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Global Institute

The future of Asia

Decoding the value and performance
of corporate Asia

Discussion paper
May 2020

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Decoding the value and performance of corporate Asia

COVID-19 is an unprecedented global challenge in the post-World War II period. This pandemic has proven to be not only a public health crisis, but also a major disruption to supply chains that may permanently change long-standing business practices to create a “next normal.” But Asia has come through crisis periods before and emerged stronger for it—and there is reason to believe it can do so again. The dynamism, speed, and agility of Asian companies have given the region resilience, enabling it to achieve macroeconomic stability in a volatile world. Asian corporations have grown rapidly and risen to global prominence over the past decade (between 2005–07 and 2015–17). However, bigger has not always meant better, at least in terms of economic profit, a measure of value creation and companies’ ability to beat the market. As a group, Asian companies lag behind their counterparts in the rest of the world despite the region’s enormous market opportunities. Why should that be? By taking a deeper look at sectors and individual companies, we attempted to answer this question, and we identified many opportunities for growth and productivity along the way.

- Over the past decade, \$1 of every \$2 in new investment made worldwide went to Asian firms. This influx of capital has enabled them to scale up, achieving size and reach in line with the market opportunities at stake. Today, 43 percent of the world’s largest companies by revenue are headquartered in Asia.
- However, for most of the region’s companies, capital inflow and revenue growth have not translated into higher economic profit (that is, profit after subtracting the cost of capital). Ten years ago, it took 80 cents of invested capital to earn \$1 of revenue, but today it takes almost \$1.10 to earn the same \$1. The world has been awash in capital, driving down returns. As a result, economic profits worldwide deteriorated from \$726 billion in the three-year period spanning 2005–07 to a loss of \$34 billion in 2015–17. Asia accounted for nearly half of that fall, as \$152 billion in economic profits swung to a loss of \$206 billion just a decade later.
- Three major factors explain Asia’s declining economic profitability over the decade we studied. A cyclical downturn in energy and materials, which has affected this sector worldwide, is the biggest factor, accounting for 44 percent of the decline. Another one-third of the drop can be attributed to the allocation of capital to value-destroying sectors, a phenomenon that occurs throughout the region but is particularly pronounced in China. The remainder of the decline is due to the underperformance of Asian firms relative to their global peers.

- Our simulation suggests that Asia could potentially unlock \$440 billion to \$620 billion of economic profit from two major opportunities. The first is improving the performance of firms—specifically, lifting about 200 of the region’s companies out of the bottom quintile of performers into the middle and boosting an additional 250 companies from the middle of the curve into the top quintile. The second is investing \$3 trillion to \$4 trillion over time in value-creating sectors; some of this may involve reallocating existing capital away from other sectors.
- Looking specifically at the performance of firms, Asia is overrepresented in the bottom quintile and underrepresented in the top quintile of firms as compared with the global average. This is partly due to endowment and the reality that Asian firms have been overrepresented in lower R&D sectors. However, part of this situation reflects the need to learn new skills such as programmatic M&A. Less than 10 percent of mergers and acquisitions in Asia are programmatic, half of the global benchmark of 20 percent. However, Asian firms can also build on the relative strengths we identified, such as their dynamic capital reallocation and rising labor productivity.
- A sector-specific view reveals significant opportunities for firms in Asia to improve performance, in turn representing opportunities to recover from the impact of the pandemic. In pharmaceuticals, Advanced Asian economies and China have the research capabilities to compete with Western incumbents, while companies in Emerging Asia, Frontier Asia and India, and China can meet the need for low-cost healthcare delivery in their countries and simultaneously lead globally in digital health solutions. In consumer goods and services, firms can take advantage of rising consumption from an expanding middle class across Asia, scale up through programmatic M&A, build global brands, and extend their reach through digital platforms. Energy and materials companies can lead the global transition to a cleaner future by strengthening their lead in renewable energy and electrification as well as expanding into rapid growth areas such as liquefied natural gas. Real estate companies can benefit from Asia’s continuing urbanization, but they need to develop new competencies in managing diverse portfolios and use technology to achieve end-to-end process improvement. Banks are facing market and competitive challenges; they may need to embrace consolidation to add scale and deepen their use of digital technologies.
- There are many opportunities for Asian corporations to build capabilities to sustain long-term growth in what will be a more volatile context in the wake of the COVID-19 shock. Corporations can accelerate digital adoption and thereby unlock productivity; build scale by exploring M&A and continued regionalization; and be bold and agile in the management of portfolios. In addition, business leaders need to manage for multiple time horizons, putting in place plan-ahead teams.

Over the past two decades, the growth of large Asian corporations has radically altered the world’s corporate landscape. Now these companies are entering a new phase in which their challenge will be not simply growth but also productivity. An external shock of the magnitude of the COVID-19 pandemic may only accelerate the widening of the gap between underperforming and outperforming companies. Looking ahead to a post-pandemic world, resilient Asian firms may be able to define the “next normal.”



1. Understanding Asia's corporate performance

We live in a turbulent world, with geopolitical tensions and an unprecedented global pandemic dominating headlines and the minds of decision makers. While the focus today is rightly on the immediate crisis response, these events highlight the importance of resilience for both governments and the corporate world.

The spread of COVID-19 has been a crisis not only for healthcare, but for entire economies. Efforts to combat the virus through physical distancing have hit many sectors, including travel and hospitality; put pressure on many consumer-facing businesses; and disrupted the many global supply chains that run through the region. But Asia has coped with adversity before and emerged stronger for it. Lessons learned during the 1997-98 Asian financial crisis, for example, changed public policy and private-sector choices; as a result, Asia came through the 2008 global financial meltdown relatively unscathed.

The performance of large corporations matters to the fortunes of workers, consumers, investors, savers, and even the stability of national economies. Asia's corporate giants have experienced a tremendous growth phase, but their next chapter will be about creating value and sustaining performance over the longer term. Volatility will always pose challenges, but Asian firms have proven to be nimble and dynamic in the way they respond. With the pandemic, Asia's corporations will need to continue to expand internationally and push ahead with innovation, and the region's horizontally integrated conglomerates will have to demonstrate the benefits of diversification in an increasingly volatile context.

In a post-pandemic world, Asian companies can play a major role in defining the "next normal."¹ In this next phase, they will have to broaden their focus beyond growth and staking out market positions to emphasize productivity and performance. In Chapter 1 of this paper, we look back over the past decade to assess Asia's capital paradox, which has fueled the rising scale of corporate Asia but produced declining economic profit. We examine the factors causing this phenomenon, then lay out the size of the opportunity that could be realized through improved firm performance and more efficient capital allocation. In Chapter 2, we look at five specific sectors to identify the opportunities for Asian companies. In Chapter 3, we suggest how companies can position themselves for the post-pandemic world.

¹ Kevin Sneader and Shubham Singhal, *Beyond coronavirus: The path to the next normal*, March 2020, McKinsey.com.

Asia is now home to 43 percent of the world's largest companies

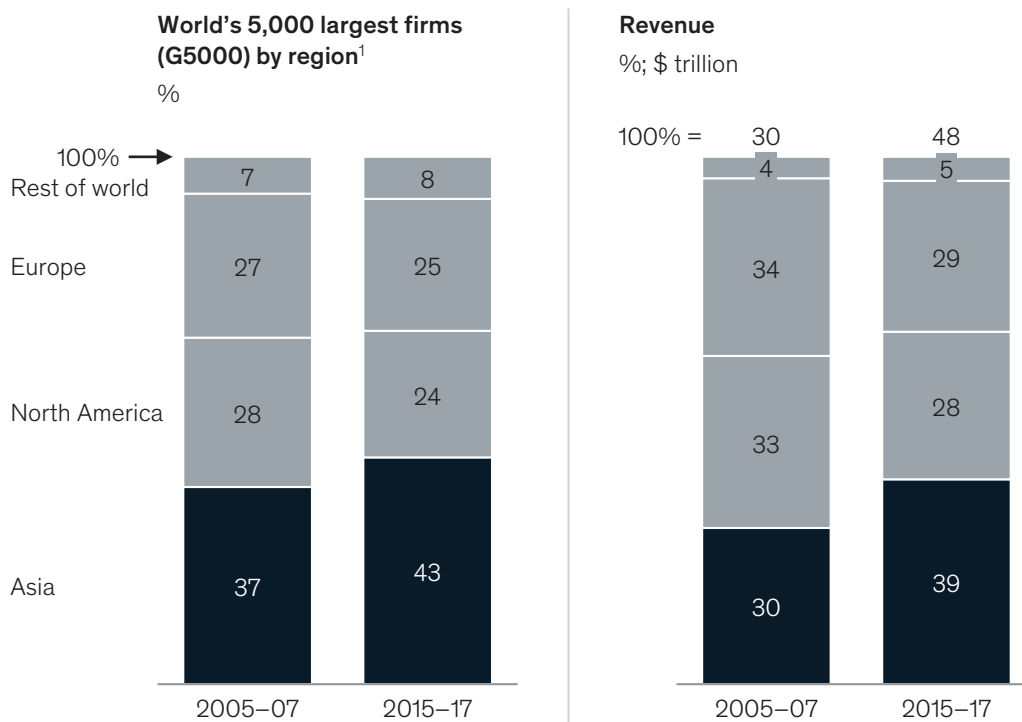
A huge wave of capital has flooded into Asia's corporations in recent years, with aggregate investment tripling over the past decade. More than \$1 of every \$2 in new investment worldwide over this period went into firms that call Asia home. In fact, \$1 of every \$3 in global investment went to China.

This funding has evidently helped many Asian companies scale up rapidly. We use the share of companies in the G5000—our term for the 5,000 largest firms in the world by revenue—as a proxy for broader trends in Asia's corporate landscape (see Box 1, "Our approach to assessing corporate performance"). In the past decade alone, Asian companies have increased their share of the G5000 by six percentage points. Asia now accounts for 43 percent of the list, a larger share than any other region in the world. In comparison, Europe has 25 percent of the G5000, and North America (Canada and the United States) has 24 percent (Exhibit 1).

The increased prominence of Asian companies is to be expected as more of the world's economic activity shifts toward the region. Yet the speed of their rise is still striking, particularly since the entry bar to the G5000 is now set much higher. To enter this exclusive club in 2015–17, a company needed revenue of \$1.3 billion—double the required level only ten years ago. Furthermore, Asia is the only region with rising representation over this period. North America's share of the G5000, for instance, fell by four percentage points, and Europe's fell by two percentage points.

Exhibit 1

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



1. Largest by revenue.

Note: Figures may not sum to 100% because of rounding.

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Representation in the G5000 is also shifting within Asia itself. The number of Japanese firms making the cut today has dropped by 300 from ten years ago. Singapore and South Korea largely maintained their representation at 40 and 160 companies, respectively. However, Chinese companies have more than doubled their share of the G5000 in the past decade to more than 900 firms. The number of Indian firms represented has also nearly doubled from a lower base of 85 to 142, the seventh-highest share. Companies from emerging Asian economies (including Malaysia, the Philippines, Thailand, and Vietnam) now have a presence on the list—and for the first time, Bangladesh has a company in the G5000.

Joining the G5000 matters because it reflects economic momentum. As firms grow and become more corporatized, they can more easily access financing, accumulate capital, and connect with the global economy. Larger corporations often tap into global demand and drive exports. They typically have higher productivity and productivity growth as well as lower marginal costs to expand than smaller businesses. Large firms generate a larger share of GDP in Advanced Asia, China, Europe, and the United States than those in other parts of Asia (Exhibit 2). High-performing emerging markets tend to have about twice as many large firms as other emerging markets, but those firms are still only about half as large on average (by revenue) as those in high-income economies.²

Asia's large firms play different roles in their national economies. China and the economies of Advanced Asia have higher corporatization rates (that is, a higher share of GDP generated by large firms), while Emerging Asia, and Frontier Asia and India have lower corporatization rates, which largely reflect their levels of economic development. However, as we have seen with the patterns of G5000 representation to date, firms from Emerging Asia, Frontier Asia and India will likely continue to rise as the “Asian century” progresses.³

² *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

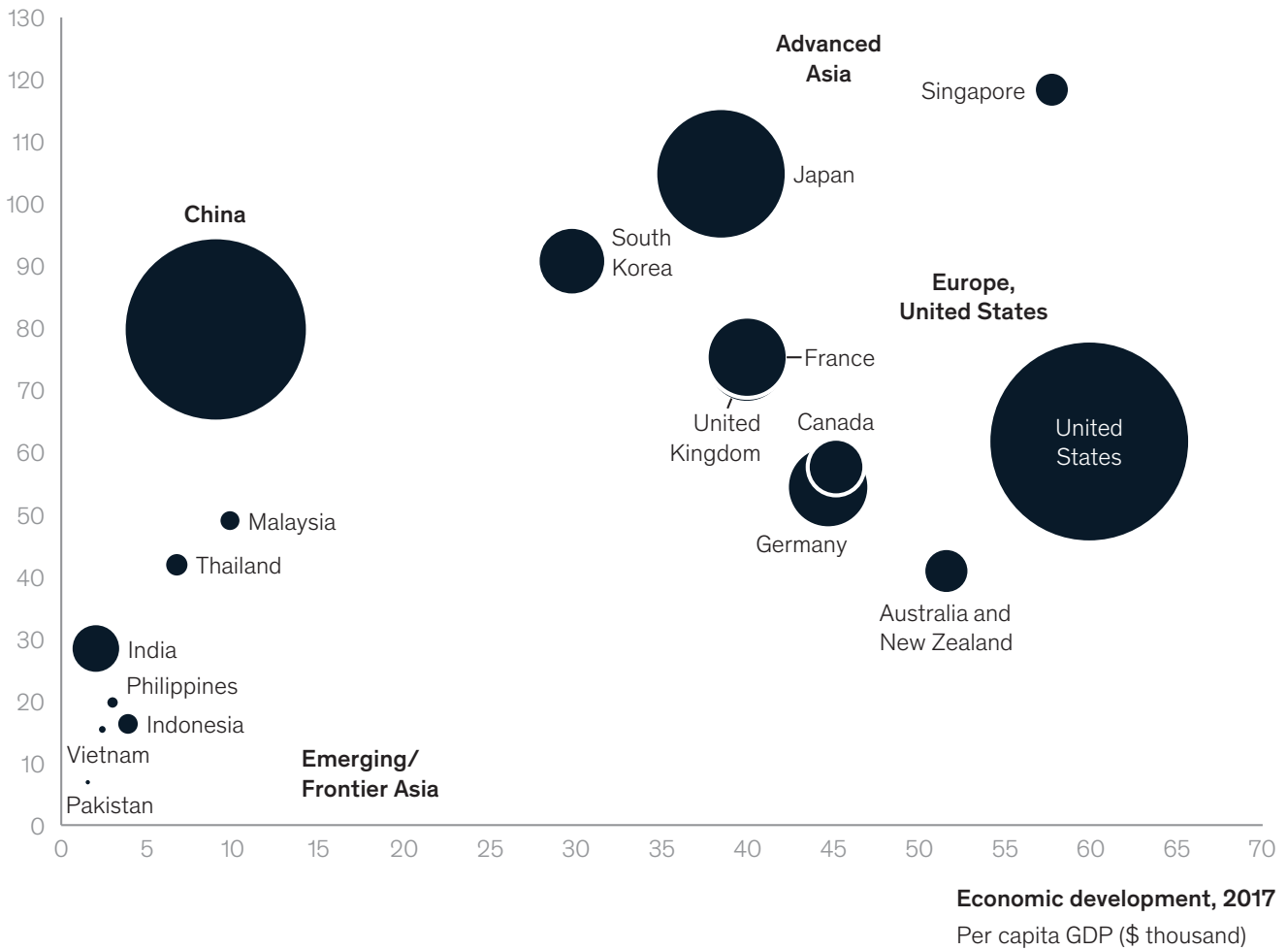
³ Asia is a highly diverse region; there is no single Asia but many. We identified four distinct groups of economies based on scale, economic development, interactions with one another, and connectedness to the world. Advanced Asia (which consists of Australia, Japan, New Zealand, Singapore, and South Korea), provides significant capital and technology to its neighbors. China (which comprises mainland China, Hong Kong, Macau, and Taiwan) is large and distinct enough to stand on its own. It anchors the region, providing connectivity and innovation. Emerging Asia (which includes Indonesia, Malaysia, the Philippines, Thailand, and Vietnam) is a culturally diverse group that provides labor and the potential for long-term market growth. Finally, Frontier Asia and India (a group that includes Bangladesh, India, and Pakistan) accesses a broad base of trade partners and investors, and provides growth opportunities. The complementary nature of these groups can make Asia more prosperous and resilient. See *The future of Asia: Asian flows and networks are defining the next phase of globalization*, McKinsey Global Institute, September 2019.

Asian economies have different levels of economic development and vary in the presence of large firms.

Presence of large firms, 2017

G5000 revenue as % of GDP

● Size of bubble represents total revenue



Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Our approach to assessing corporate performance

This paper draws on McKinsey's Corporate Performance Analytics data set, which covers more than 30,000 firms around the world. We identified the world's largest 5,000 firms by revenue for which financial information spanning 2015–17 is available to arrive at a group we term the Global 5000, or G5000. While most are publicly listed, we also compiled data on large unlisted corporations. Where multiple companies came under the umbrella of an overall parent company, we considered only the parent to avoid double counting. We then allocated firms to geographies based on the location of their headquarters.

