches, such as M&A and joint ventures, companies should also study relatively new techniques, like open innovation. "Open innovation" refers to an entire range of innovation activities that goes beyond the ordinary organizational structures to leverage ideas, knowledge, and technologies from both inside and outside the organization. Open innovation programs, particularly when they are starting up, need to select the proper network design for their circumstances, recruit a broad range of candidate participants, and make offers that communicate the project's attractions to participating companies. Given the benefit that such programs offer, it is not surprising that in a recent McKinsey survey, around 70 percent of Kansai companies indicated they were interested in open innovation as a way to use external partnership to drive innovation.

4. Create organizational foundations conducive to innovation

By nature, innovation activities cannot be measured with the same metrics used to manage existing businesses, nor can their results be expressed in terms of profit targets. It is therefore necessary to use different targets and metrics to manage this aspect of a company. One approach is to split off the unit responsible for innovation into a new organization able to create the foundations from which innovation will spring.

In our survey, 70 percent of Kansai companies identified “gathering information on the latest technology and market trends and recruiting talent and building organizational mechanisms able to turn them into businesses” as a challenge they were especially enthusiastic about achieving.

Regional innovation success story: American Underground, North Carolina, USA

There are examples all over the world of clusters of knowledge where innovation takes place on a regional level. Silicon Valley in the United States is the prime example, but there are many other places where venture companies have assembled around universities to form naturally-occurring innovation centers. One is in the US state of North Carolina, where the state government deliberately set out to recruit companies and create a unique high-tech cluster.

North Carolina has traditionally been an agricultural state, with tobacco and textiles its main products. After the Second World War, it failed to develop industries that could take their place in the forefront of US business, and as a result suffered from an outflow of young people. Research Triangle Park was conceived in the 1950s as a way to stem the outflow. The state government took the lead, working in cooperation with nearby universities, to actively recruit companies to the area.

More recently, North Carolina has added "American Underground," an incubation effort that involves, among other participants, Google and Duke University. American Underground is operated as a subsidiary of Capitol Broadcasting Company, a local television station owner, and it provides office space to startups, innovators, and investors, targeting innovation in the healthcare and digital areas. Below are some of the attributes that set it apart.

- **Mentor system**: The sponsor provides referrals to mentors and advisors so that participating companies can be advised by successful entrepreneurs.

- **Diverse community**: In 2017, American Underground provided permanent office space to 275 companies, ensuring a diversity of participants, and also making it possible for them to develop networks and share challenges.

- **Coordination with investors**: For investors, American Underground serves as an "exhibition hall" where they can view potential investments and the large possibilities they hold out. This makes investment decision-making easier for investors and entrepreneurs alike. From 2015 to 2016, American Underground companies raised a total of 26.7 million dollars in new funding.

- **Inexpensive offices for startups**: It is often impossible for startups to sign multiple year contracts for conventional leased offices. American Underground instead rents out furnished offices.

It is possible for Kansai to do something similar; it already has an innovation culture, not to mention talent, educational institutions, and businesses. One important perspective is that innovation needs to be fostered not just at the individual company level, but as an undertaking for the region as a whole.

5.5 Evolve into truly global companies

What is a truly global company?

For most large companies, globalization represents both a great opportunity and a major headache. In fact, globalization can take a wide range of forms, from the export and import of products and services, to cross-border M&A, to the establishment of offices and plants in other countries. Regardless of the form, however, there will be numerous challenges to overcome in execution. This is true regardless of home country, but for Japanese companies, the problem of globalization is especially pernicious and long-standing.

The top countries for globalization have shifted with global trends and economic developments. In the early 2000s, the BRICs (Brazil, Russia, India, and China), with their strong economic growth, garnered all the attention. More recently, focus has shifted toward the ICASA group (India and China remain, but now alongside Africa and Southeast Asia). ICASA countries are projected to account for half of global economic growth between 2015 and 2025.

Irrespective of country, we can highlight some qualities that globalizing companies demonstrate:

- Working to develop important parts of their corporate activities outside of their home countries
- Building clear operational and organizational capabilities to continuously shape and grow these parts for the business
- Clearly understanding the rationale for prioritizing globalization over other options (e.g., strengthen capacity in the home market, enter other industries)

Objectively measuring a company's degree of globalization requires a comprehensive approach that incorporates several metrics. Differences among industries, products, and services mean that one-size-fits-all targets are not appropriate, but looking at the world's most globalized companies, a number of factors can be observed and used as markers: international sales ratio (60 percent or more), ratio of international assets to total company assets (60 percent or more), percentage of employees located outside the home country (60 percent or more), foreign national ratio in the management layer (20 percent or more), and foreign shareholder ratio (40 percent or more). For our purposes in this chapter, we consider global companies with respect to general qualitative and quantitative metrics.