To evaluate performance, we consider economic profit, which measures a firm's profit after subtracting the cost of capital. We note that there are many indicators that can be used to assess corporate performance and contributions, including revenue, market share, productivity growth, and employment. Depending on the context of economic development, these measures matter, especially in emerging economies. In this paper, we focus on economic profit as an indicator of sustainable performance in the long term. Firms will need to generate profit above the cost of capital in order to generate sustainable returns to various stakeholders.¹ Economic profit is calculated as net operating profit less adjusted taxes (NOPLAT) subtracted from capital charges. NOPLAT can also be derived from return on invested capital (ROIC) multiplied by invested capital. For capital charges, we use the weighted average cost of capital (WACC) multiplied by invested capital. Since financial firms are fundamentally different in nature, we use an alternative performance measurement: return on equity (instead of ROIC) and cost of equity (instead of WACC).

This paper includes in-depth analyses on profit performance at the sector and firm levels, which we use to construct a "power curve." This curve shows the distribution of companies ranked in order of economic profit earned in a given period. The curve has a distinct shape, with three parts: an upward spike representing the top 20 percent of companies in terms of economic profit per company; a flat middle of companies that earn only just above their cost of capital; and a downward tail of the bottom 20 percent of companies, which tend to incur economic losses. This power curve illuminates the relative performance of companies within and across sectors. Comparing power curves in different periods can also highlight corporate mobility.²

We acknowledge that economic profit is only one way of looking at corporate performance. It only measures additional value that remains available as surplus or residual value. Yet companies may want to use that surplus for other purposes than profit, for instance for innovation or protecting employment. It remains the case, however, that if economic profit grows, it will be easier for companies to accomplish their other objectives over the next decade as the role of corporations evolves. Companies answer not only to their shareholders but also to a broader group of stakeholders—ranging from governments looking to build new infrastructure to keep up with staggering urbanization rates to environmentally and ethically aware consumers.³ The role that corporations play in society is being redefined, a shift that forthcoming MGI research will explore.

¹ For more on economic profit, see *Superstars: The dynamics of firms, sectors, and cities leading the global economy*, McKinsey Global Institute, October 2018; and Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick*, Hoboken, New Jersey: Wiley, 2018.

² Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 2018, McKinsey.com.

³ James Manyika and Lareina Yee, "The questions companies should ask themselves to prepare for a new era of business," *Fortune*, November 15, 2019; and *The social contract in the 21st century*, McKinsey Global Institute, February 2020.

Asia's capital paradox: Rapid scaling has not translated into economic profit

Asian companies have put capital to work in scaling up rapidly and staking out market positions. But they have been unable to turn investment into economic profits as they underperform other regions on average returns.

Viewed through the lens of economic profit, corporations globally are not looking particularly healthy. From 2005 to 2007, the G5000 generated \$726 billion of economic profit. Only ten years later, G5000 companies posted economic losses of \$34 billion—a staggering turnaround, especially considering the low interest rates and loose monetary policy prevailing in much of the world. Where—and how—was this value lost?

The answer to “where” is largely Asia and Europe. Corporate Asia turned an economic profit of \$152 billion into an economic loss of \$206 billion in this period. Indeed, Asia accounts for almost half the global decline in economic profit between 2005–07 and 2015–17 (Exhibit 3). North American firms, by contrast, were largely able to sustain economic profitability, achieving a total of \$245 billion, similar to \$276 billion ten years ago.

Turning to the question of how so much value evaporated, the overwhelming answer is capital intensification. The world has been awash in capital, with too few profitable places to deploy it all—a phenomenon that has a cumulative effect.

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

Globally, ROIC declined by 3.2 percentage points, from 11.0 to 7.8 percent, between 2005–07 and 2015–17. During the same period, invested capital grew almost twice as fast as revenue, boosting capital intensity from 0.8 to 1.1.⁴ This implies that, ten years ago, it took 80 cents of invested capital to earn \$1 of revenue, but today it takes almost \$1.10 to earn the same \$1. At the same time, profitability (that is, net operating profit less adjusted taxes, or NOPLAT) grew more slowly than revenue, reflecting a global decline in margins of 0.3 percentage point, from 8.7 to 8.4 percent. Even setting aside more cyclical sectors such as energy and materials, a similar phenomenon remains across other sectors.

The steepest drop in ROIC over this period occurred among China's large firms, which posted a decline of 4.6 percentage points, from 11.4 to 6.8 percent.⁵ This fall is almost three times larger than the drop in the rest of Asia, where ROIC declined by 1.7 percentage points, from 9.1 to 7.4 percent.⁶ Yet capital continued to pour in even faster than revenue could grow (Exhibit 4).

This combination of increased capital intensity and reduced margins offers a technical explanation for the decline of economic profit. To understand the root causes and pinpoint the losses, however, requires a more in-depth look at how capital has been deployed in different sectors and regions.

⁴ Capital intensity is calculated as invested capital divided by revenue.

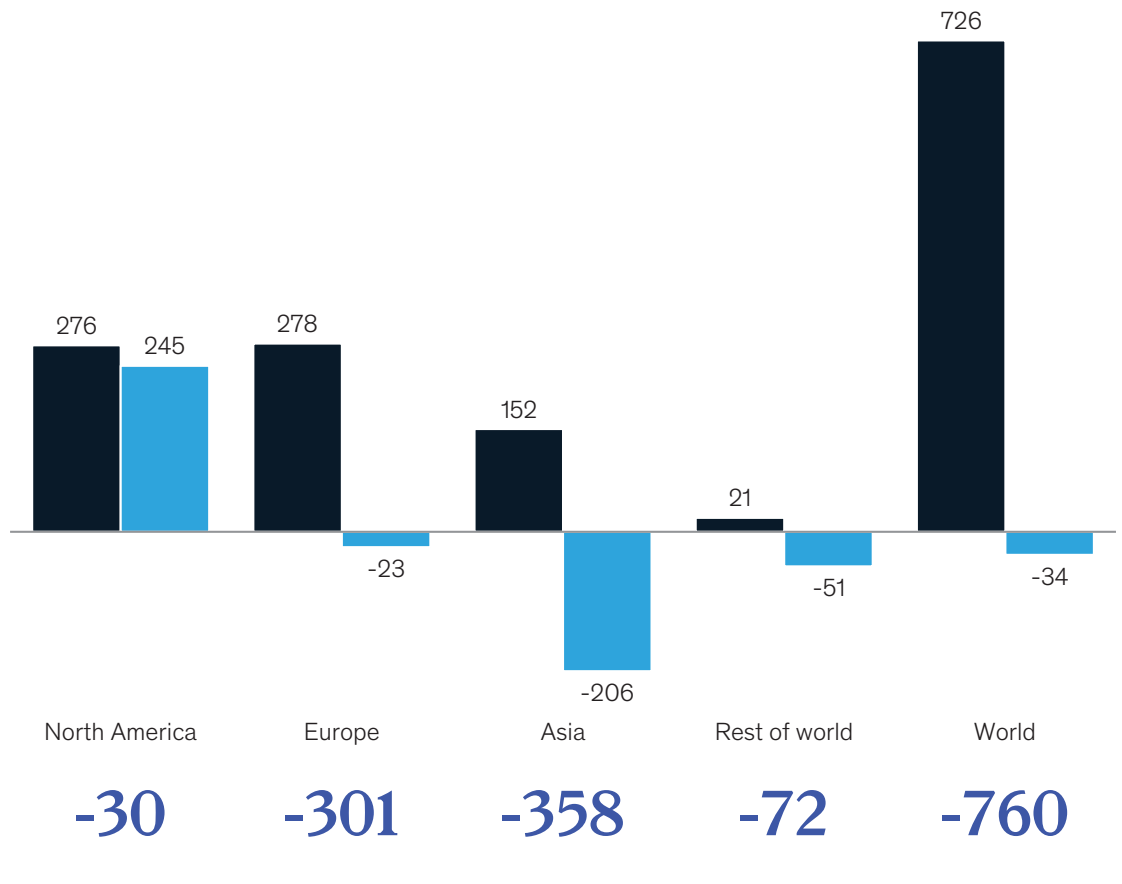
⁵ Nick Leung, *China Brief: The state of the economy*, McKinsey & Company, March 2019.

⁶ For all of Asia, ROIC declined by 2.7 percentage points, from 9.7 to 7.0 percent, over the same period.

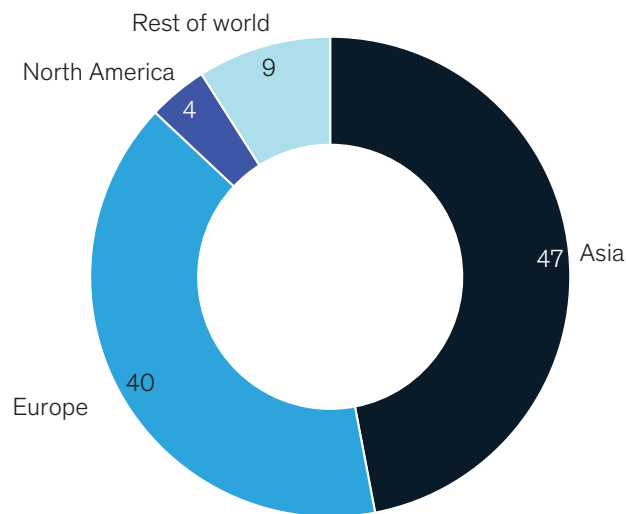
Economic profitability has declined around the world over the past decade, with Asia accounting for about half the decline.

Economic profit
\$ billion

■ 2005–07 ■ 2015–17



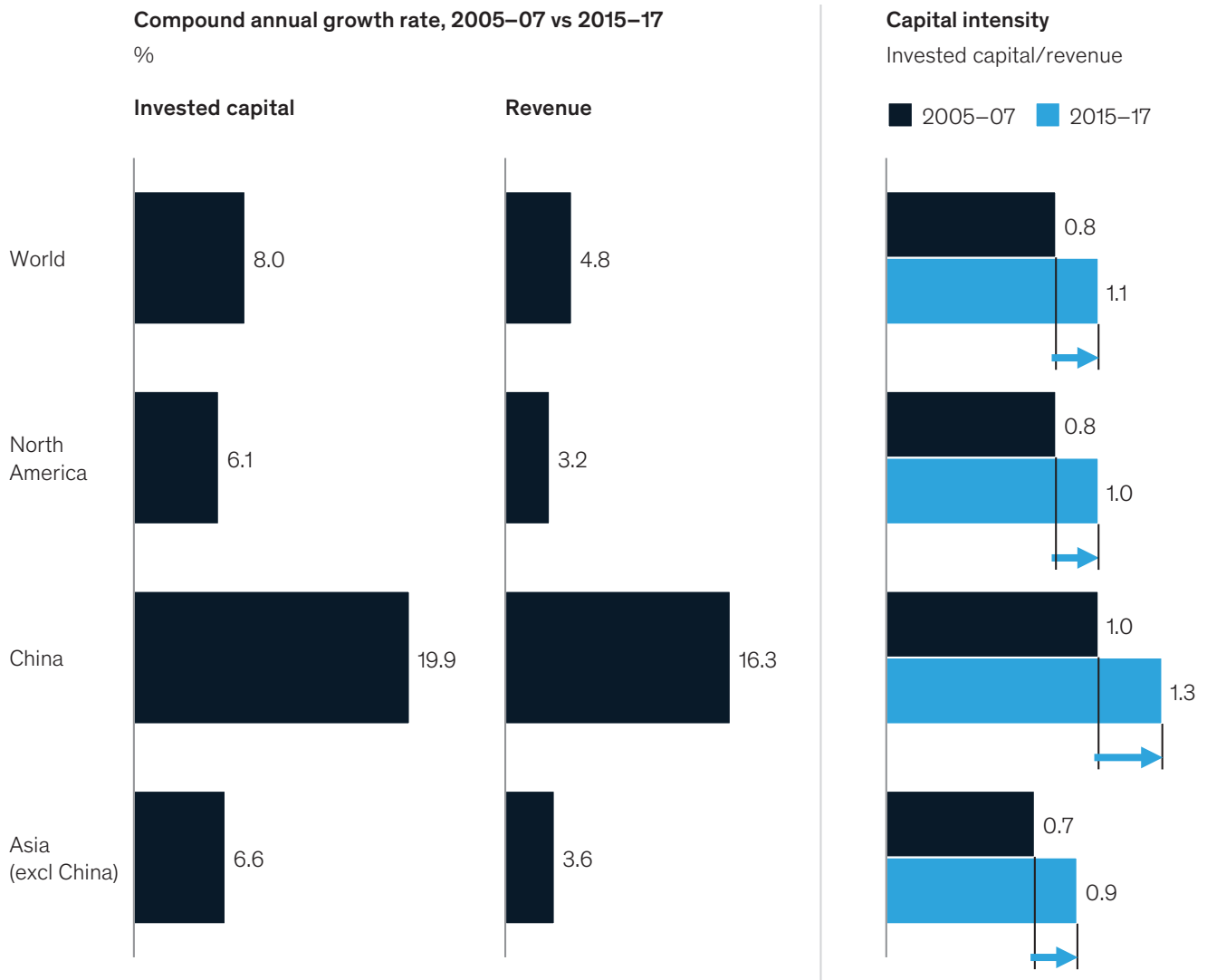
Share of global economic profit decline
%



Note: Figures may not sum to 100% because of rounding.
Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

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

G5000 companies, 2007–07 vs 2015–17



Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Three main drivers have lowered the profits of large Asian companies

Digging deeper into why so much economic profit has been lost over the past decade, we find three major factors. The first and largest is the cyclical nature of returns in the energy and materials sector, which accounted for 44 percent, or \$156 billion, of the total decline. Second, the allocation of capital to value-destroying sectors in Asia—and especially in China—accounted for one-third of the decline, or \$117 billion. The third and final factor is corporate underperformance, which drove just under a quarter of the decline, or \$85 billion (Exhibit 5). Below we examine each of these factors in turn.

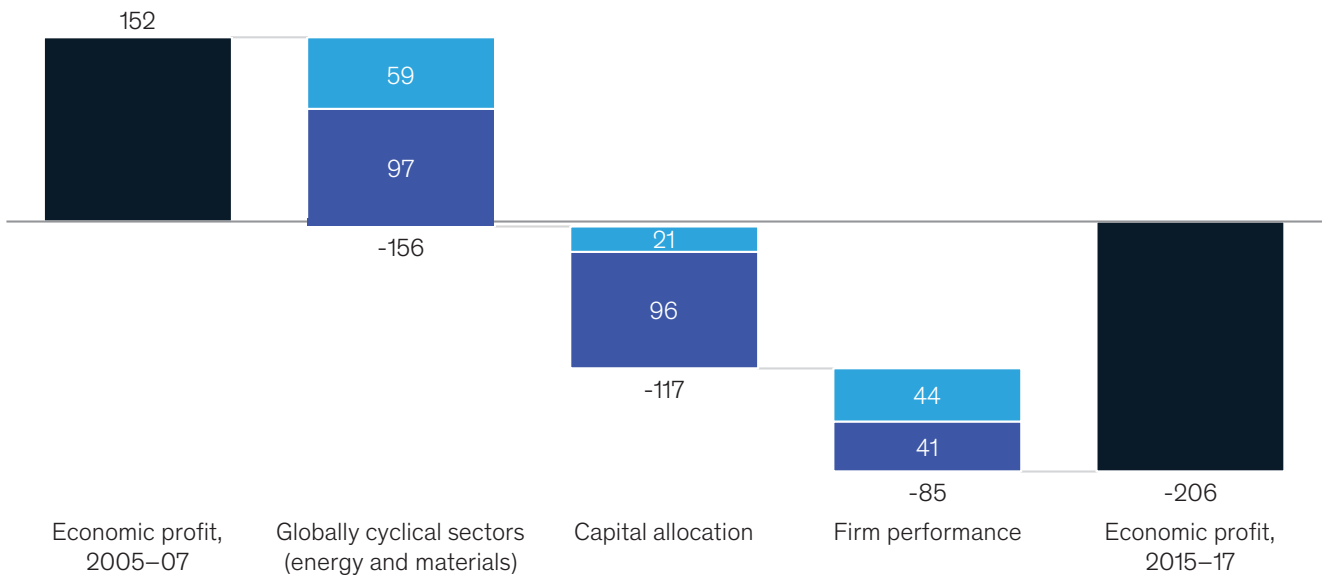
Exhibit 5

Cyclical effects in energy and materials as well as capital allocation to underperforming sectors in China have eaten away at Asia’s economic profits.

Drivers behind Asia’s G5000 economic profit change from 2005–07 to 2015–17

\$ billion

Asia (excl China)
China



Note: Figures may not sum to 100% because of rounding.

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

The cyclical nature of returns in the energy and materials sector

In just ten years, the energy and materials sector has gone from being a major generator of economic profit to being a significant source of economic losses. The energy sector is heavily exposed to changes in global commodity prices. During the commodity supercycle that ran from 2003 to 2015, spending on resources such as oil, natural gas, thermal coal, iron ore, and copper rose above 6 percent of global GDP for only the second time in a century.⁷ But, ten years later, falling oil and commodity prices are destroying huge amounts of economic profit, significantly damaging the performance of upstream oil and gas companies around the world.

This is not only an Asian story. Indeed, Asia, Europe, and North America each account for about one-third of the total economic profit lost in the energy and materials sector over this period. Furthermore, cyclical nature is a natural feature of this sector. Instead of looking at a three-year average, if we take a longer period from 2005 to 2017, average annual economic profit was \$12 billion, compared with an average annual economic loss of \$280 billion from 2015 to 2017.