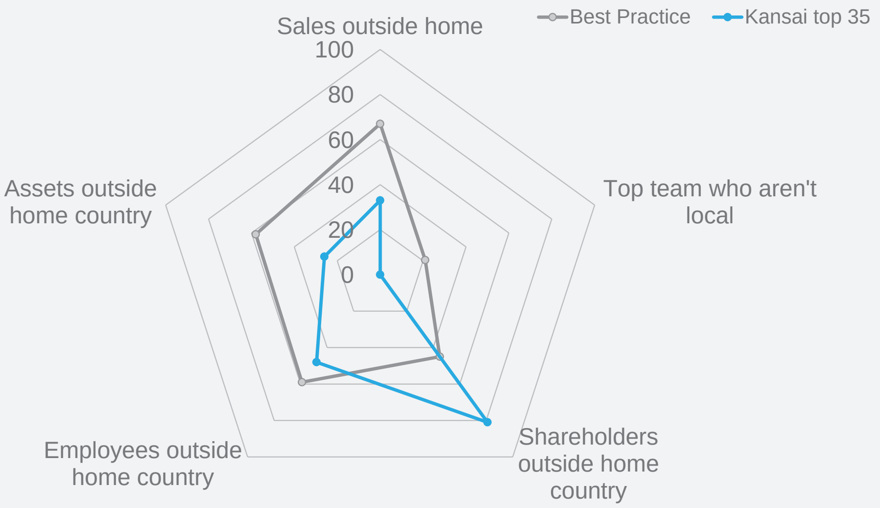
The state of globalization at Kansai companies

With a handful of exceptions, Kansai companies have by and large not globalized. Even the top 35 Kansai companies by sales in 2016 were far below the 2006 average value for the world's 50 most globalized companies on all of the quantitative metrics described above except for the foreign shareholder ratio (Exhibit 22).

Exhibit 22. Kansai companies score below peers on sales, assets, and employees outside the home country

Global best practice[1] in 2006 vs. Kansai's top 35 companies by revenue in 2016

Average percentage against each measure



1 Average globalization level of the 50 most globalized companies (selected from the largest 100 global companies)

SOURCE: Capital IQ; press search

A survey conducted by the JETRO Osaka Office in FY 2016 entitled "Trends in the Development of International Operations at Kansai Companies" found that roughly 85 percent of companies were planning to expand exports over the next three years. Currently, the region depends on just three destinations for roughly half its exports: China, the United States, and Taiwan. Potential for expansion into Southeast Asia, a traditional target, is substantial. The same may be said for India and other parts of southern Asia, as well as Africa. All of these regions are expected to be growth markets. More than half of Kansai's companies currently have international locations, mostly in China, Thailand, the United States, and Vietnam, but only around 30 percent were interested in expanding their overseas presence. This attitude underscores the low levels of M&A activity at Kansai companies already touched on in this chapter.

The JETRO survey – and our own experience – indicate three major challenges that Kansai companies have yet to overcome:

1. *A dearth of people to lead globalization:* In the survey, more than 70 percent of large companies responded that they lacked people able to lead international businesses. Companies need people who are able to think in terms of global-level strategy, including an understanding of business and finance, have the flexibility to work and live outside of Japan, and have the necessary hard skills, such as English-language proficiency.

2. *Lack of information on local business environments:* Most of the large companies in the survey cited a lack of information on local business environments, particularly business partners, markets, and legal systems. They are particularly hesitant about moving into markets where Japanese companies have yet to establish a foothold.

3. *Weak governance structures between head offices and local subsidiaries:* In relation to the two challenges above, sufficient trust has yet to be developed between head offices and local subsidiaries, resulting in head office-led governance or, to be blunt, a tendency to micromanage which, in many cases, prevents companies from maximizing their business value at the global level. Head offices have failed to cede sufficient authority to local subsidiaries, and it is difficult for local subsidiaries to make decisions as a result.

Actions for Kansai companies to become truly global

The population is declining in the Kansai region and across Japan as a whole, and as the world becomes more interconnected, Kansai companies will have no choice but to accelerate globalization if they wish to maximize business value. The positioning of globalization within an organization must be derived from the company's vision and overall strategy. To that end, management must set ambitious goals and articulate a scenario for global development. What, then, are the key actions Kansai companies need to take as they seek to become truly globalized? We think there are four actions of particular importance to Kansai companies:

1. Study unexplored regions

In terms of export markets, Kansai companies are currently biased toward the familiar markets of Europe, North America, China, and Taiwan. Given the rapid growth forecast for the ICASA markets and other emerging economies, we think that companies need to take a deeper dive into Southeast Asia, an area they have probably already studied, and also investigate the potential for moving into places like India and Africa.

The decisions on where to go, in what order, and how, must be made on the basis of regional affinities, market trends, and the company's own competitive advantages. When considering markets, companies should look not at the country level, but at the more granular levels of local regions and even cities; most countries expected to see growth will also see rapid urbanization, and there will generally be large differences between urban and outlying areas in terms of market size, population density, competitive environments, and procurement trends. Once high-priority regions have been identified, study them in greater detail by, for example, analyzing legal systems, other barriers to entry, and risk, and formulating and analyzing scenarios for sales and profits if the company were to enter. For lower priority regions still deserving of consideration over the medium and longer terms, conduct regular monitoring to remain sensitive to and informed about market trends.

Accessing essential information about a region requires the use of local people and recruitment of local partners who have the necessary insights. Doing this will require at a minimum that one person able to study the potential for expansion into the region be sent from the head office to work on the ground.