The world is moving out of a historically significant supercycle, driven in large part by unprecedented capacity expansion to fuel China's development. At its peak (2006–12), China's average capital expenditure in the energy and materials sector grew by more than five times as a share of GDP, compared with 2000–05. Its investment doubled again between 2012 and 2015. The average oil price was \$110 a barrel from 2011 to 2014, but prices fell by more than half at the end of the supercycle in 2015. This drop made it far more difficult for players in the energy sector to grow revenue and profit. High capital investment coupled with lower revenue has resulted in exceptionally high capital intensity.

Allocation of capital to value-destroying sectors

Across Asia, significant capital has been invested in sectors that posted returns below their cost of capital. The past ten years saw \$14.5 trillion of incremental capital invested, and about three-quarters of it went into these "value-destroying" sectors (see Box 2, "How does sector affect top and bottom performing firms?").

This issue is particularly acute in China. Almost \$12 trillion of incremental capital was invested there—and 80 percent of it went to sectors that earned below their cost of capital. Domestic services (that is, utilities, telecommunications, transportation, and real estate and construction) accounted for the highest share of investment at 46 percent. They are followed by capital goods (that is, machinery, automotive, chemicals, and fabricated components) and energy and materials, at 18 and 16 percent, respectively. In fact, the difference in capital allocation between China and North America explains some 70 percent of China's lower economic profits (Exhibit 6).⁸

It is worth noting that the top 10 percent of Chinese firms in domestic services and capital goods actually averaged more economic profit per company than their counterparts in the rest of the world (\$640 million versus \$570 million on average). However, these sectors have long tails of underperforming firms in China. The bottom 10 percent of companies in China's capital-goods sectors lost \$75 billion, or 57 percent of the total loss accumulated by all of the players in the world. On average, Chinese firms generated 1.6 times less economic profit than their counterparts in the rest of the world. Although revenue from companies operating in domestic-services sectors largely plateaued between 2014 and 2017, invested capital increased by \$1.7 trillion—a 9.1 percent compound annual growth rate from 2013 to 2017. This drove capital intensity to an all-time high of 1.9 in 2017.

⁷ *Beyond the supercycle: How technology is reshaping resources*, McKinsey Global Institute and McKinsey's Global Energy & Materials Practice, February 2017.

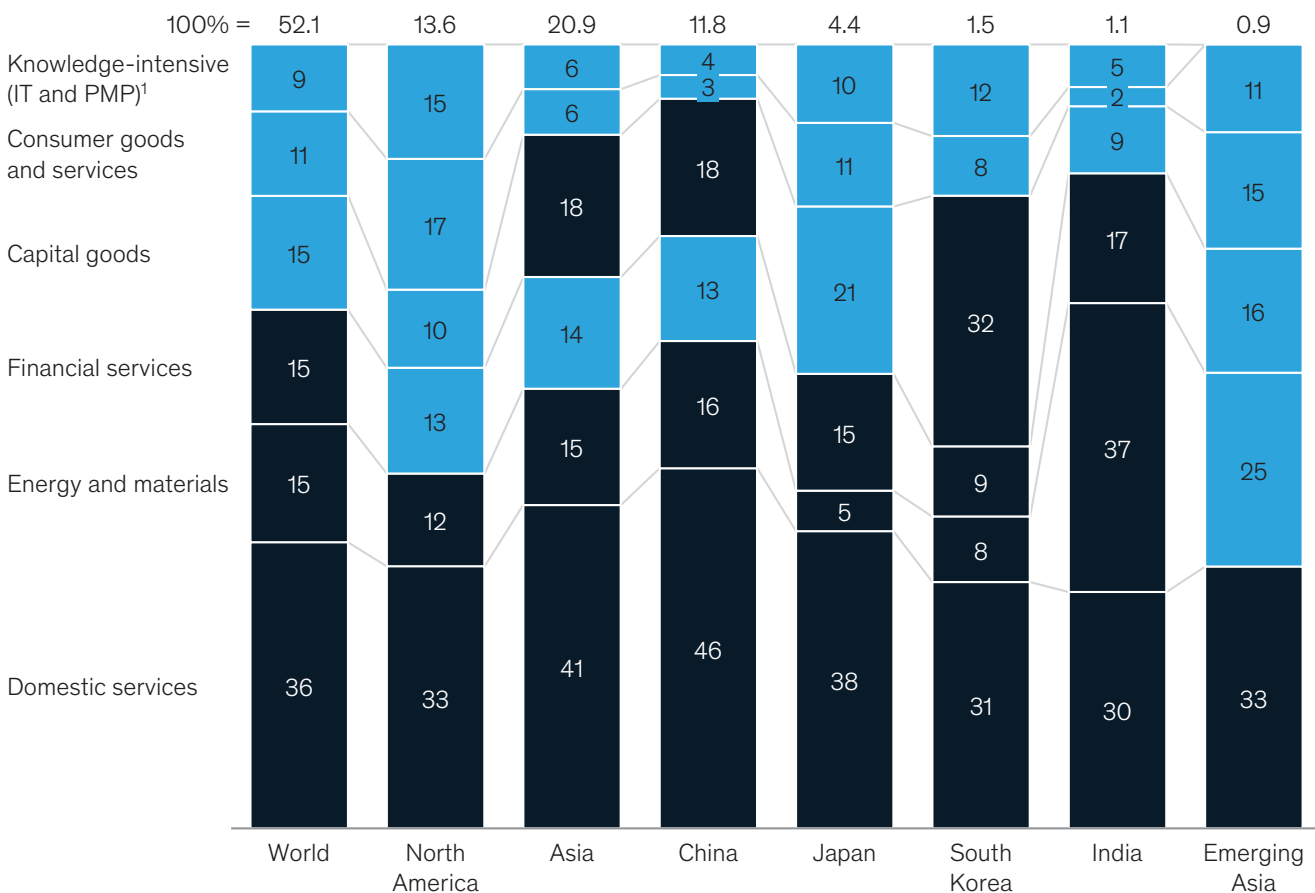
⁸ Subsectors in energy and materials include oil, gas, consumable fuels, energy equipment and services, metals, and mining. Domestic services include infrastructure, real estate, utilities, transportation, telecommunications, and business services. Capital goods include machinery and equipment, automotive and parts, fabricated components, and industrial chemicals. Financial services include banks, insurance, and asset management. Knowledge-intensive include pharmaceuticals, medical products, computers and electronics, internet, and media.

Asia allocates more capital to value-destroying sectors than other regions.

Share of invested capital, 2015–17

%; \$ trillion

■ Value-creating sector (ROIC>WACC)
 ■ Value-destroying sector (ROIC<WACC)



1. Information technology; pharmaceutical and medical products.

Note: Figures may not sum to 100% because of rounding.

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

How does sector affect top and bottom performing firms?

As previously discussed, sector mix explains more than half of the gap between ROIC in North American and Asian companies.⁹ In some parts of Asia (particularly China), sector—or, in other words, where you play—explains up to 70 percent of the gap. Does this imply that companies are doomed before they start if they are in a sector with low economic profit?

We identified two groups of Asian companies. The first is the Terrific 200. With the highest economic profits in the region, these firms account for one-quarter of worldwide economic profit creation by the G5000. The second group is the Troubled 200, companies with the lowest economic profit, which collectively account for one-third of worldwide value loss.

Looking at the industry breakdown of these two groups, we see that where a company plays is not a particularly strong determinant of performance—at the top, at least. In the 2015–17 period, 51 percent of the Terrific 200 came from value-creating sectors and the remainder from value-destroying sectors. This split has largely stayed constant for a decade, which implies that top performers can succeed in any arena. Whether a sector is growing or weakening, firms can beat the odds, but merely being part of a value-creating sector does not guarantee superior performance (Exhibit 7).

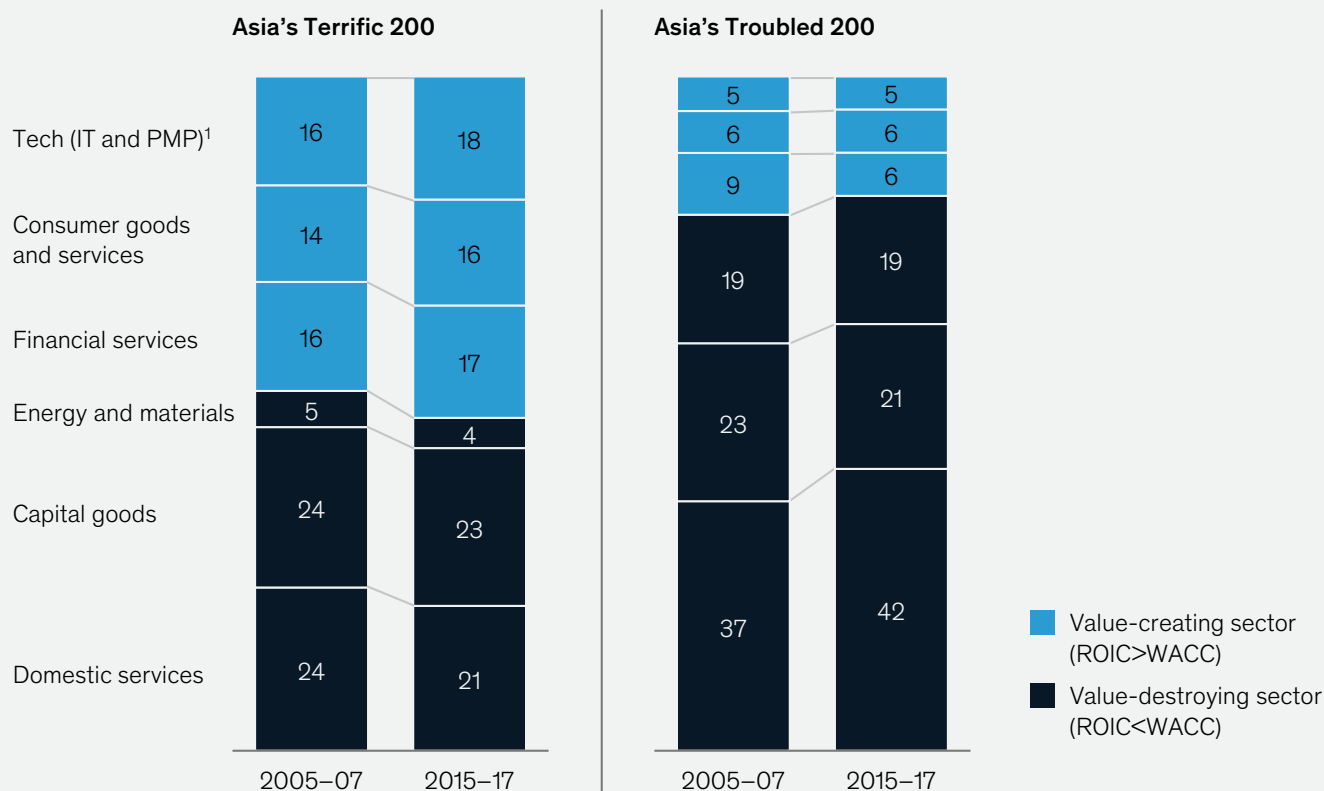
The opposite seems to be true for the Troubled 200. Eighty-two percent of the companies in this group from 2015 to 2017 came from sectors that were losing value. Industry trends can have an amplifying affect for firms that are already struggling.

Exhibit 7

Sector does not guarantee success but does bias toward failure.

Breakdown of Terrific 200 and Troubled 200 by sector

Share of total number of companies, %



1. Information technology; pharmaceutical and medical products.

Note: Figures may not sum to 100% because of rounding.

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

⁹ This excludes the energy and materials sector, given its highly cyclical nature.

Corporate underperformance, especially in knowledge-intensive, domestic services, and capital-goods sectors

The fortunes of broader sectors are only one factor determining economic profit or loss. The performance of individual firms is also critical. Previous McKinsey research on the power curve (the relative performance of companies on generating economic profit) found that the bulk of economic profit gained and lost is at the top and the bottom of the curve. The middle of the curve is the broad flatland where the majority of firms do not create or destroy economic profit.¹⁰

We mapped all the G5000 companies on the power curve by country and sector.¹¹ Overall, Asia is underrepresented at the top. Sixteen percent of Asian G5000 firms are in the top quintile while 24 percent of North American firms are in that quintile. Companies in Asia are also overrepresented in the bottom quintile of global companies with 24 percent of G5000 Asian firms in this quintile versus 17 percent in North America. In other words, Asia has a higher concentration of firms that destroy economic value and a lower share of companies that create it (Exhibit 8).

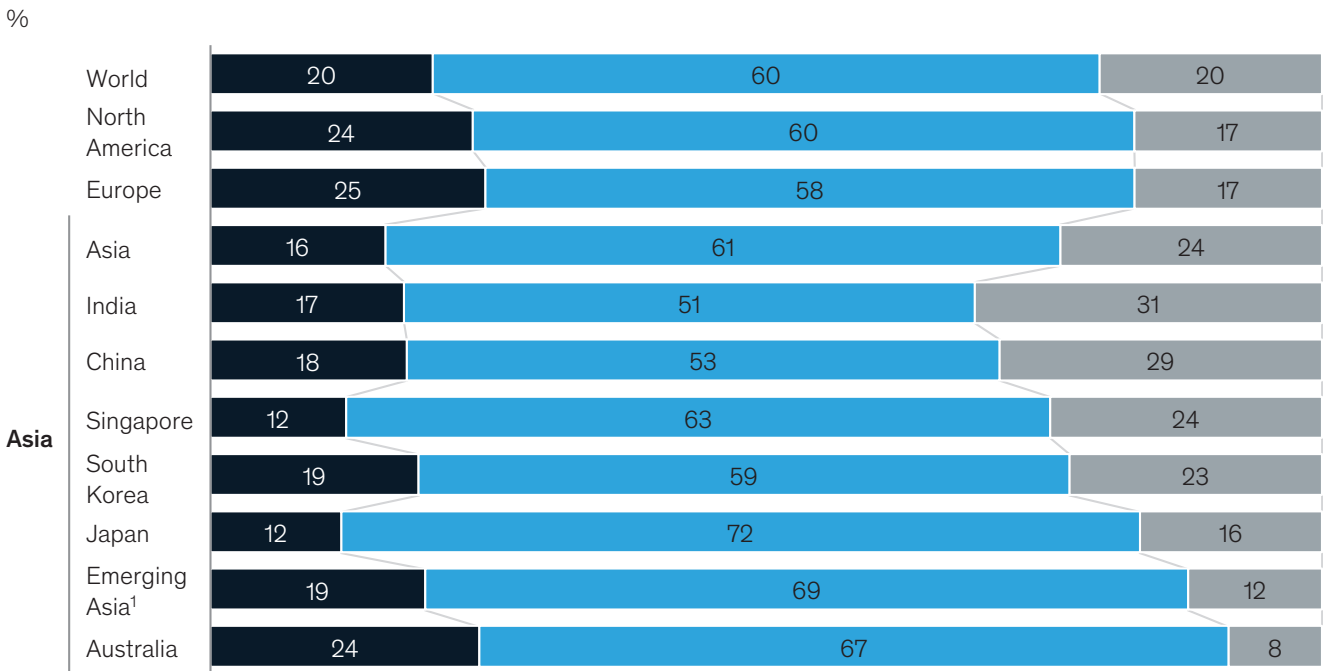
Looking at individual countries, we find that China and India have a higher share of underperforming firms. Nearly one in three companies in these two large economies are in the bottom quintile. Japan has a lower share of bottom performers, but few companies that are top performers; 70 percent are in the neutral middle ground. Emerging Asia and Australia appear to have the healthiest distributions, with large representation at the top and a smaller share of firms destroying value.

Exhibit 8

Asian firms are overrepresented in the bottom quintile of performance and underrepresented in the top quintile.

Average distribution of G5000 firms based on within-sector performance, 2015–17

■ 1st quintile ■ 2nd, 3rd, and 4th quintiles ■ 5th quintile



1. Emerging Asia includes Indonesia, Malaysia, Philippines, Thailand, and Vietnam.
 Note: Figures may not sum to 100% because of rounding.
 Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

¹⁰ Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick*, Hoboken, New Jersey: Wiley, 2018.
¹¹ We conducted this analysis at the sector level and calibrated it to ensure that sector does not bias the results.

Where do Asian firms outperform and underperform?

The interaction of the factors discussed above feeds into Asia's overall underperformance in economic profit. When we combine the sector view with firm performance, we can discern some interesting patterns of strength and weakness (Exhibit 9):

- **Asian superstars outperform in finance.** The top 10 percent of financial service firms in Asia outperform those in the rest of the world. Overall, Asian financial firms generated \$43 billion in economic profit, a stark contrast to the \$52 billion loss elsewhere. The significant economic profit generated by Asian financial firms was achieved despite the region only having half as many companies in this sector as the rest of the world. Their performance largely reflects the high average profitability of Chinese firms in the sector; in fact, firms in Frontier Asia and Advanced Asia on average posted losses of economic value. However, China's four largest banks alone contributed almost half of the entire economic profit generated by all Asian financial institutions. Much of this result is linked to varying regulatory and policy regimes across countries (for instance, policy frameworks to protect profit margins for certain sectors and firms). Especially in nontraded sectors like finance, performance tends to correlate with local policies on market competition.¹² Individual Asian economies take varying stances on foreign competition, licensing requirements, and guidance on interest rates.
- **Asian firms tend to underperform in consumer and knowledge-intensive sectors.** The biggest gap in economic profit performance between large Asian firms and those in the rest of the world is found in consumer sectors, technology, and pharmaceutical and medical products. These high-value sectors were dubbed "superstars" in previous MGI research.¹³ The top-performing firms within them invest heavily in R&D, (digital) technology, and intangible assets such as licenses, patents, subscribers, and brands rather than tangible assets. These characteristics create high barriers to entry for challengers, which explains why more developed economies tend to lead in superstar sectors. Firms in developing economies are not at the same stage of maturity as their peers in wealthier countries, and they tend to have scarcer resources and more limited investment. They also tend to be smaller firms, which can be a disadvantage in surmounting these barriers. Although Asia is well represented in these three sectors in terms of sheer numbers, the top 10 percent of companies in the rest of the world substantially outperform the top 10 percent in Asia, generating three to 20 times more economic profit. This pattern of relative performance reflects the strength of Western multinationals that have well-known global brands in the consumer sector, innovative capabilities in the technology sector, and a strong portfolio of innovative drugs and favorable market opportunities in the pharmaceutical sector.