2. Clearly articulate the role of the head office

As noted above, local subsidiaries require sufficient independence if decisions are to be optimized to local circumstances and business value maximized at the global level. Instead of management and control, head offices should emphasize support. This specifically means articulating what decisions should be made at what level, and giving local operations the authority to make all decisions other than those absolutely requiring head office sign-off.

It is also important to increase the autonomy of the organization by, for example, appointing local hires to officer positions within the local subsidiary. Having, for example, local talent as the majority of the top management of the local subsidiary and giving them authority over HR and even M&A decisions up to a certain value will allow the local subsidiary to function with greater agility and better address local needs.

3. Improve integration after M&A

For M&A, and particularly cross-border deals, the most important aspect of success is not the deal itself, but how the target is integrated into management, existing organizations, and businesses after acquisition, and that includes planning at the due diligence stage. Integration of the acquisition must be designed and executed in line with an initial strategy that states why the acquisition is required. Without that level of planning the company will be unable to capture anticipated synergies or maximize expected value. The acquisition may, in fact, end up being a burden.

The most important point is that the top management of both companies have multiple opportunities to speak directly and develop a strong, common understanding of what is intended by the acquisition, the position of the acquired business and company within the overall strategy, and the objectives and major milestones of integration after acquisition. Communications from the management level set the tone and direction for all activities, and in employee communications related to acquisition and integration, it is crucial to define the right direction from the outset.

In terms of practical operations, the key points are to assign people with the proper capacities to the proper positions, which may include enlisting the cooperation of outside firms. There should be encouragement for interaction between the two companies, and clear responsibilities as the organizations are integrated. If the acquisition is large, much more attention must be paid to this work, and integration activities will need broader, deeper collaboration.

Companies that are looking for large growth should probably do several small-scale M&A deals a year and build their own teams and capacities specifically for M&A and integration. The first step, however, is for management to take the lead in successfully completing the deals that are available right now to create success stories and begin to form a group of experienced people within the organization.

4. Recruit the talent for globalization

A later chapter discusses comprehensive talent strategy in more detail, but here we touch on the particular difficulties that Kansai companies may face in recruiting people able to move globalization forward. There are two types of talent required for globalization. The first is people who are able to initiate globalization, including the formulation of business strategy and execution of M&A. The second is people who are able to grow the business, who understand operations, and are willing to spend the necessary time with local talent. Recruiting and training the first group is of particular importance, and thought should be given to recruiting outside talent as well.

5.6 Transform organization operating models

Environmental changes require a conversion of organization operating models

In chapters 3 and 4, we examined the major changes that have recently taken place in the corporate landscape. These changes are accelerating, and it is difficult to predict the future, which increases the risk that traditional, hierarchical organizations will lack sufficient speed in information transmission and decision-making to respond to constantly changing needs.

Global companies, and particularly the digital giants and other platformers who dominate entire value chains, drive self-directed transformations to their organizations' operating models, which enable them to provide high value to their customers at all times. Slimming the decision-making process and keeping it as close to the customer or problem as possible enables these companies to build organizational structures and processes that rapidly adapt to changing environments. As the world grows more interconnected, companies in all areas are confronting similar challenges and all will need to convert their traditional organization operating models to stay competitive.

Current organization operating models at Kansai companies

Most Kansai players across industries have been unable to move away from the decision-making processes and implementation structures of rigid, hierarchical organizations. For these companies to become more adaptive to change, they need to gain flexibility and slimness as organizations, and improve the quality and speed of their decision making.

A McKinsey survey of Kansai corporate management teams found that 70 percent of managers felt that their framework – often described as simple organizations and commonly held values – was their company's strength. Conversely, more respondents rated their companies as weak on flexibility, or the ability to flexibly reallocate resources and update business processes as circumstances changed. On the topic of lean management (discussed in detail below), which corresponds to slimness, only 12 percent of all companies responded that they had "introduced customer-oriented lean management throughout the company," while 40 percent responded that they had "never even considered introducing it."

Many companies are likely to also face weaknesses in the pursuit of customer value and rigorous decision-making focused on customer value. For example, some companies presume that ideas proposed by older, more experienced employees and "experts" will be acted upon in manufacturing processes, regardless of merit. Today, however, with the accelerating change in customer needs, it is crucial to continually observe, investigate, and verify whether individual processes are really contributing to customer value, and if they are, by how much. Going a step further, from the perspective of customer value, it is not enough to eliminate waste in working hours, inventories, or other aspects of the manufacturing process; waste is also to be found in the time spent on internal coordination and complex decision-making processes. Thoroughly eliminating this kind of waste from an organization is one of the most important means of delivering high value to customers.

Organization operating models for Kansai companies

This section examines two organization operating models, "lean" and "agile." The approaches are not mutually exclusive. Indeed, from the perspective of maximizing customer value, they are complementary. Ideally, organizations should master both approaches, but it may be difficult to pursue both simultaneously. Therefore, in situations where there is comparatively little dynamic change in customer needs, priority should be given to the lean approach, but where there is a high risk of exposure to digital giants and other disruptive forces, or there are sweeping changes in customer needs, the agile approach should be prioritized. In either case, converting organization operating models is not an easy task, and we recommend an intensive focus on whichever approach is selected.

Both approaches reshape the way an entire organization works, and the goal is quite literally to ensure the company's survival. It will not be achieved with haphazard sub-optimization; there must be consistent commitment and deliberate decision making from top management to see the process through.

1. The lean organization operating model

Lean management refers to top management and all employees, all units and functions, focusing on customer perspectives, eliminating all waste that is irrelevant to customer value, and continually improving efficiency. It is an initiative to bring more customer-orientation into an organization's processes with the long-term involvement of all employees.

Lean is often associated with manufacturing improvement approaches, but lean management techniques have been effectively employed in banking, insurance, and other financial services, travel and other service industries, and even telecoms and energy. It is also applicable to a wide range of functions that go beyond manufacturing, for example, internal functions like procurement, marketing, and customer support.

In recent years, digitization has changed and increased customer contacts, while big data has been used to improve the depth and granularity of customer understanding. While this has increased the opportunities and means of identifying customer needs, globalization has shifted customers and produced a broader range of customer profiles, and technology has accelerated change in customer needs, making it more difficult to accurately grasp customer values. Much more care and effort will be needed than in the past to fully implement lean management.

The lean company, in the truest sense of having optimized organizational processes based on customer perspectives, has the following characteristics:

- *Customer-orientation:* Continued improvement from customer perspectives and based on the customer's understanding

- *Efficient processes:* Design and administration of only those processes necessary to most efficiently provide the goods and services that customers want

- *Visualization of results:* Metrics are transparent and linked to customers to encourage continued improvement

- *Organizational design and allocation of staff:* Systems are able to efficiently provide the goods and services that customers want

- *Employee attitudes and behaviors:* All employees seek to improve from a customer perspective

Bringing lean to Kansai companies

What is required for lean management? We think there are four crucial elements.

1. Consistent business strategy

Lean management success involves major changes to organizational processes, and the objectives must be consistent with business strategy. In this, it is essential that the management team formulate a customer-oriented strategy and articulate the philosophy and vision on which it is based. This strategy must be shared throughout the organization, and performance management metrics (KPIs) developed in line with strategy so that the organization as a whole moves toward the lean ideal.

2. Detailed understanding of customer needs

As already noted, lean management consists of activities that are tied to improving the value proposition for customers. This requires a detailed understanding of customer needs and the ability to quickly adapt the company's activities to meet them. There are two components: the first is to develop the organization-wide capacity management required for quick adjustment to ever-changing customer needs; the second, bold prioritization of the different aspects of the company's business activities.

3. Ongoing search for operational improvements

Lean is not a one-off improvement program, but a series of ongoing improvements in an organization's structure and capacity. Lean requires that companies identify waste and its root causes, and put into place mechanisms able to systematically execute solutions. To build these mechanisms, the organization must assign people responsible for activities at all levels and obligate them to articulate clear execution plans. Having done that, it is crucial to monitor execution of the plan from an organization-wide level. If there are fundamental problems that impinge upon organization-wide strategy, the solutions cannot be left to the working level. It is the management team itself that must take the lead.

4. Development and improvement of employee lean capacity

In building a lean organization, it is imperative that employees throughout the company at all levels be involved in activities. That is why results will be significantly affected by employee capability-development and improvement. That is also why it is necessary to develop skills by sharing best practices and providing coaching. Frequent checks on improvement execution and detailed examination of capabilities based on skill matrices will also be effective in ensuring steady progress.

Kansai companies should especially concentrate on the following points when introducing lean management.

Waste and the customer perspective

Kansai culture is already very sensitive to waste, and it will be important to determine how this sensitivity can be leveraged so that it is truly driven by the customer’s perspective. Customer-orientation must be more than conceptual, more than just lip service to the notion that the customer is king. For example, customer satisfaction should be measured and visualized, the organization should be viewed from the customer's perspective, and the customer's perspective itself should be clarified.

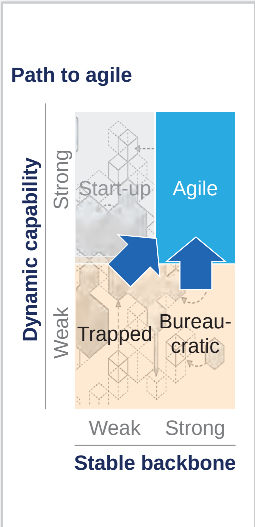
Coordinated effort across functions and units

It is important to emphasize coordination across functions and units. Viewed from the customer's perspective, waste consists of coordination, redundant processes, and differences in approach among various customer-facing units that end up impeding overall optimization. Japanese companies place particular emphasis on the consensus-building process, and it is often difficult for them to approve initiatives that span units. These bottlenecks must be dealt with for the organization as a whole to operate in a lean manner.

2. The agile organization operating model

Agile companies combine a framework that steadies the company, regardless of change, with the flexibility to adapt in response to environmental forces. This approach is considered ideal for companies in times of change. Corporate administration has long been thought to be a choice between two styles, a stable, efficient, waste-free organization or an organization not afraid of major change, able to learn and adapt quickly. Survival going forward, however, requires that companies combine both approaches, that they be truly agile.