¹² *How to compete and grow: A sector guide to policy*, McKinsey Global Institute, March 2010.

¹³ *Superstars: The dynamics of firms, sectors, and cities leading the global economy*, McKinsey Global Institute, October 2018.

- **Asian energy and materials firms tend to match the global average in performance.** Companies in the energy and materials sector face the challenges of cyclicity and overcapacity no matter where they are based, and the leaders perform similarly in Asia and the rest of the world. The top 10 percent of firms generate 80 to 90 percent of the entire economic profit in these sectors. Companies from the 20th to 30th percentile downward are incurring economic losses, similar to the global pattern. However, Emerging Asia's energy and materials sector is a bright spot of outperformance. While the sector is destroying value globally, Emerging Asia was the only region where the top firms managed to generate a positive economic profit. In fact, they generated roughly half of the value created across all of Asia even though they represent only about 30 percent of the region's firms in this sector.

- **In domestic services and capital goods, Asia has strong top performers but a long tail of underperformers.** In domestic services and capital goods, the gap between the top 10 percent of Asian firms and their peers in the rest of the world is smaller than in other sectors—but Asia also has many underperforming companies. Its bottom 10 percent of firms in capital goods lost \$79 billion, 2.2 times more than those in the rest of the world. One explanation for this phenomenon could be ownership. The structure of ownership seems to have an impact on companies' priorities, strategy, accountability, and performance. For example, state-owned enterprises (SOEs) tend to prioritize national aims such as boosting employment, building infrastructure for society, and offering affordable utilities for citizens. They may therefore take on low-return projects that publicly owned firms would not, since the latter are under pressure from shareholders to maximize earnings. About half of the world's largest SOEs are in China. India and countries in Southeast Asia also have large concentrations in sectors such as telecommunications, utilities, and resource extraction.¹⁴ Of the bottom-quintile Asian firms in domestic services and capital goods, about 43 percent are privately owned; within China specifically, almost two-thirds are SOEs. This significant concentration is a major factor behind the aggregate economic profit loss in the region. But, given their importance in providing basic services for citizens, it is important to continue to offer affordable choices. Furthermore, there is a debate as to whether profitability should be the top priority for these companies. Given that the nature of these sectors is providing basic services for citizens, these SOEs have to weigh additional considerations and the interests of various stakeholders as they make business decisions. Raising costs for end users to improve margins and profitability may not be the most favorable option. Especially in times of crisis, such as COVID-19, having strong domestic services and infrastructure to help a country respond quickly and weather the storm is necessary.

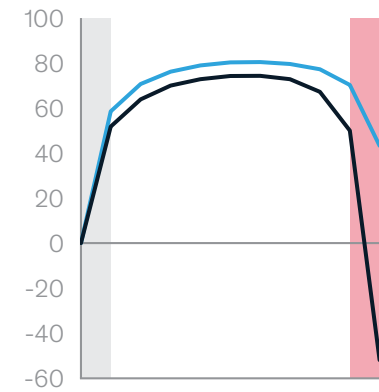
¹⁴ *Playing to win: The new global competition for corporate profits*, McKinsey Global Institute, September 2015.

A combination of capital allocation and individual firm capabilities has lowered economic profit in Asia.

Contribution of firms to total economic profit by percentile, 2015–17
\$ billion

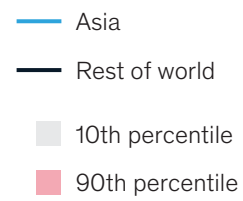
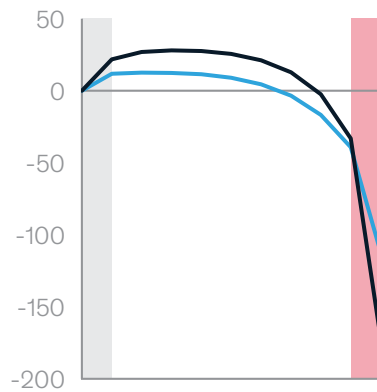
Where Asia outperforms

Financial services



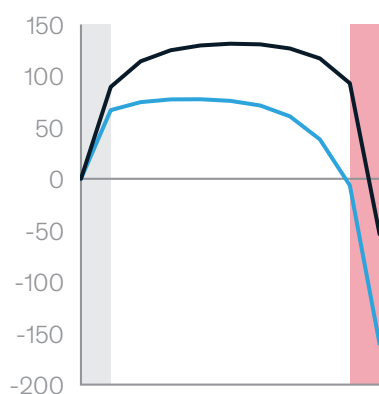
Similar to global average

Energy and materials

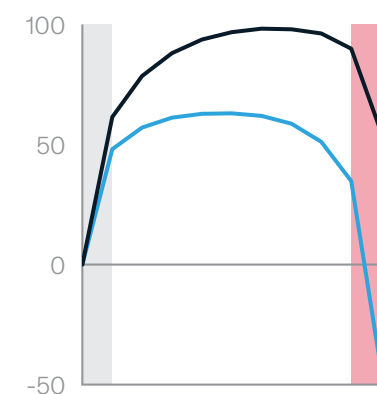


Good top performers but many bottom performers

Domestic services

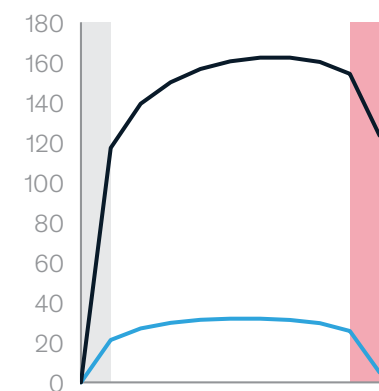


Capital goods

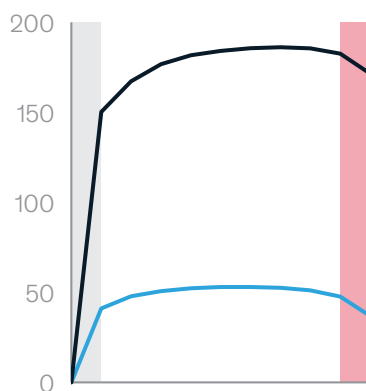


Where Asia underperforms

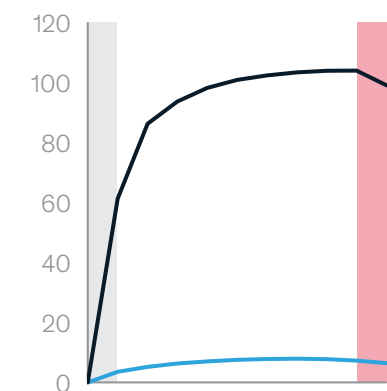
Consumer



Information technology



Pharmaceuticals and medical products



Note: Not to scale.

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Managing through volatility and short-term turbulence

Cyclical, capital allocation, and underperforming firms may have eroded economic profit in Asia. But one of the region's clear strengths is proving to be increasingly valuable: its ability to navigate through short-term volatility.

Over time, Asian nations and firms have weathered multiple crises and come out stronger when they passed. Previous MGI research on developing economies worldwide singled out 18 long-term and recent "outperformers," in part because of their resilience and consistent growth—and Asia dominates the list. Even countries that were hit hard by the Asian financial crisis of 1997-98, such as Indonesia, Malaysia, South Korea, and Thailand, returned to positive per capita GDP growth within a year or two. In contrast, middling and underperforming economies and regions, such as some Latin American countries and Russia, were laid low by events such as external debt shocks, currency fluctuations, or commodity slumps. Their recoveries were slower, marked by prolonged periods of fiscal instability and high inflation.¹⁵ Having absorbed the lessons of 1997-98, Asia was better prepared when the 2008 global financial crisis struck, and it weathered this period with minimal disruption, even as most advanced economies were hit hard.¹⁶

Asian companies are resilient in part because they have to be. They operate in highly dynamic markets that are growing rapidly—all against a backdrop of digital disruption and rapidly evolving consumer demands. As we will discuss in the next section, it is hard to stay at the top of many Asian industries. Indeed, contested leadership in these markets is a vital piece of the puzzle that explains the success of large firms in outperforming economies and, by extension, the success of the economies themselves. Operating under unrelenting pressure, in high-churn environments, Asian companies have learned to move fast and be agile. The region's horizontally integrated conglomerates, in particular, have the diversification needed to pivot quickly.

Today, Asia is being challenged to navigate through COVID-19 and its economic fallout. The COVID-19 outbreak began in Asia—but so have containment strategies and new protocols; economic activity has resumed. At the time of writing in May 2020, the response to the pandemic appears to have been successful in reducing transmission and cases of infection in China, and South Korea; however, peak impact had not yet been reached in Southeast Asia and India. McKinsey has run scenarios regarding containment and recovery; in most, China is expected to return to growth faster than the rest of the world.¹⁷

¹⁵ Long-term "outperformers" are defined as economies that had real annual per capita GDP growth of at least 3.5 percent for at least three-quarters of the past 50 years; they include mainland China, Hong Kong, Indonesia, Malaysia, Singapore, South Korea, and Thailand. Recent outperformers are defined as economies that grew at least 5.0 percent annually over 20 years; they include Azerbaijan, Belarus, Cambodia, Ethiopia, India, Kazakhstan, Laos, Myanmar, Turkmenistan, Uzbekistan, and Vietnam. See *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

¹⁶ See, for example, Phakawa Jeasakul, Cheng Hoon Lim, and Erik Lundback, *Why was Asia resilient? Lessons from the past and for the future*, International Monetary Fund, February 2014; Lino Briguglio and Stephen Piccinino, "Growth with resilience in East Asia and the 2008–2009 global recession," *Asian Development Review*, Volume 29, Number 2, pp. 183–206, 2012; and Donghyun Park, Arief Ramayandi, and Kwanho Shin, "Why did Asian countries fare better during the global financial crisis than during the Asian financial crisis?," in *Responding to Financial Crisis*, Washington, DC: Peterson Institute for International Economics, 2013.

¹⁷ Sven Smit, Martin Hirt, Kevin Buehler, Susan Lund, Ezra Greenberg, and Arvind Govindarajan, *Safeguarding our lives and our livelihoods: The imperative of our time*, March 2020, McKinsey.com.

A shock of this magnitude has the potential to change business, society, and the global economic order in multiple ways. In only around two months in early 2020, several well-established supply chains and business practices have been completely disrupted. Some may recover and return broadly to the way they operated before the pandemic; others may have been changed for good. Contactless commerce, for example, could become the norm for consumers permanently.

Supply chains may be reconfigured to remove some of the vulnerabilities that were laid bare by the COVID-19 pandemic—and not only the supply chains of the largest corporations that drive Asian economies and are the focus of this paper, but also the small and medium-size enterprises (SMEs) that are also vital to the health of the region's economies. Large corporations and SMEs, which are often their suppliers, have a symbiotic relationship that is crucial to maintaining supply chains and the health of the corporate ecosystem. The pandemic may well be a proving ground that tests whether businesses can become more resilient to shocks, more productive, and better able to deliver to customers.¹⁸ As Asia's corporate sector continues to mature, expand internationally, and push ahead with digital innovation, the ability of the region's companies to adapt to whatever a post-pandemic world brings could be enhanced.

Asia could unlock \$440 billion to \$620 billion of economic profit by improving firms' performance and investing in value-creating sectors

The corporate ecosystems operating in Asia today will be tested by the extent of the COVID-19 shock, which could raise competitive intensity but also offer new opportunities for outperformers to pull further ahead.

To ascertain how corporate Asia might generate greater economic profit, we explored two levers. The first is improving performance at the firm level. More Asian companies at the bottom of the power curve need to move up, and more need to move into the top quintile or solidify their position in it. In other words, more troubled companies need to turn around, while middle and even top performers need to unleash more of their unrealized potential. The second lever is investing in value-creating sectors. The source of capital for this can be net new, or it could come from rebalancing away from value-destroying sectors or firms to value generators. Combining these two areas, we see room for Asian companies to unlock \$440 billion to \$620 billion of economic profit (Exhibit 10).

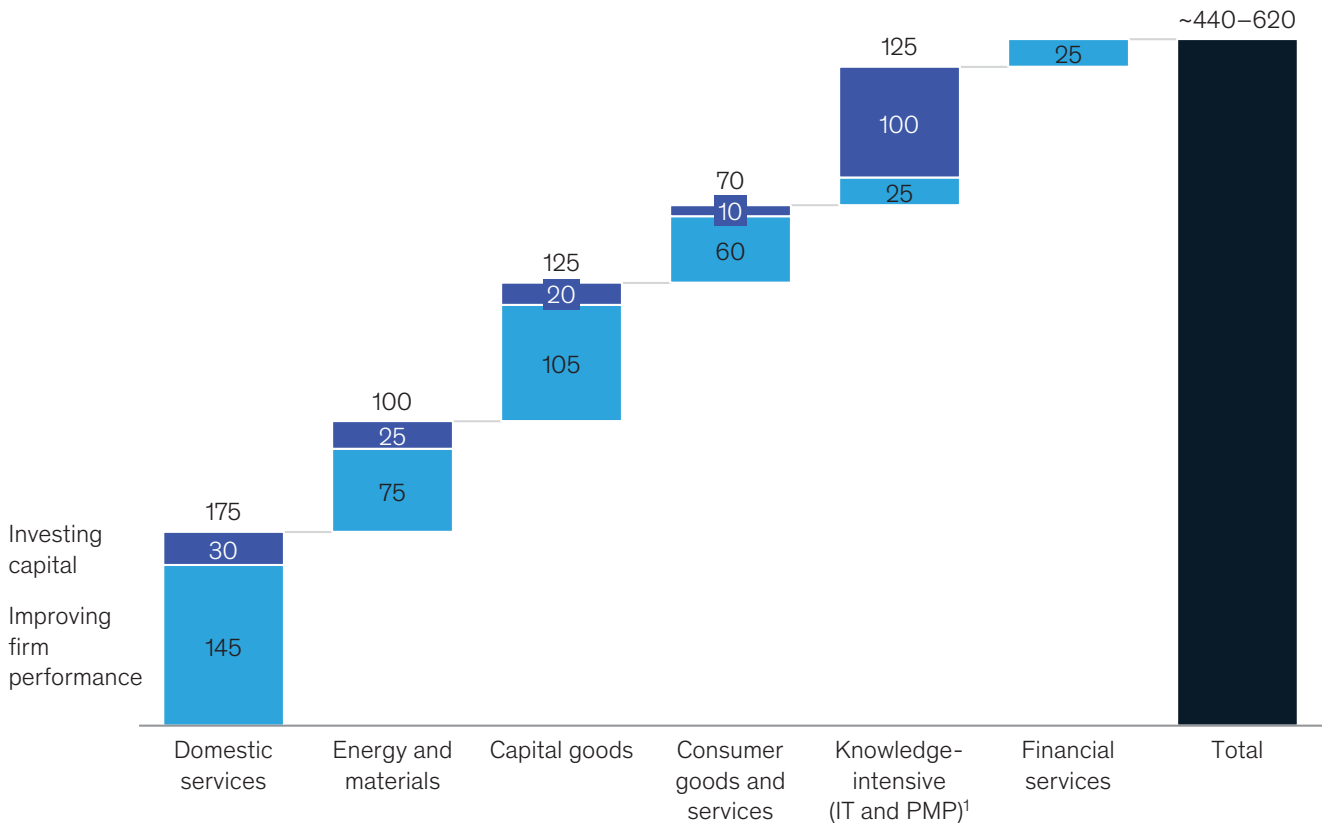
If Asia were to match North America's power curve distribution, our simulations show that it could boost economic profit by \$440 billion—a substantial prize. But to do so, about 200 Asian companies would have to move from the bottom to the middle quintiles to create \$180 billion in economic profit, and an additional 250 companies would need to move from the middle quintiles to the top, which would generate \$260 billion. In short, if about 200 large companies are turned around, and 250 more boost their productivity in a significant way, Asia would achieve the largest representation in the G5000 and would be a large generator of profit. Asia's average ROIC would have to increase from 7.0 percent to 9.1 percent to match the average of North American companies.

¹⁸ Kevin Sneader and Shubham Singhal, *Beyond coronavirus: The path to the next normal*, March 2020, McKinsey.com.

Asia can unlock significant economic profit creation by improving firm performance and investing in value-creating sectors.

Incremental economic profit creation

\$ billion



1. Information technology; pharmaceutical and medical products.

Note: This analysis is a mathematical simulation of a hypothetical scenario assuming an unconstrained environment generated to optimize maximum economic profit. This is a partial equilibrium simulation that does not account for the increase in competition and decrease in prices that may result from the entry of new firms into high-profit sectors. Figures may not sum to 100% because of rounding.