Exhibit 23. Agile companies combine a stable backbone and flexibility



	Stable backbone	Dynamic capability
Strategy	**Top team sets direction** ▪ Shared vision, purpose ▪ Clear on "how to win"	**Fast reaction to changing circumstances** ▪ Sensing opportunities ▪ Rapid resource allocation ▪ Rapid iteration and testing
Structure	**Stable, simple structure** ▪ Simple reporting structure ▪ Hands-on governance around content ▪ Minimal bureaucracy	**Built up by small modular cells** ▪ End-to-end ownership, clear mission and autonomy ▪ Internal & external networks
Process	**Processes support value-adding work** ▪ Lean and digitized core processes ▪ Performance transparency	**Fluid reconfiguration to stay ahead** ▪ Role clarity and prioritization ▪ Continuous improvement in ways of working
People	**Values hold company together** ▪ Trust, collaboration ▪ Accountability and professionalism	**Engaged people drive results** ▪ Strong motivation, passion ▪ Culture of self-improvement and stretch ▪ Open, honest feedback

SOURCE: McKinsey & Company

Agile companies combine the opposing requirements of a robust framework and flexibility (Exhibit 23). The framework consists of the core, unchanging strategic guidelines shared by all employees, a simple, non-bureaucratic organizational structure, refined and perfected business processes, and shared values among employees. The flexibility comes from a corporate culture that encourages reallocation of resources as needed in response to changing circumstances, flexible team organization, ceaseless improvement in business processes, and a pervading mindset that everyone is growing and learning together.

Companies that are agile have higher levels of organizational health[9] and better performance than those that are not. More specifically, 70 percent of the companies considered to be agile rank in the top 25 percent or higher of all companies on measures of organizational health, like employee satisfaction and ease of expressing opinions. Performance is also well above average. Agile companies require just one month to bring innovations and technologies to market as products, while ordinary companies need an average of 12 months. The costs for companywide change are also 40 percent less at agile companies, and they employ 30 percent fewer people in indirect units.

9 Metrics from McKinsey's OHI Survey. An indication of whether the necessary corporate culture and attitudes are in place for sustainable growth.

Bringing agile to Kansai companies

The agile organization operating model is significantly different from conventional organizational administration, and a certain amount of time will be needed before it is understood and embedded in daily operations. Nor is the model necessarily suited to all kinds of business. With these caveats, we think there are two actions that Kansai companies should start with as they endeavor to become more agile:

1. Pilot an agile organization operating model, then roll it out

Identify units that are a good fit for the agile approach, and give them complete independence from existing internal systems and decision-making processes so that they can bring in agile team organizations and begin to make process improvements. It will be difficult to introduce agile all at once across the company, and it is better to begin with units where the benefits will be largest. These will probably be units that, by the nature of their operations are already somewhat agile (e.g., software development) and units that can easily gather feedback from customers (e.g., sales). They should be identified, split off from existing internal processes and organizational structures, and tasked with introducing thorough, rigorous agile programs. Introducing the agile approach, even in a localized manner, will start to provide insights into how agile works in the company, and how it can be more broadly applied. When doing this, it is up to the CEO to ensure that the employees of units introducing agile are convinced, enlist the cooperation of other units that have deep operational ties with the agile units, and build a structure that is able to function without being bound by existing systems.

2. Penetrate an agile culture across the organization

The agile approach is, in fact, the traditional source of development and growth for Kansai companies, and one they should find immediately familiar. Agile offers standardized triggers and mechanisms for a repeated process of identifying customer needs and then dynamically using trial and error to address them, and it is these triggers and mechanisms that should be used to allow agile to take root as part of a company’s culture. The job of management is to provide support, financial and otherwise, to these activities and intentions, assisting employees so that they are able to operate more freely and spread the agile culture throughout the organization as a whole.

5.7 Ramp up the talent strategy

Talent strategy refers to the entire range of investments in recruiting and training, and all of the medium and longer term measures associated with them as a means of achieving a company's business strategy. It includes, for example, clearly identifying the skills that employees must have to achieve the business strategy, allocating the requisite investments to employee training, and setting priorities between the talent and business strategies.

Talent strategy should be a key focus of a company's growth strategy, as it directly translates to corporate performance. Comparing, for example, employees who achieve excellent results in relatively complex operations with those who are just average, one finds a three-fold difference in productivity among software engineers and a six-fold difference among sales managers.[10]

Looking at Kansai companies, and indeed, Japanese companies in general, talent strategy is generally little more than a formality, and most companies, as a result, have failed to fully tap their potential personnel and organizational capabilities. The focus tends to be on institutional improvements, such as hiring new graduates, revising internal evaluation standards, and enhancing wage systems, but there is insufficient coordination between HR and business divisions on the kinds of people who should be hired so that most of the improvements become merely localized remedies with no clear relevance to overall corporate business strategy.

Fierce competition for talent and the implications for talent strategy at Kansai companies

The global competition for talent is intensifying, and many large companies suffer from a shortage of labor as a result. A 2014 survey of Fortune 500 companies found that more than 80 percent considered themselves "unable to attract talented people." In many fields, deeper and deeper levels of expertise are required for those at the forefront, and labor liquidity is increasing at a global scale. IT, in particular, has strong demand for highly-skilled employees, and as falling birthrates and aging demographics progress, the competition for this talent will only become stiffer.

Similarly, Kansai's labor markets are also tight. According to Teikoku Databank's 2018 Survey of the Economic Outlooks of Kinki [Kansai] Companies, roughly half of all companies listed a shortage of labor among their top three concerns, and "how to attract and retain talent" was a common challenge.

Nonetheless, it is also a fact that Kansai has a strong and robust talent pool. A survey of schools conducted in FY 2016 by the Ministry of Education, Culture, Sports, Science and Technology found that the ratio of university students and graduate students to total population was roughly the same in both Kansai and Kanto (Tokyo), and Kansai is home to Kyoto and Osaka Universities, institutions with some of the highest educational and research levels in the world.

10 Based on standardized economic value added. Lyle M. Spencer. The Economic Value of Emotional Intelligence Competencies and EIC-Based HR Programs.

Ideally, Kansai companies could attract not only this talent pool, but also talent from Kanto and foreign countries. However, there is a talent drain among the top students in particular, who tend to take positions with Tokyo companies after graduating from Kansai universities. Kansai companies also often lament that they are unable to bring back students who have attended universities in Tokyo, and are forced to hire only from Western Japan. It is not uncommon for global companies to offer more than double the starting salaries of Japanese companies to top graduates. If Kansai companies are to prevail in this war for talent, they will need different approaches and comprehensive strategies.

The right emphasis on talent strategy for Kansai companies

Talent strategy has four major steps: 1) Identify, 2) Attract, 3) Develop, and 4) Retain. Below we examine each of these four steps and discuss directions for actions to address likely challenges at Kansai companies.

1. Identify

Clarify the talent that the company requires, and articulate the reasons targeted talent would want to work at the company, the skills they require, and the roles they are expected to fill. Many Kansai companies have likely never stated this clearly.

As with international M&A, innovation creation, and digital strategy, innovative business strategies will only grow in importance, and executing and succeeding at these strategies requires that the company be attractive to the target pool of talent. This, in turn, requires that the company clearly articulate what it hopes to achieve through these strategies, the “edge” that it will bring to the process, and the people that it wants. As specific actions, companies will need to go beyond the mass recruitment of new graduates and include strategies to hire specific targets required by the business strategy. In other words, they need a comprehensive talent recruitment strategy.

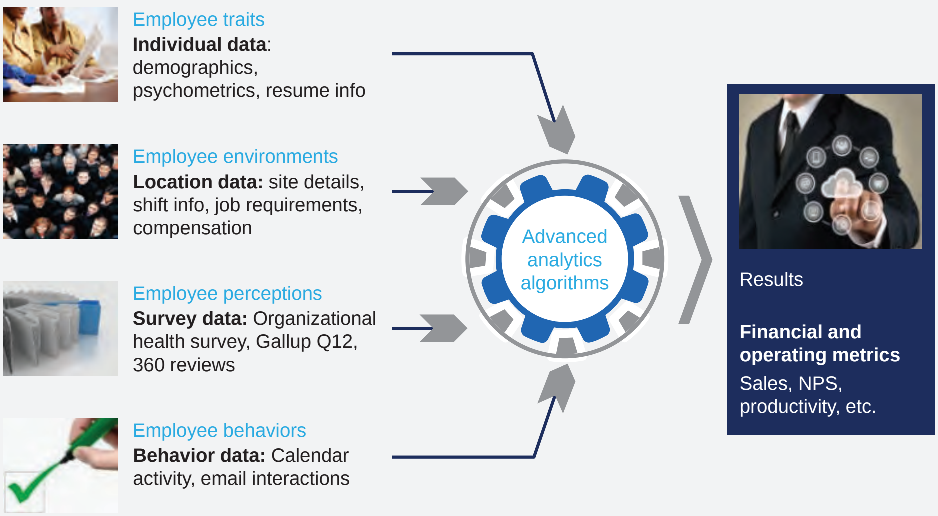
2. Attract

Having clearly identified the skills and aptitudes required, the positions to be filled, and the specific targets, companies must develop flexible, effective recruiting activities geared to those targets while also optimizing the costs associated with recruiting activities.

Data utilization has become essential in every area, and companies are increasingly employing "people analytics" (advanced data analysis within the context of talent strategy) to address their recruiting challenges. People analytics uses machine learning and other advanced analytical methodologies to develop forecasts based on information about individual employees, workplaces, and other environmental factors, evaluations, survey findings, and ordinary work performance (Exhibit 24).

It is possible to use people analytics at any step in the talent strategy, and in many cases it provides answers that upend the common wisdom about what kind of talent is needed and how to recruit it. Two examples of analytics use in practice follow.

Exhibit 24. The “people analytics” approach aggregates a broad range of data to get underneath what truly drives performance



SOURCE: McKinsey & Company

Example 1

A professional services company received 250,000 resumes every year, and it used machine learning to develop an algorithm based on historical resume information and ultimate hiring results. Using this algorithm, it was able to reduce the number of resumes requiring screening by about half; the top 5 percent automatically proceeded to the next step, and the bottom 50 percent were automatically dropped. This resulted in a 15 percent increase in the ratio of women passing resume screening (i.e., a reduction of arbitrary rejections) and, because the company was able to better prioritize its recruiting activities, an ROI of 400-500 percent.