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Moving up the power curve and staying at the top is not easy (Exhibit 11). Leadership is highly contested in Asia. China's superstar firms tend to have a higher share of economic profit (see Box 3, "China and the superstar effect"). However, they have to fight to stay on top. Only 36 percent of the firms in the top quintile were able to protect their position over a period of ten years, compared with 53 percent in North America and 40 percent in Advanced Asia. Yet China does not have the same dynamism in the underperforming group; 38 percent of bottom-quintile firms were stuck at the bottom, and 21 percent dropped out of the G5000 altogether. This implies that only 41 percent were able to move up the power curve. This is partly because China's banking system continues to allocate resources to companies that do not generate high returns, supporting unproductive companies that may otherwise go out of business. The International Monetary Fund estimates that resolving these weak firms could generate significant gains of 0.7 to 1.2 percentage points in annual growth over the long term.¹⁹

The patterns in Advanced Asia tend to mirror those of the relatively mature and stable markets of North America and Europe. In Advanced Asia, only 32 percent were stuck in the bottom quintile and 40 percent were able to remain in the top quintile.

The movement within the curve of firms in Emerging Asia and India and Frontier Asia is most dynamic at the top and bottom. In these countries, 34 percent of firms from the bottom quintile dropped out of the G5000 altogether, implying that a third of the largest companies from these regions are net new each business cycle. It is difficult to remain a leader in these regions, with only 33 percent maintaining their position at the top.

How does an individual firm beat the odds and move up the power curve? McKinsey research has identified the ten strongest factors in firm performance (see the technical appendix, "Ten levers for improved corporate performance").²⁰ These factors fall into three categories. The first is endowment, which is essentially a firm's starting point (specifically, its size as measured by revenue, its debt level or leverage, and its innovation, measured by looking at past investment in R&D). Within this category, debt level is especially important given the context of today's business environment. Even though interest rates are exceptionally low at the moment, liquidity is going to be even more critical as companies learn to build resilience to fend against external shocks such as COVID-19. Therefore, firms with more equity could have an increased edge. The second category consists of strategies: programmatic mergers and acquisitions; dynamic allocation of resources; strong capital expenditure; productivity not only in labor but also in selling, general, and administrative expenses; and differentiation. The third category is the playing field—that is, whether a firm is operating in an industry that is expanding or declining, and in a geography that is thriving economically or struggling.

¹⁹ W. Raphael Lam et al., *Resolving China's zombies: Tackling debt and raising productivity*, International Monetary Fund, November 2017.

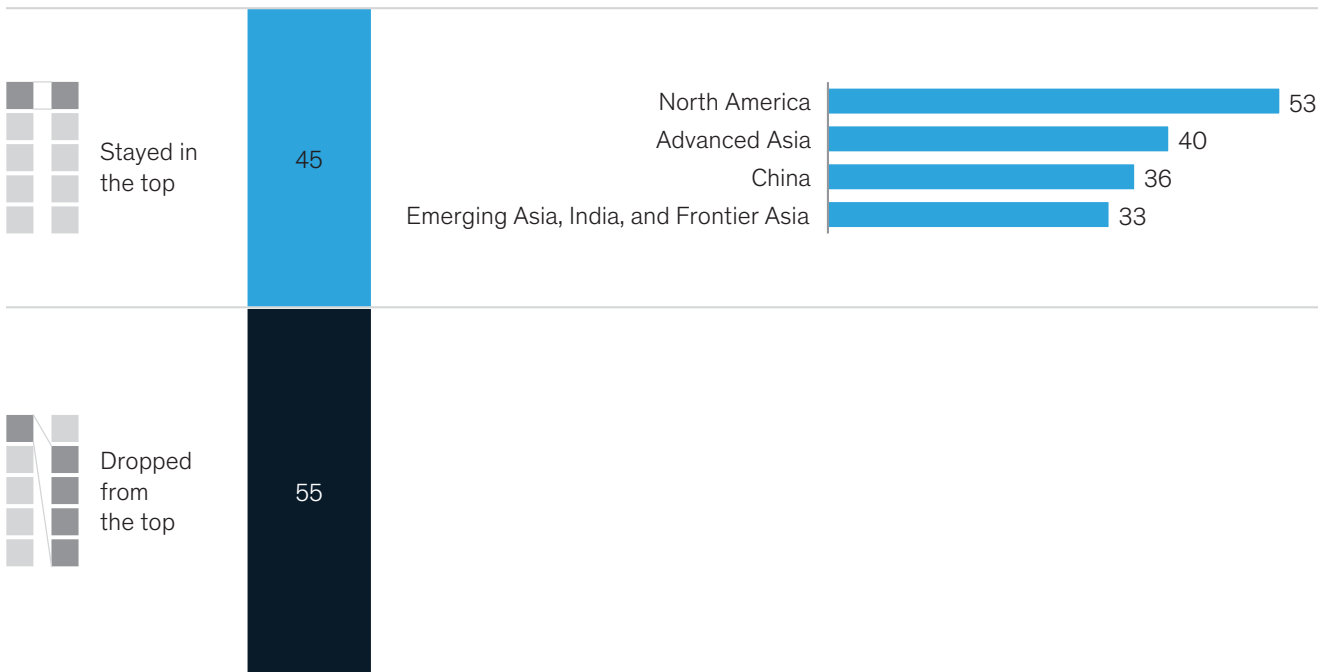
²⁰ Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick*, Hoboken, New Jersey: Wiley, 2018.

Asia has stronger contested leadership at the top of the curve and waning dynamism in the bottom quintile.

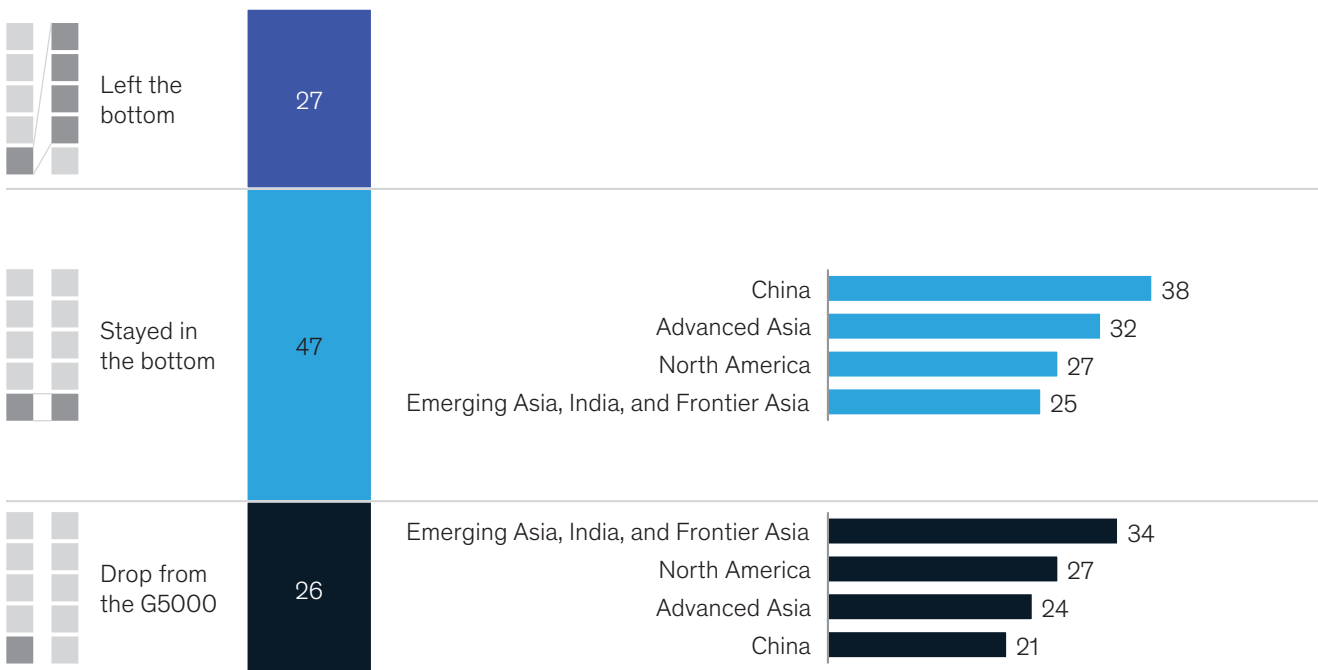
Movement of firms across the global power curve over the past decade, G5000 companies, 2015–17

%

Top quintile



Bottom quintile



Note: Figures may not sum to 100% because of rounding.

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Using the global performance as a benchmark, we found that the four Asias have varying track records and need to focus on different levers (Exhibit 12).

- **Advanced Asia has a robust position but needs bold growth moves.** In this group of Asian economies, companies tend to start from a position of strength, playing in the geographies and industries that generate higher economic profit. They have robust positions not only at home but also in lucrative markets such as the United States. This boosts their geo-scores.²¹ Advanced Asia is the only set of Asian economies in which companies have significant and consistent representation in value-creating sectors such as technology, pharmaceuticals and medical products, and consumer industries. They also have sizable revenue and leverage, and have strategically allocated resources. In other areas, firms in Advanced Asia generally perform in line with the global average, contributing to a somewhat stagnant average performance and a large middle quintile of companies. These firms have room for improvement in R&D investment (which is necessary to remain competitive in value-creating sectors) and labor productivity (which is vital in the face of slowing GDP growth in these economies).
- **China is growing fast, but needs to globalize and continue to invest in innovation.** Chinese firms, already large and dynamic, are still growing rapidly. Comparing 2005–07 with 2015–17, they more than doubled their representation in the G5000, from about 430 companies to more than 900. Chinese business leaders tend to be very bold in their allocation of resources, enabling their companies to pivot and enter new markets quickly. Chinese firms also tend to have relatively high labor-productivity improvement, outpacing other parts of Asia and exceeding the global average by 17 percentage points. This reflects China's continuous process improvement to stay competitive in manufacturing but also its ongoing economic transformation away from labor-intensive manufacturing and into higher value-added sectors. Making this transition successful will require more investment in R&D and innovation. On this measure, China's average still lags behind the global average by ten percentage points—but it is catching up rapidly, becoming the second-largest spender on R&D in the world after the United States.²² It is notable that China also has a low geo-score, which reflects the fact that its firms overall still earn the majority of profit in their home market. Given that China's overall economic profit is negative, its geo-score is naturally lower than that of other countries. As Chinese firms globalize and expand into profitable markets, their geo-score can improve. Finally, Chinese firms have relatively low scores on programmatic M&A, implying capability gaps managing M&A programs and in using M&A as a growth driver and post-merger integration for synergies.
- **Frontier Asia and India and Emerging Asia can build scale.** Companies in these parts of Asia tend to be highly dynamic, willing to invest, and able to make strides in operational productivity. These rapidly growing economies are changing quickly, and so are their businesses. Companies based in these markets tend to be bolder and more agile in allocating resources, capital expenditure, and cost programs. This partly reflects their ownership structure. A sizable share of large firms in these economies tend to be family-owned, which can sometimes expedite business decisions. Nevertheless, these firms are generally smaller in scale than those in Advanced Asia and China, and because they have relatively limited resources, their ability to invest in R&D and undertake strategic mergers and acquisitions is constrained. The priority for companies in these parts of Asia is to build scale.

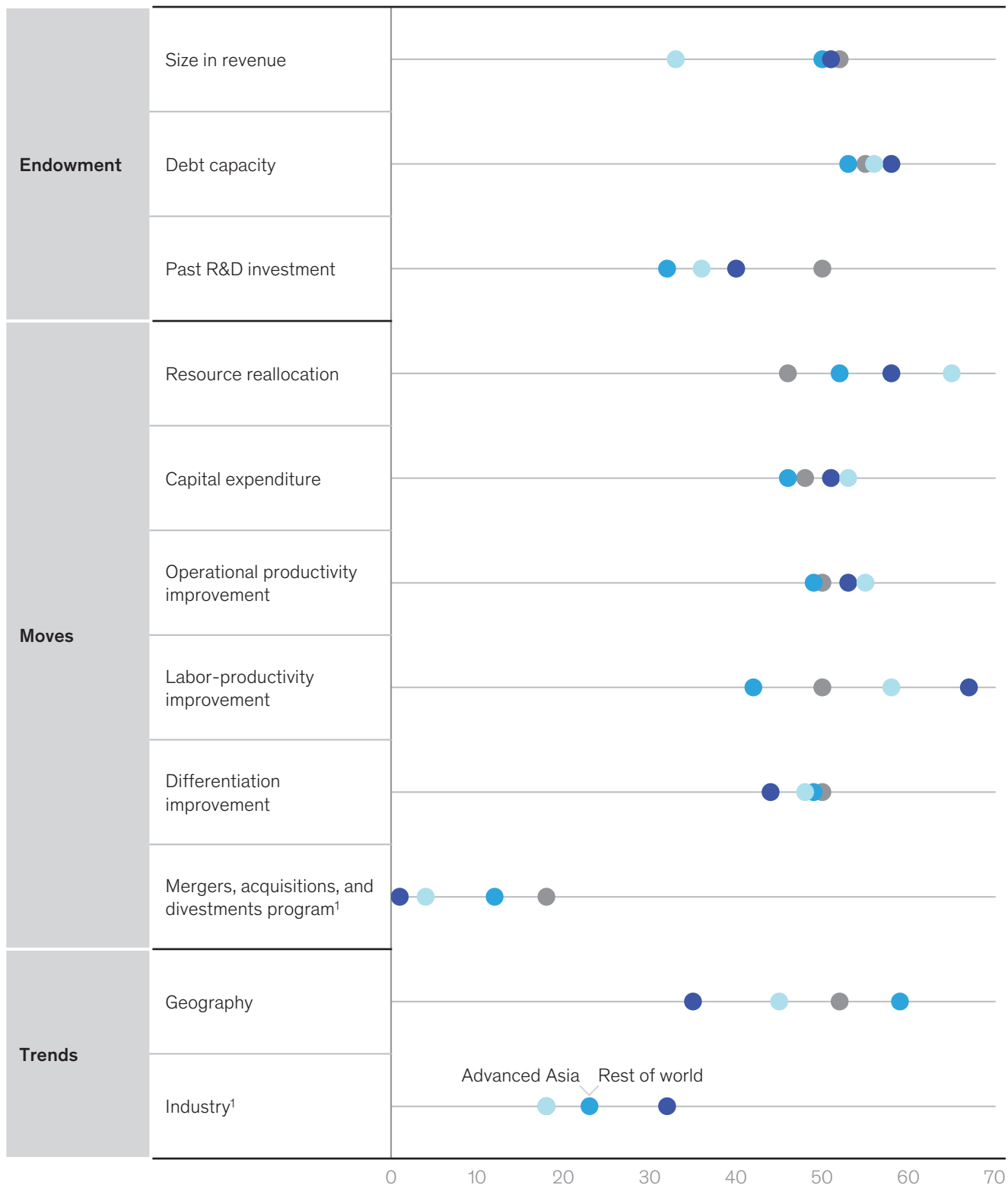
²¹ Geography, or "geo-score," is calculated by breaking down each company's source of revenue by country and applying a country score to assess whether a company's footprint is in value-creating or value-destroying countries. The country score is calculated based on the average change in economic profit for that country.

²² *How much does your country invest in R&D?*, UNESCO Institute for Statistics, <http://uis.unesco.org/apps/visualisations/research-and-development-spending/>.

Firms in different parts of Asia vary in their standing on ten levers that create economic profit, indicating different strengths and gaps.

Average percentile of G5000 companies, 2015–17

● Rest of world ● Advanced Asia ● China ● Emerging Asia, India, and Frontier Asia



1. Unit of measure is percentage (eg, the percentage of mergers, acquisitions, and divestment programs that are programmatic; the percentage share of companies in value-creating industries).

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

China and the superstar effect

MGI has studied superstar firms and how they differ from their peers.²³ In addition to capturing a greater share of income, superstars tend to be more highly digitized. They have more skilled labor and innovation capabilities, as well as more intangible assets. They are also more deeply connected to global flows of trade, finance, and services than their peers.

This is not just a Western phenomenon. In Asia (excluding China), the top 10 percent of firms generate 71 percent of all positive economic profit, while the bottom 10 percent account for 70 percent of the economic losses (Exhibit 13). The trend holds true across all four groups of Asian economies—but it is especially pronounced in China.

The top 10 percent of Chinese firms generate 90 percent of the country's total economic profit, higher than the global average. It is also striking that China's overall underperformance reflects its long tail of weaker companies. From the 40th percentile of firm performance downward, Chinese companies generate economic losses. These underperforming firms push the national figure into negative territory.

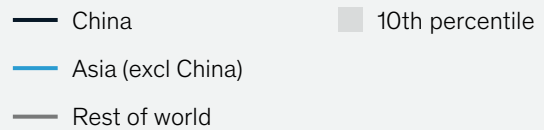
The superstar effect has bearing on the issue of improving individual firm performance. A stronger superstar effect implies that more of the value creation is concentrated in fewer companies, and a longer tail of low performing firms means that the average firm is more likely to be losing value. The combination of these two strong patterns illustrates just how difficult it is for businesses to compete and win in the Chinese market.

Exhibit 13

The superstar phenomenon exists in Asia and is particularly pronounced in China.

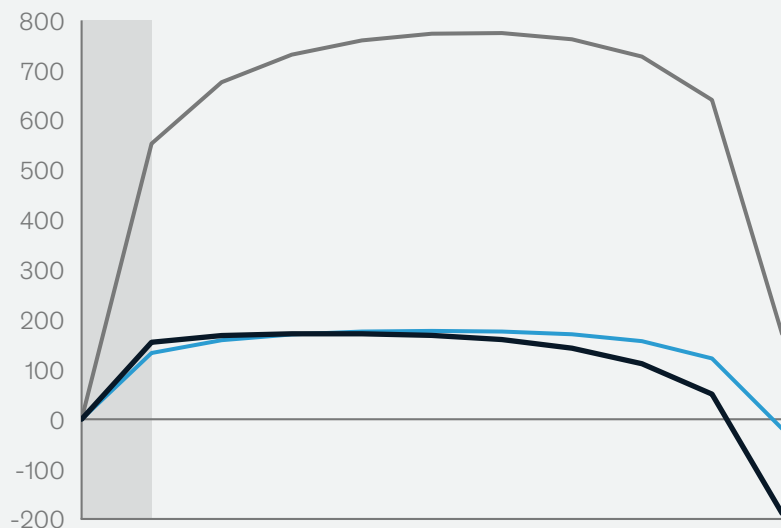
Contribution of firms to total economic profit by percentile, 2015–17

Asia vs rest of world



Economic profit, 2015–17

\$ billion



Share of economic profit generated %

	By top decile
China	90
Asia (excl China)	71
Rest of world	71

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

²³ Superstars: The dynamics of firms, sectors, and cities leading the global economy, McKinsey Global Institute, October 2018.

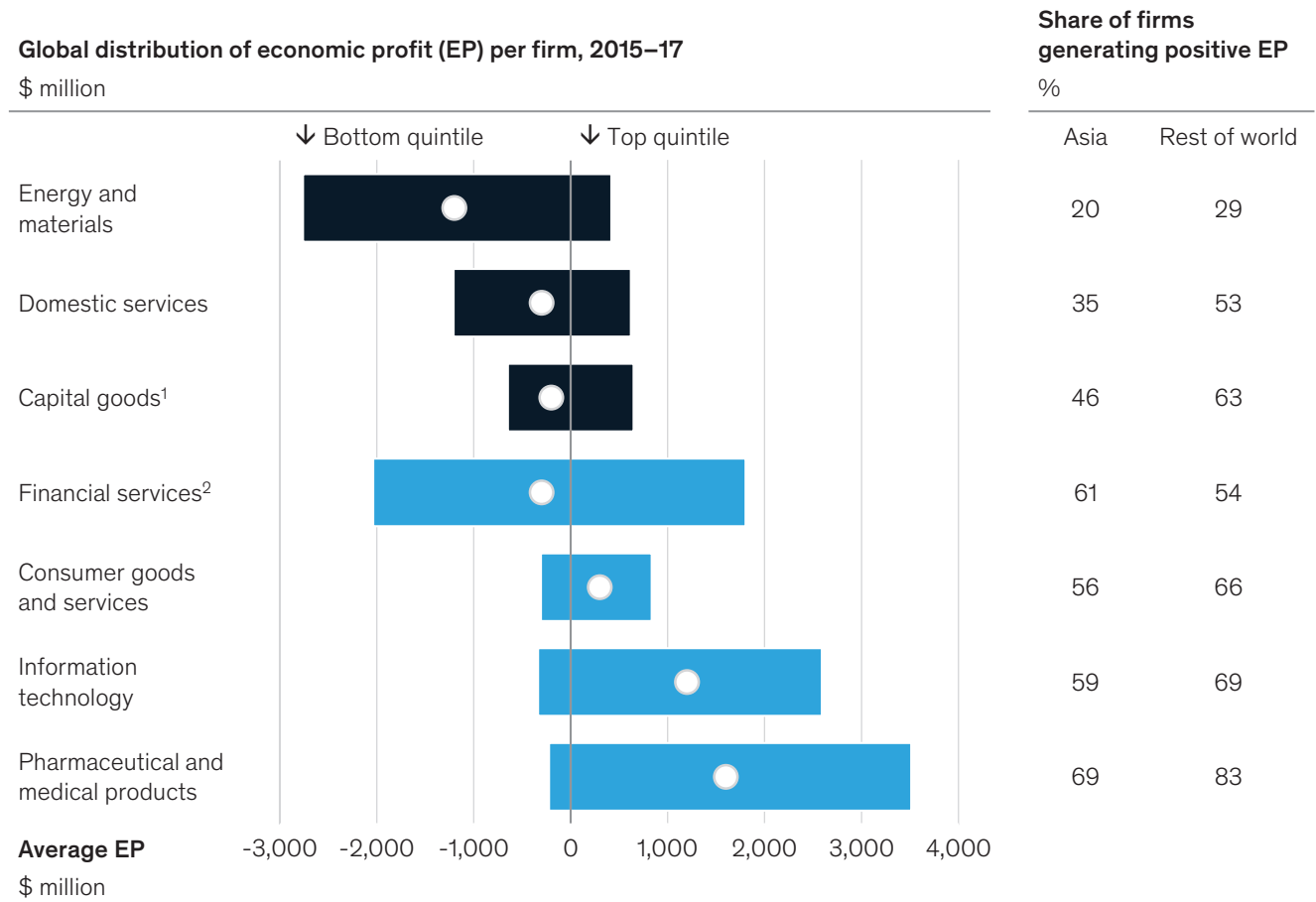
Investing in the most productive sectors

Across Asia, capital continues to flow into value-destroying sectors. We created a simulation in which the prevailing ratio is changed, with more investment in sectors such as pharmaceuticals and medical products, technology, and consumer industries. Globally, 63 to 83 percent of firms in these high-performing sectors generate positive economic profit. In Asia, the range is lower, from 56 to 69 percent. In pharmaceutical and medical products, companies average \$786 million, while tech firms average \$538 million, and consumer sectors average \$128 million, although the wide range in performance in any given sector also demonstrates the opportunity for any given company to buck the trend. In contrast, energy and materials companies are generating a \$600 million economic loss on average worldwide, and domestic services, a \$141 million economic loss. In those underperforming sectors, only 29 to 54 percent of global firms are posting positive economic profits. In Asia, 20 to 46 percent of firms are capable of generating positive economic value in value-destroying sectors (Exhibit 14). If we assume that Asia matches the capital-allocation mix of North America, this would imply \$3 trillion to \$4 trillion of capital to be invested in value-creating sectors. This can be net new capital or capital that is shifted from value-destroying to value-creating sectors. This could yield additional economic profit of about \$180 billion, mostly in IT and pharmaceuticals and medical products.

This simulation is a hypothetical view in an unconstrained environment. In reality, there will be constraints—and both levers have to be complementary. Simply reallocating capital toward sectors that generate higher economic profit is not sufficient if the firms within them are inefficient. For example, even though the consumer sector generates substantial global economic profit globally, reallocating capital to that sector alone would generate only \$10 billion in incremental economic profit, since Asian firms in these industries generate lower economic profit than their Western peers. There are also noneconomic reasons to invest in lower-return sectors and firms, especially when they provide vital infrastructure and utilities. Institutional capabilities such as competition policy and modern financial markets will need to be in place to enable better resource allocation. The entire corporate ecosystem needs to be healthy and sustainable if corporate Asia is to be able to weather current and future shocks effectively.

Where you play matters: Companies in value-creating sectors are twice as likely to generate economic profit as those in value-destroying sectors.

■ Value-destroying sector ■ Value-creating sector ○ World average



1. Capital goods is considered a value-destroying sector in Asia but a value-creating sector for the rest of the world.

2. Financial services is considered a value-creating sector in Asia but a value-losing sector for the rest of the world.

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

2. Directions for corporate development

Corporate Asia may underperform in measures of economic profit on aggregate. But that should not obscure the many bright spots in various sectors across the region with resilient, outperforming firms facing an opportunity to define the “next normal” in a post-pandemic world. Looking beneath the averages, some Asian companies and sectors are performing exceptionally well (Exhibit 15).

Consider the following:

- Japan’s capital-goods sector performs on par with its counterparts in North America and Europe.
- Financial services are highly profitable in China and Australia.
- Technology-driven sectors, especially IT, create a great deal of value in China, Japan, and South Korea, and are improving as a source of value creation in India. China has a host of dynamic new internet companies, and India gains most of its economic profit from its IT services firms. Japan and South Korea lead in high-tech manufacturing.
- Southeast Asia’s energy and materials sector generates substantial value despite the sector’s global challenges. A few vertically integrated energy companies are standouts.

To fully unlock their potential and lead the recovery from the pandemic, Asian companies need to address some significant sector-performance gaps. Asia has the largest markets in the world. Yet its pharmaceutical companies have not been able to compete globally. Its consumer-goods players lack scale and major brands, and they account for a small share of global economic profit made in this sector. Asia has a very large and rising share of global demand for energy and materials, but profitability in this sector may be on hold until the next energy cycle turns and demand catches up to overcapacity in both markets. Real estate players in the region can benefit from continued urbanization, using new competencies and technologies to boost productivity. Asia also has the world’s largest regional banking market and has been relatively successful at building scale and leading financial technology innovations.

The strength of Asia’s corporate ecosystem offers hope that the region will be able to weather the pandemic shock and take economies forward in what may well be a volatile post-pandemic world. There are plenty of opportunities for individual Asian corporations to build the capabilities to sustain long-term growth. In the wake of the economic and social shock of COVID-19, supply chains will be disrupted. Consumer behavior that was forced to change because of physical distancing—notably adopting remote working and even heavier use of digital technologies—may represent a lasting step change. Many companies may, in response, need to rethink their business models and strategies.

In each sector we have identified the directions that will help grow productivity and economic profit in the context of a more volatile post-COVID-19 world. Necessarily there is uncertainty about the timing and scale of initiatives given public health requirements, and nothing in this paper should be taken as a recommendation for a specific action agenda. However, we believe that recovery will require continued initiative-taking across Asia’s corporate sector and that these directions are fundamental to adapting to the volatility.

Asia has pockets of corporate excellence.

G5000 economic profit creation by sector and geography, 2015–17 average¹

-170  220

\$ billion

	Energy and materials	Domestic services	Capital goods	Consumer goods and services	Financial services	Knowledge-intensive	Total
North America	-82	-6	32	78	3	220	245
Europe	-56	-33	31	45	-59	49	-23
Rest of world	-34	-14	-8	-0.2	4	1	-51
Asia	-112	-161	-44	5	43	64	-206
China	-88	-125	-64	2	62	24	-189
Japan	-6	-5	23	3	-17	12	11
South Korea	-4	-13	-1	-0.3	-1	19	-1
Australia and New Zealand	-5	3	0.1	1	10	1	9
Singapore		-7	-1	-1	1	2	-6
India	-14	-12	-0.4	-0.1	-15	6	-36
Southeast Asia	5	-1	-2	1	3	0.4	6
Total	-284	-214	11	128	-9	334	-34

1. Subsectors in energy and materials include oil, gas, consumable fuels, energy equipment and services, metals, and mining. Domestic services include infrastructure, real estate, utilities, transportation, telecommunications, and business services. Capital goods include machinery and equipment, automotive and parts, fabricated components, and industrial chemicals. Financial services include banks, insurance, and asset management. Knowledge-intensive include pharmaceuticals, medical products, computers and electronics, internet, and media.

Note: The purpose of this exhibit is to showcase economic profit. It is not meant to be used as a means to pit sectors against each other for comparison. The exhibit shows a three year snapshot of economic profit performance and may not capture the cyclical dynamics of several of the industries. Given the nature of the financial services sector, its economic profit is calculated differently, using equity to calculate capital charge. The financial data used here reflect numbers that are publicly available based on accounting practices accepted by each geography. Figures may not sum to 100% because of rounding.

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Pharmaceuticals and healthcare: Advanced Asia and China can drive drug innovation, and Emerging Asia, India and Frontier Asia and China can lead on digital health

Asia accounted for 19 percent of global spending in 2019, a share that could rise to 27 percent by 2040.²⁴ Nevertheless, Asian pharmaceutical firms have yet to increase their share of global value in this scientifically sophisticated sector. Worldwide, the pharmaceutical industry generated net positive economic profit in all regions analyzed, combining for a total of \$105 billion from 2015 to 2017. However, Asia accounted for only 6 percent of this, suggesting that considerable opportunities for improved performance and value creation lie ahead. In fact, the pharmaceutical sector has one of the highest financial year-to-date returns at the time of writing amid the COVID-19 pandemic. Although the outbreak has put short-term pressure on budgets and reduced treatment of non-COVID-19 patients, it has raised expectations of rising investment and supportive policies as economies recover.

First, on the demand side, healthcare systems across the world and within Asia are at different stages of adopting more innovative products. Asia has historically had a lower use of innovative products. Local companies have had to catch up in terms of their development capabilities. Imported newer drugs must be approved by local regulators—and even if they are, they are typically not covered by insurance. As a result, treatment standards in many parts of Asia lag behind those in the West, with providers relying on previous generations of drugs. For example, a high share of diabetes patients in the United States are treated with innovative oral drugs (such as DPP-4, GLP-1, or SGLT-2), but older protocols, such as metformin and acarbose, are more commonly used in China.

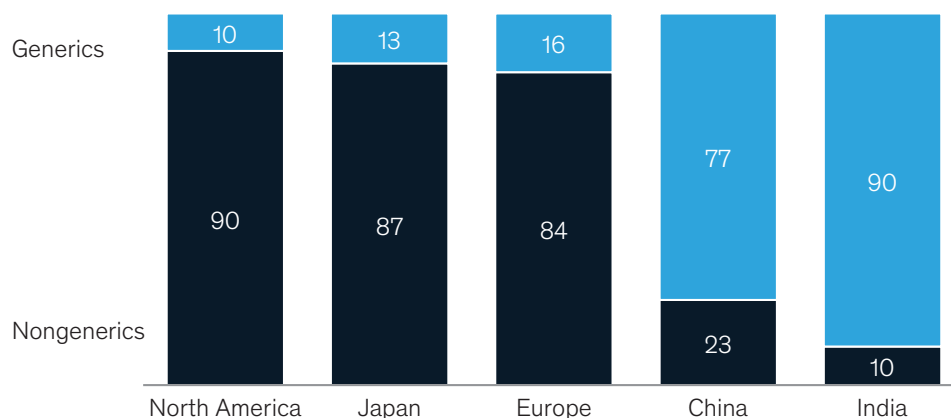
On the price side, drug prices overall are much lower in Asia compared with the global average, largely driven by the use of local generics rather than branded drugs. Given the lower prices, reimbursements have also historically been lower, which in turn has discouraged companies to pursue innovation. This has led to a high use of generics. Less than one-quarter of drugs sold by Chinese and Indian pharmaceutical companies are nongeneric, compared with 90 percent in North America (Exhibit 16).

Exhibit 16

Asia's pharmaceutical sector tends to have a higher share of generic sales.

Drug sales distribution, 2019

Share of sales, %



1. Includes biocomparables, early-entry generics, and other nongenerics.

Note: Figures may not sum to 100% because of rounding.

Source: IQVIA; Rx database; McKinsey Global Institute analysis

²⁴ This discussion focuses entirely on the pharmaceutical industry; it does not include healthcare (providers and payers) or the medical products sector.

However, the answer to improving economic profit is not simply raising drug prices, which in turn increases the cost of care to patients. Rather, there is a movement toward breaking the traditional barriers to innovation and old norms of the market with regulations and incentives. The rise of competitive Asian pharmaceutical companies could change the face of the global industry and its R&D trajectory. To make progress, Asian companies engaged in pharmaceuticals need to leverage the strengths of their home region, which vary across the four Asias.

China and Advanced Asia have the makings of globally competitive pharmaceutical companies

China is the world's second-largest pharmaceutical market, trailing only the United States. It is projected to continue posting 5 percent compound annual growth through 2030. No global pharmaceutical CEO can overlook the Chinese market, and those based in other regions need to track the country's rapidly developing policy landscape.

In recent years, government reform of this sector has stepped up. The China Food and Drug Administration (CFDA), for example, implemented regulations that halved the time between a drug's release in China and its global launch from 2016 to 2019.²⁵ Furthermore, China recently made an important shift from updating its National Reimbursement Drug List once every five years to annually.²⁶ In 2019, 150 drugs were evaluated, of which 97 were successfully negotiated. However, foreign drugs still accounted for the majority of the drugs approved; 74 of the 97 that passed were foreign drugs, largely from multinational corporations. Nevertheless, the government's efforts are still enabling Chinese pharmaceutical companies to compete on the world stage. China's drug pipeline may have gaps compared with leading countries, but favorable regulation and improved access to the market have given companies more financial incentives to develop or launch innovative products. As a result, venture capital and private-equity capital have been flowing into the market, accelerating the sector's growth. China's venture-capital and private-equity investment in biotech grew at a 97 percent compound growth rate between 2015 and 2018. Looking at the number of publications under the pharmaceutical Patent Cooperation Treaty (PCT), we see that China has overtaken Japan and is now ranked second in the world. Its share of such publications jumped from only 1 percent in 2003–07 to 15 percent in 2019 (Exhibit 17).