Example 2

A global fast food chain with tens of thousands of workers scattered across the globe used data on employees' internal orientations, attributes, distance to workplace, work environment, and workplace behavior to identify which factors were closest related to performance (e.g., customer satisfaction at the store, store sales growth, speed of service). Contrary to the received management wisdom, there was little correlation to monetary incentives or store managers' years of experience; rather, it was opportunity to develop a career and cultural norms that had the highest correlation with performance (we discuss compensation for results in greater detail below, but can surmise that monetary compensation did not necessarily translate into fair evaluations or opportunities for advancement). At the individual employee level, attributes such as age and gender had little correlation, and among internal orientations, "work-oriented temperament" was unexpectedly more important than "friendly personality." The company used these results to set clear targets for its recruiting activities, make assignments to positions, and run pilot stores with training programs that emphasized developing culture. Customer satisfaction rose an average of 130 percent, and sales, 5 percent.

3. Develop

"Develop" refers to improving staff skills and knowledge, and cultivating the skills required of future leaders from a longer term perspective. Kansai companies tend to lack a development culture and, in many cases, training tends to take place on a person-to-person basis.

How a company trains its employees directly translates to performance. A McKinsey survey of 60,000 companies on leadership found that the companies in the top 25 percent with respect to leadership metrics achieved roughly double the EBITDA of others. There are many factors that go into developing leadership, but approximately 90 percent of leadership can be explained by just four components: problem-solving ability, results orientation, enthusiastic embrace of different perspectives, and support for others. It is on these factors that employee training should focus.Below are some points to keep in mind for effective leadership training:

- *Provide a complex mix of learning styles, including actual practice at the working level:* Hands-on learning in real-life environments is the most effective form of adult education. Rather than an ordinary classroom training with one instructor and multiple students, a mixture of online lectures, peer coaching, and group sessions will be more effective.

- *Build long-term programs:* Do not be satisfied with simple, one-off skills improvements in single-day workshops or multiple-day classroom sessions. Rather, put together programs that look at a span of one or more years to decide what needs to be learned and how it should be learned. Also take a step back and look at training as a whole, identifying the needs and aptitudes of the individual, and providing advice and coaching on how to build a more tailored program.

- *Provide learning experiences that delve into personal values as well:* Training should go beyond just experiences and knowledge to get to more fundamental aspects, such as attitudes and values. When trying to instill the attitudes and ways of thinking at the foundation of leadership, it is important to encourage deep reflection and insight about one's own values.

4. Retain

In the midst of a fierce competition for talent, we should remember that the process does not end with a signature on a piece of paper; it is also necessary to retain the people you hire. The attrition rate[11] among Kansai companies was 15.6 percent in 2016, somewhat higher than the 13.7 percent seen in Kanto. As the population of the Kansai region is expected to decline, the loss of talent can have a serious impact both on corporate performance and on the cost to recruit replacements.

Retaining the talented, skilled staff required for future growth means developing clear HR evaluation systems based on companywide strategy, fair evaluation criteria consistent with the strategy, and compensation and incentives linked to evaluations so that people feel a greater sense of satisfaction and fulfillment with their jobs.

11 Attrition rates are found by dividing annual separation numbers by the number of full-time workers as of January 1.

It is often the case at Japanese companies that attempts to reform HR evaluation systems become empty formalities due to suspicions among employees that reforms want to make people unnecessarily competitive or will not produce fair evaluations, and in a number of cases, employee opposition meant that reforms ended up being merely financial exercises to reward sales performance. Below are some points to bear in mind about how to avoid these pitfalls and develop effective HR evaluation systems.

- *Share the company's direction and medium and long-term strategy with employees:* No HR evaluation system wants to encourage unnecessary competition among employees. The goal is to achieve the direction and strategy that have been charted, and evaluations are just one tool for achieving the goal. This is a message that the management team must communicate at all times. It is important that these communications are clear, and that they make use of opportunities like employee meetings and newsletters.

- *Don't just focus on compensation and benefits, also develop evaluation and training systems:* Changing just the compensation portion of HR evaluations will not effectively translate into better motivation. It is necessary to develop evaluation systems that produce the talent required by strategy, and to introduce administrative methods that ensure evaluations are fair. The non-results aspects of HR evaluations are a particular area where the company's personality and orientations tend to be exposed, and it is desirable for the evaluation criteria and approaches to be defined in terms of the kinds of people the company wants to develop as leader candidates.

- *Ensure results are easy to pinpoint for units, teams, and special projects, and factor them into compensation systems*: In business launches directly under the control of the CEO, corporate acquisitions, and other large-scale cost-savings projects that are linked to companywide strategy, expected results tend to be clear, and it is worthwhile studying results-based compensation directly tied to team and individual projects. Generally at Japanese companies, even when there are results-based compensation systems in place, a part of the bonus is linked to evaluations, but how the results portion is allocated is up to the unit to decide, or in some cases, the majority of wages and bonuses are linked to an annual measurement known as the "gradational salary." When introducing results-based compensation, systems should be designed to clearly reflect individual efforts and contributions to achieving the strategy, if for no other reason than to ensure that results are evaluated fairly.