Over the past five years, Chinese pharmaceutical champions have emerged in three areas: biotech, innovative pharmaceuticals, and auxiliary players. In biotech, BeiGene and Innovent Biologics develop molecularly targeted, immuno-oncology drugs to treat cancer and monoclonal antibodies, respectively. Both have been largely successful. BeiGene was founded in 2010 and went public six years later, and during its second listing in 2008 the company raised more than \$900 million in funding.²⁷ On the other hand, Hansoh Pharmaceutical, a more classic pharmaceutical company, is pivoting toward innovation and has also recently held successful initial public offerings. To combat COVID-19, Chinese pharmaceutical companies such as I-Mab Biopharma have joined the global race to conduct clinical trials to find a potential cure.²⁸ Other, less specialized Chinese firms operate across the full value chain as more auxiliary players. One prominent company is WuXi AppTec, which provides a wide range of R&D and various manufacturing services. As a one-stop platform for new drug development and manufacturing, WuXi AppTec became China's largest contract research organization for drugs in 2018. Riding the opportunity in China, WuXi AppTec was able to globalize; it now plays a significant role in the development of many drugs in international markets.²⁹ Such platform-based service models could enable more small to medium-size Chinese pharmaceutical companies to build scale.

²⁵ *Running on the China bridge to innovation 2019*, McKinsey & Company, white paper commissioned for the 6th BioCentury-BayHelix China Healthcare Summit, November 18–20, 2019, Shanghai.

²⁶ Wenting Zhang and Taylor Watson, *China: There's a new NRDL in town*, CB Partners, August 13, 2019.

²⁷ Joanne Chiu, "Chinese cancer-drugmaker raises \$900 million in Hong Kong listing," *Wall Street Journal*, August 2, 2018.

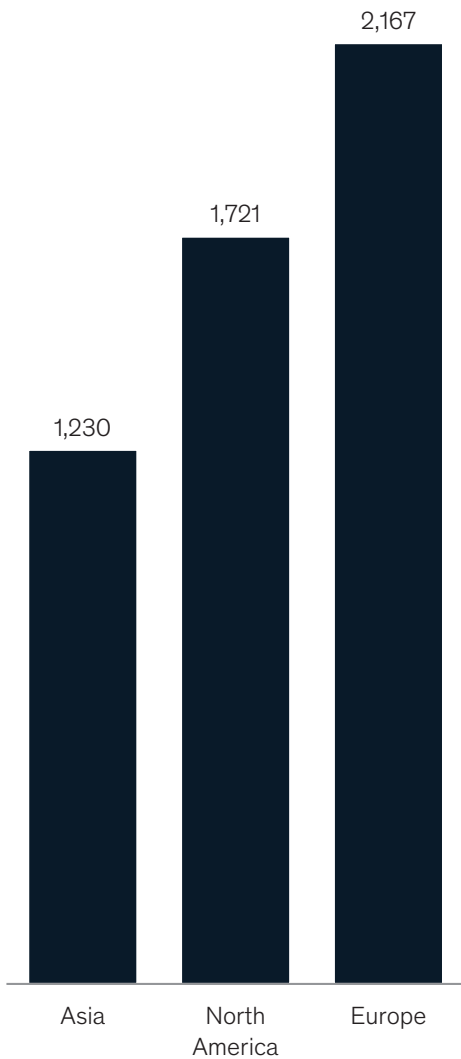
²⁸ Eric Ng, "Chinese biotech, flushed with funds and armed with ideas, join the race to find a coronavirus cure as pandemic ravages the world," *South China Morning Post*, March 28, 2020.

²⁹ WuXi AppTec research enabled Agios, a US biotech company, to develop ivosidenib, a first-in-class drug approved by the US Food and Drug Administration (FDA) for the treatment of leukemia.

Asian companies lag behind on researching and developing drugs, but are catching up.

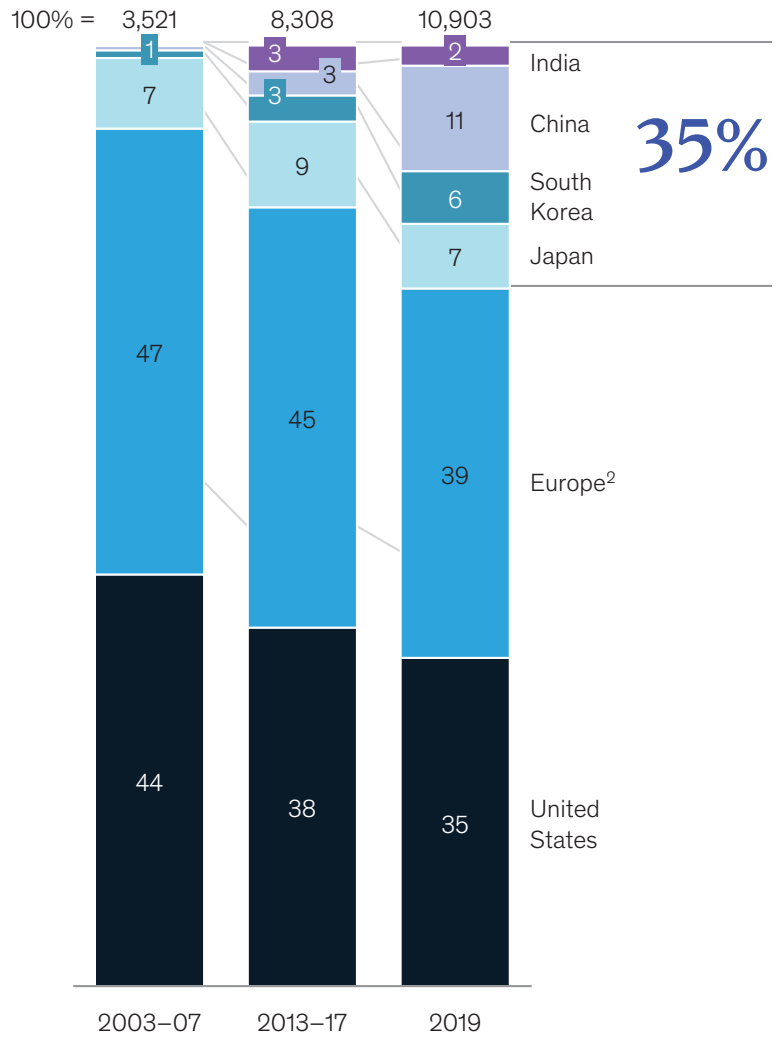
Drug pipeline of top five pharmaceutical companies in each region, 2019¹

Number of small-molecule drugs



Number of pharmaceutical PCT publications in top 10 countries

%; million



1. Includes 5 companies for primary drugs and 5 companies for specialty drugs for each region.

2. Patent Cooperation Treaty; includes France, Germany, Italy, Switzerland, and the United Kingdom.

Note: Figures may not sum to 100% because of rounding.

Source: IQVIA; WIPO statistics database; McKinsey Global Institute analysis

Advanced Asia has developed significant research capabilities that are now on a par with those of Western economies. Japan's drug pipeline is particularly noteworthy, and its top pharmaceutical companies are globalizing. One major player is Takeda, which focuses on oncology, gastroenterology, plasma-derived products, rare diseases, and central nervous system diseases. It began to expand outside Japan into the rest of Asia in the 1960s, moved into Europe in the late 1970s, and then to the United States in the mid-1980s. This expansion was undertaken largely by initially forming joint ventures with local partners through targeted as well as large-scale M&A. Today, Takeda is a fully globalized company operating in 80 countries, with about half of its \$30 billion revenue earned in the United States.

Japan also has a generation of midsize pharmaceutical companies that are increasing in prominence. Examples include Ono Pharmaceutical and Shionogi. Building on existing global collaborations, they have strengthened and renewed their R&D pipeline. Despite their relatively limited international presence and scope of services, these companies have strong R&D in the specialty areas in which they focus. As Advanced Asian and Chinese pharmaceutical companies develop their core innovation capabilities, they will also have to consider how to globalize.

China, Emerging Asia, and India have the potential to reinvent care delivery and lead on digital health solutions

Asia is well positioned for opportunities beyond developing drugs. The combination of large and digitally savvy consumer bases with major digital giants is leading to the formation of a new ecosystem. Digital health is an immense market that can include telehealth, chronic disease management, fitness and wellness, precision medicines, cloud-connected devices, advanced diagnostics, and clinical decision support. These are wide-open areas in which Asia is in a strong position to lead. The adoption of digital health is expected to be accelerated significantly by the COVID-19 outbreak.

In fact, given the gap in healthcare, Asia may well have to leapfrog in order to provide care for its citizens. In India, online medical consultation platforms have experienced a large increase in users during the nationwide lockdown for COVID-19 outbreak. Medical consultancy startup Practo shared that volume of users on its platform increased on average over 100 percent week-on-week between since beginning of March by mid-April. In Indonesia, telehealth firm Halodoc partners with pharmacies, laboratories, and ride-hailing service Gojek to provide medicine delivery.³⁰ Across Emerging Asia as well as India and Frontier Asia, most countries have less than one doctor per 1,000 citizens, compared with more than 2.6 in the United States, 2.4 in Japan, and 1.8 in China. At the same time, the share of out-of-pocket healthcare expenses in these countries can be over 60 percent, compared with 22 percent in high-income countries, indicating the need for health finance solutions. As the population grows in these regions, innovative healthcare solutions offering both scale and efficiency will be critical. Ping An in China, Apollo in India, and Grab in Southeast Asia have already digitized significant parts of their value chains and are going after digital health opportunities.

³⁰ Online medical consultation platforms see huge rise in traffic during lockdown," *Economic Times*, April 13, 2020; and "Indonesia leans on health tech start-ups to cope with coronavirus," *Straits Times*, April 10, 2020.

Leading in the region, India's pharmaceutical companies have established strength in producing generic drugs to serve not only domestic but also international markets. They are now pushing hard to climb up the value chain to produce innovative drugs and healthcare solutions. In fact, India today is home to 32 percent of Asia's recognized health-tech startups.³¹ Emerging Asia, too, is rapidly developing new digital health solutions, reflecting the spread of broadband coverage in these countries.³²

In India, players started with telehealth. Apollo Hospitals Group, India's largest private hospital group, owns 3,400 brick-and-mortar pharmacies across the country, the largest branded network in India. Now Apollo has launched an end-to-end 24/7 service combining its own e-pharma platform (that includes distribution), the Ask Apollo platform, and a first-of-its-kind online diagnostics platform. As a result, Apollo has expanded its reach to consumers and remote patients via mobile, video call, and email.

MedGrocer, a technology platform backed by Ayala Group of the Philippines, is one of Emerging Asia's first telehealth advisers. It provides online pharmacy and healthcare programs, and has gained more than 200,000 users since it was launched in 2016.³³ In the case of chronic disease management, Hypoband, a health-tech company from Malaysia, offers a product that alerts caregivers when the life of a diabetic patient is in danger.

An increase in the use of digital solutions has been one of the defining characteristics of the COVID-19 outbreak. Telehealth was adopted in order to reduce face-to-face interaction, in many cases with government support. For instance, the Australian government expanded its Medicare-subsidized telehealth services in March 2020 so that citizens could obtain medical consultations via telephone or videoconferencing.³⁴ Online pharmacies also played a key role. In China, the volume of online prescriptions rose tenfold in early 2020, according to the government. Increased adoption of digital technologies appears likely to persist even if the pandemic is brought under control, and pharmaceutical companies should consider how to continue building omnichannel customer engagement and distribution models.

³¹ Christina Lago, *What's the state of healthtech in Southeast Asia?*, CIO, April 26, 2019.

³² Alvin Marcelo et al., *Transforming health systems through good digital health governance*, ADB Sustainable Development Working Paper Series, Number 51, February 2018.

³³ MedGrocer, Tech in Asia, <https://www.techinasia.com/companies/medgrocer>.

³⁴ Kath Sullivan, Matthew Doran, and Stephanie Dalzell, "\$1.1 billion Medicare, mental health, domestic violence package on its way in response to coronavirus crisis," *ABC News*, March 29, 2020.

Consumer goods and services: Asian companies can build scale and brands while leveraging digital platforms

Asia is becoming the world's center for consumption as rising incomes across the region boost spending power. In many product categories, it is the world's largest consumer-goods market, accounting for 35 percent of global sales in tobacco and beverages, 34 percent in household and personal-care goods, 43 percent in food, and 47 percent in apparel, for example. The consumer sector experienced a moderate decline in shareholder returns during the COVID-19 outbreak, with discretionary goods such as luxuries suffering more than the essentials such as groceries.

Despite the massive scale of the region's consumer markets, Asian consumer-goods companies do not appear to be turning opportunity into economic profit to the extent that one might expect. Today, Asia accounts for only 10 percent of the economic profit generated by G5000 consumer-goods companies worldwide (Exhibit 18).

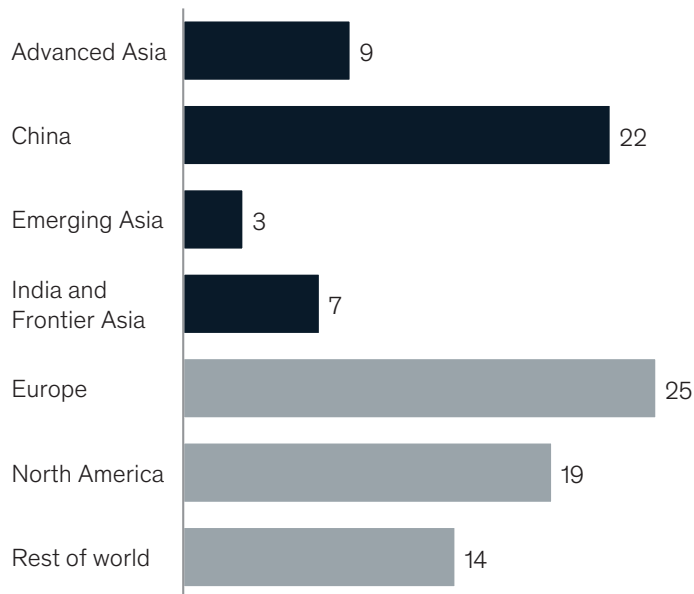
This trend is especially true for Asia's consumer powerhouse, China, which accounted for 22 percent of global spending on consumer goods in 2019. In apparel, for example, China is 27 percent of the global market, the highest share in the world, compared with 24 percent in Europe and 23 percent in North America. Yet sales are only one side of the story. Despite operating in an enormous home market, Chinese consumer-goods companies account for only 4 percent of the economic profit generated by all G5000 companies in this sector.

Exhibit 18

Despite its large consumer-goods market, Asia generates only a low share of global economic profit in the sector.

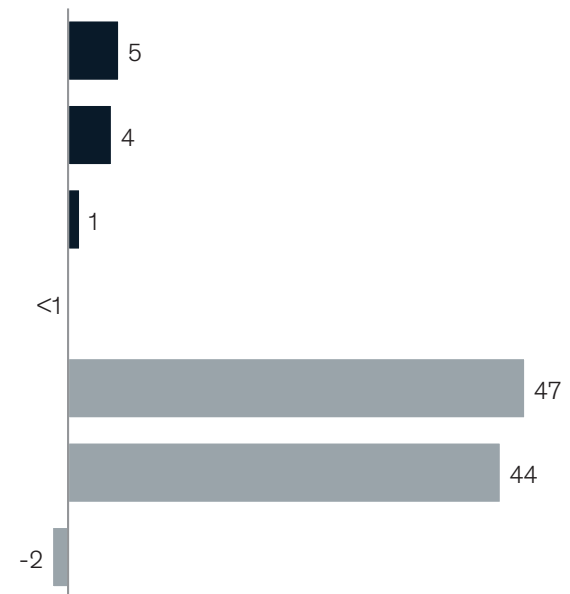
Share of market size, 2019

%



Share of economic profit, 2015–17

%



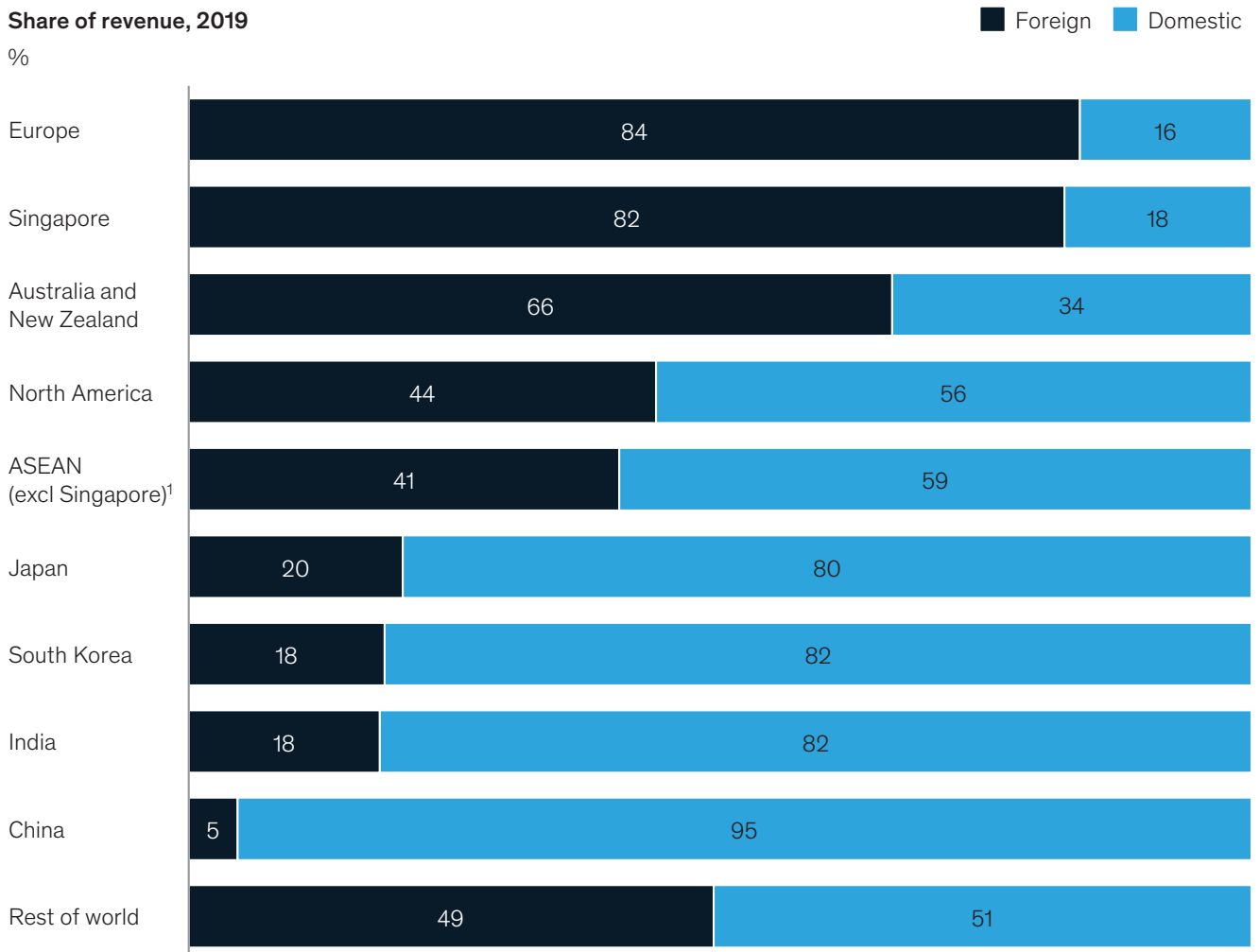
Note: Figures may not sum to 100% because of rounding.