Arashiyama bamboo grove, Kyoto.

6. Conclusion: Bold moves under the leadership of top management

Pursuing and perpetuating a "transformation journey" will maximize enterprise value

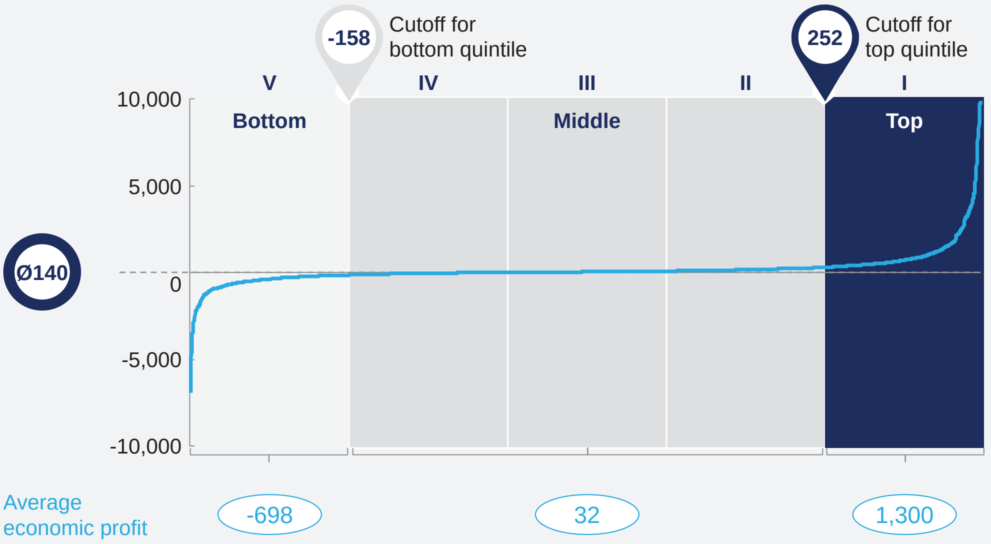
Globally, the economic value produced by companies[12] is concentrated in the top 20 percent (Exhibit 25). Looking at historical corporate trends, over a decade just 9 percent of companies in the 60th percentile will move out of that group and into the top 20 percent.

The primary factors influencing whether these companies will rise to the top are their initial position and market trends, but also the actions that they themselves take. More importantly, the company's own actions are what will effectively determine whether it emerges in the top tier.

Exhibit 25. The global distribution of economic profit can be split into three clear classes

Average economic profit, 2011–15; USD Millions; N=2,402

Economic power curve



SOURCE: McKinsey Strategy & Corporate Finance Practice

By "actions," we refer to large, visible moves such as M&A activity, reallocation of strategic resources, and changes of business models. Conducting one or two M&A deals every year to improve productivity and enter the top 30 percent of the industry is an example of a large, visible change – probably much larger and more visible than what competitors are doing. The accumulation of these bold, decisive actions increases the probability that a company will move from the middle 60 percent to the top 20 percent.

12 The economic value produced by a company = net operating profit - (adjusted capital x weighted average cost of capital) = invested capital x (return on invested capital - weighted average cost of capital). Subtracting capital procurement costs provides an indication of a company's "profit earned."

In the previous chapter, we recommended seven moves that Kansai companies should study and implement. We reiterate that these actions are not a set of simple tool introductions or minor tweaks to the business, they are prominent, visible actions worthy of the term "transformation." It is no easy task to repeatedly "transform," and the effort should be thought of more as a "journey."

Achieving the "transformation journey" will lead to growth for the company, and contribute to the Kansai region overall

The growth of the company and the growth of the region are intertwined. It works as a virtuous cycle. When the company grows, the region becomes more attractive, making it easier to recruit talented people; when the region grows, there are more business opportunities that can be leveraged for the growth of the company.

Kansai companies should visualize their aspirations from two perspectives. The first is to internally define its role in the Kansai region. In light of the disruptive trends, companies should define their role in Kansai, considering how the region should change in a sustainable and independent manner, leveraging its unique history, culture, education, and social infrastructure. The other perspective is to consider how to externally achieve leadership in the Japanese economy, competing boldly on the world stage through innovation and globalization.

Visualizing aspirations can help companies shape and prioritize their actions, both to improve performance and to stimulate development of the Kansai region more broadly. Achieving these two goals can only be achieved, however, if management teams, including those at the very top, have the will and leadership to drive transformation. Management teams must be aligned in committing to what will doubtless be very difficult decisions.

Ultimately, we recommend this "transformation journey" to Kansai companies because we are confident in Kansai companies and the management teams who lead them. To confront global-scale disruptive forces head-on and take their rightful place on the global stage, Kansai companies, and the region as a whole, need the strong commitment and rigorous action of top managers who believe in the enormous potential, and have the vision to capture it.

Osaka Marathon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www.mckinsey.com