Source: Euromonitor; McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Most of this sector's economic profit is generated by North American and European companies. Their Asian peers are still largely meeting domestic rather than international demand. While European companies generate as much as 84 percent of their revenue in foreign markets, Chinese companies get 95 percent from their home markets. Even those Asian companies that have reached sufficient scale to enter the G5000 tend to lack international name and brand recognition, and, for the most part, their margins have not risen (Exhibit 19).

Exhibit 19

Asian consumer-goods companies still generate most of their revenue in their home markets.



1. Association of Southeast Asian Nations.

Note: Figures may not sum to 100% because of rounding.

Source: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Asia has four primary types of consumer-goods companies

The varied development of the consumer goods and services sector across the four groups of Asian countries has given rise to corporations with different degrees of business scope and capabilities. We identified four types of regional firms: Asian multinationals, local champions, ecosystem players, and next-generation disruptors. This categorization is not static, however, and companies may shift from one type to another or appear and disappear.

- **Asian multinationals.** Asian multinational firms tend to be those with the scale and international presence to be represented in the G5000. In consumer goods and services, most of them are based in Advanced Asia, with a smattering of companies from China. Between 2015 and 2017, Advanced Asia had 96 consumer-goods companies in the G5000, similar to North America's 96 and Europe's 104. Many Asian companies operating in this sector have developed prestigious brands that have enabled them to expand internationally—although there is still a great deal of room for them to capture more of their revenue in foreign markets. Today, Japanese consumer-goods companies in the G5000 make only around 20 percent of total revenue in international markets.

Amore Pacific, for example, is a multinational beauty and cosmetics conglomerate from South Korea that owns more than 30 brands, including its flagship Amore Pacific line. Japan's fashion company Uniqlo had revenue of 2.3 trillion yen in 2019, an increase of 7.5 percent year-on-year.³⁵ The company duly adjusted its sizing system for the international market and brought in world-famous fashion designers and creative directors to revamp its product lines. Today, the company has more than 2,200 stores, nearly two-thirds of which are outside Japan. Between 2015 and 2019, its domestic profit declined slightly from 117 billion yen to 102 billion yen, while its international profit tripled from 43 billion yen to 140 billion yen.³⁶

- **Local champions.** These are successful consumer companies that have established themselves as market leaders in their home countries. This type of champion is most prevalent in China, India and Frontier Asia, and Emerging Asia. Chinese consumer-goods companies in this category in particular are on a distinct upward trajectory because of the size of the market in their backyard. Maotai, a Chinese brand of baijiu liquor, has built a prestigious brand in a niche market, becoming the world's most profitable distiller and attaining a market valuation of \$200 billion in 2019. In Indonesia, Indofood has expanded beyond its original core business of producing instant noodles. The company diversified along the value chain by acquiring businesses operating in plantations, agribusiness, distribution, shipping, dairy, household products, and beverages.³⁷
- **Ecosystem players.** Present in all four country categories, these technology firms have developed online or mobile platforms to connect consumer-goods companies, consumers, and other service providers. They are building the infrastructure to serve Asia's increasingly digital-savvy consumers. A combination of rising incomes, a desire to shop digitally, and aspirational consumers in Asia has propelled the growth of major players including Alibaba and JD in China, Shopee and Lazada in Southeast Asia, Flipkart in India, Coupang in South Korea, and Rakuten in Japan.

³⁵ Fast Retailing, <https://www.fastretailing.com/eng/ir/financial/summary.html>.

³⁶ Ibid.

³⁷ Riska Rahman, "Indofood CBP plans to acquire manufacturers of Indomie in Middle East, Africa," *Jakarta Post*, February 13, 2020.

- **Next-generation disruptors.** This type of champion may not yet have built significant scale or profit but is growing rapidly on the back of innovation. This innovation can be in distribution systems for particular consumer products, the design and development of products using new technologies, or business models that engage more effectively with consumers. For example, Gentle Monster, a South Korean brand of glasses and sunglasses, quickly attracted consumers with a fresh shopping experience, creating futuristic e-tail spaces with fashionable designs, artistic exhibits, and high-tech services.³⁸ In five years, it had achieved \$250 million in revenue, 70 percent of which came from direct sales. It now has flagship stores in major cities such as Hong Kong, London, and New York.³⁹ In China, Feiyue revived an old brand that used to be the footwear of Shaolin monks, thereby tapping into the appetite among millennial and Generation Z consumers for heritage brands. It then expanded its range from the traditional models and adopted an engagement-driven marketing strategy anchored on hip, urban-branded stores that resonate with both Chinese and foreign consumers, including Orlando Bloom and model Poppy Delevingne.⁴⁰

Asia's consumer-goods companies have three distinct opportunities: scaling up, riding the Asian demographic wave, and leveraging digital platforms. First, they are in a very strong position to grow in scale because their home markets are in a region that is the very center of global consumption growth and will continue to be in the years ahead. The key consumers are the expanding middle class. The Chinese middle class, defined as households with \$20,000 or more in disposable income, jumped from 8 percent of total urban households in 2010 to 49 percent in 2018.⁴¹

Mergers and acquisitions can help Asian companies fuel growth both domestically and internationally, and COVID-19 might create new consolidation and M&A opportunities. Previous McKinsey research has found that most large corporations can benefit from programmatic M&A—pursuing many small deals that add up to large additions to market capitalization and synergies over a number of years instead of disconnected one-shot deals.⁴² Some Asian companies have begun to embrace programmatic M&A, undertaking serial acquisitions of competitors in their home markets to diversify beyond their core businesses. One example is Asahi, which started as a small beer brewer but then acquired a number of Japanese brands to build a leading position in Japan's alcoholic beverages market. Asahi today commands 49 percent of Japan's beer market, a 34 percent share of whiskey and spirits, 14 percent of ready-to-drink alcoholic beverages, 7 percent of wine, and 6 percent of shochu. Asahi has also had an extensive program of foreign acquisitions. Since 2011, it has acquired alcoholic beverage companies in New Zealand and Malaysia as well as several SABMiller beer businesses in Europe.⁴³ Japanese household products company Unicharm has been working on expanding internationally by leveraging product development and marketing capabilities developed in its home market. In 2018, it made one of its largest overseas acquisitions ever by purchasing Southeast Asian diaper maker DSG International (Thailand) for \$530 million.⁴⁴

³⁸ Dave Makichuk, "A 'Gentle Monster' is being unleashed on China," *Asia Times*, December 7, 2019.

³⁹ Qin Qian, "The secrets to luxury eyewear brand Gentle Monster's rapid rise," *Jing Daily*, July 17, 2017.

⁴⁰ Jessica Rapp, "How China's Feiyue sneakers, shoes of Shaolin monks, are making a comeback," *South China Morning Post*, June 23, 2019.

⁴¹ *China consumer report 2020: The many faces of the Chinese consumer*, McKinsey & Company, December 2019, McKinsey.com.

⁴² The research followed the largest 1,000 global companies by market capitalization between 2007 and 2017 and found that programmatic acquirers continue to perform better than peers in terms of excess total shareholder returns. See Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small M&A deals add up to big value," *McKinsey Quarterly*, July 2019, McKinsey.com.

⁴³ "Asahi Group's history," <https://www.asahigroup-holdings.com/en/whowere/history.html>; and *Asahi Group Integrated Report 2018*, https://www.asahigroup-holdings.com/en/ir/pdf/annual/2018_19.pdf.

⁴⁴ "Unicharm buys Thai diaper maker for \$530m, stepping up M&A," *Nikkei Asian Review*, September 26, 2018.

Second, Asian companies can take advantage of the region's positive demographics and the boom in middle-class consumption to build better-recognized brands. Middle-class consumers tend to look for products (and services) that offer higher quality and differentiators, and they are willing to trade up to obtain them. McKinsey's 2018 Global Consumer Sentiment Survey showed that 26 percent of Chinese respondents were trading up overall, compared with 17 percent in ten other top economies.⁴⁵ The consumer boom in Asia extends far beyond China. Today, some 67 million Southeast Asian households are part of a new affluent class, with incomes exceeding the level at which they can begin to make significant discretionary purchases. This number could almost double to 125 million households by 2025, making the Association of Southeast Asian Nations (ASEAN) a pivotal consumer market of the future.

To date, however, Asian firms have not yet built strong global brands. Only nine of the world's top 100 most valuable brands are Asian (eight from Advanced Asia and one from China). However, there are signs of momentum. In consumer electronics, brands such as Huawei, LG, Samsung, and Toshiba are recognized globally for quality and innovation. In cosmetics, Asian brands such as Shiseido and Amore Pacific are also becoming household names. However, in apparel and footwear, Asia has yet to break through with international luxury brands.

A third opportunity is harnessing digital ecosystems to extend the reach of brands and to learn from digital champions. E-commerce is rapidly expanding in Asia. Companies have pushed aggressively to use data analytics to better understand customer preferences and react more quickly to demand trends, to support cashless transitions on- and offline, and to personalize digital marketing. As Asian technology companies expand globally, they are creating channels for smaller next-generation disruptors to reach new corners of the world. For example, Tmall, an e-commerce unit of Alibaba Group, is a platform that offers Chinese consumer-goods companies a marketplace to set up online shops and showcase products to overseas consumers. In less than four years, Tmall International has sold 1.2 billion products to more than 27 million overseas customers in over 200 countries and regions. Tmall has become one of the most important channels for Chinese consumer-goods companies to expand internationally. It provides Chinese brands with training and support in digital marketing, international shipping, customs clearance, and cross-border settlement. Joyoung, a leading Chinese manufacturer of small kitchen appliances, is one of the most popular brands on Tmall International and has partnered with Tmall to create pop-up showrooms in Melbourne and Sydney.

The rapid expansion of digital consumer solutions helped to support people's livelihoods during the COVID-19 pandemic. The sector experienced a significant and immediate spike in e-commerce and food deliveries. In South Korea, WeMakePrice reported that sales of food and health-related items from high-end retailers grew by more than 700 percent in February 2020, compared with the same period in 2019.⁴⁶ In China, delivery platform Meituan experienced a 400 percent spike in online grocery sales in some cities.⁴⁷ The shift to online channels is expected to persist even after the pandemic. Asian consumer companies can build on the momentum of digital expansion to further extend the reach of their brands.

⁴⁵ *China and the world: Inside the dynamics of a changing relationship*, McKinsey Global Institute, July 2019.

⁴⁶ Online sales increase at WeMakePrice due to COVID-19 in South Korea in February 2020, Statista, <https://www.statista.com/statistics/1103042/south-korea-online-sales-growth-of-high-end-retailers-due-to-covid-19-at-wemakeprice-by-category/>.

⁴⁷ Charlie Campbell, "These delivery drivers are risking their health to keep China running during the coronavirus epidemic," *Time*, March 16, 2020.

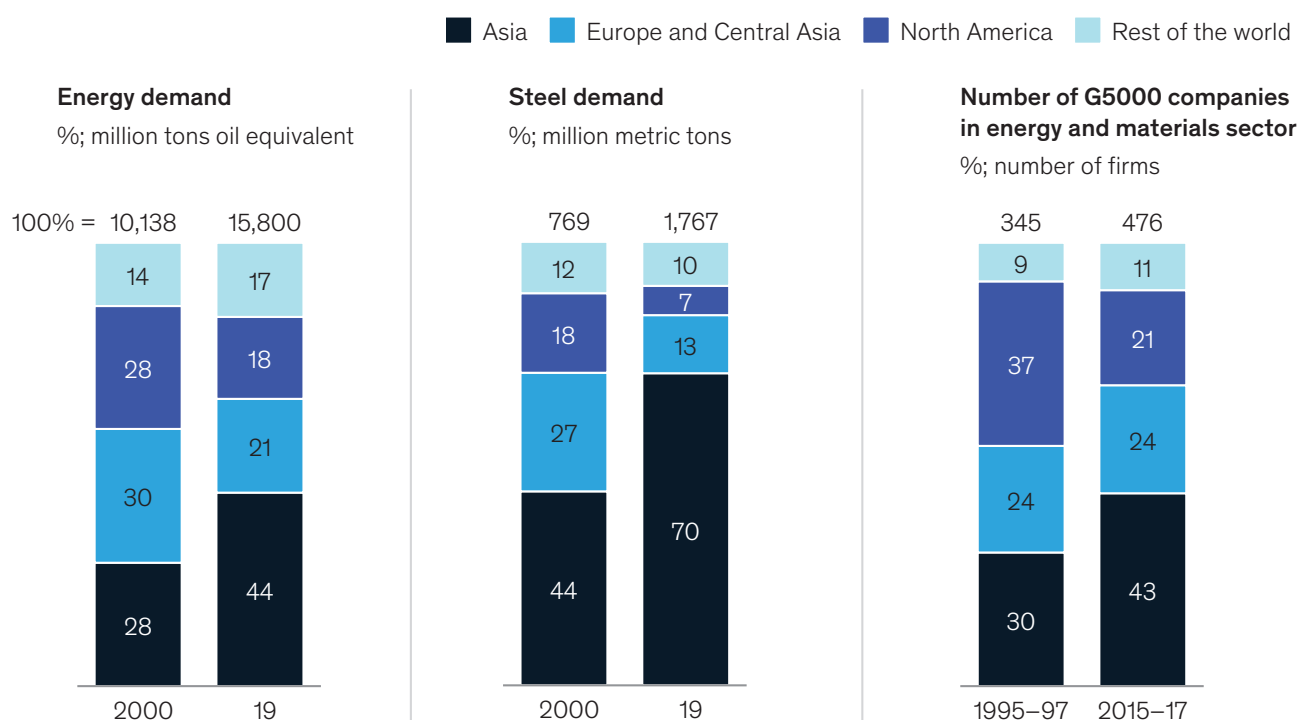
Energy and materials: Asian companies can lead the global energy transition toward new and sustainable sources

Asia is a major force in both energy and materials markets. It accounts for a very large and increasing share of global energy demand—44 percent in 2019, up from 28 percent in 2000. As the region continues to urbanize and industrialize, its demand for materials is soaring. In 2019, Asia accounted for 70 percent of global steel demand, up from 44 percent in 2000.⁴⁸ Energy and materials experienced one of the highest declines in shareholder returns among sectors during the COVID-19 outbreak. Rising demand has propelled large firms in the sector to become even larger. Today, Asian companies account for 43 percent of the G5000 list in energy and materials, up from 30 percent in 1995–97. Most of the firms represented in these sectors are Chinese (Exhibit 20).

However, these companies are now under pressure. The commodity supercycle ended, and Asian firms engaged in it are now feeling the effects of overcapacity. In 2015–17, Asia's losses in the energy sector were \$62 billion (30 percent of global losses in economic profit); in materials, Asian companies posted economic losses of \$50 billion (almost two-thirds of global losses). The International Energy Agency forecast a 6 percent decline in energy demand for 2020 as people adopted some form of lockdown to slow the spread of the coronavirus, while on the supply side, geopolitical tension between Russia and Saudi Arabia contributed to an oversupply of oil. The demand shock coupled with supply shock pushed the WTI futures price to an unprecedented negative territory, leading to significant pressure on financial performance of the sector.⁴⁹

Exhibit 20

Asia accounts for a growing share of global energy demand and more of the world's largest energy firms.



Source: BP Statistical Review of World Energy, June 2019; McKinsey Corporate Performance Analytics; US Energy Information Administration; McKinsey Global Institute analysis

⁴⁸ For more detail on Asia's role in the energy transition, please see a forthcoming article from McKinsey colleagues Rahul Gupta and Azam Mohammad titled *Will Asia lead energy transition?*

⁴⁹ International Energy Agency, "Global energy demand to plunge this year as a result of the biggest shock since the Second World War," *press release*, April 30, 2020, www.iea.org/news/global-energy-demand-to-plunge-this-year-as-a-result-of-the-biggest-shock-since-the-second-world-war.

The end of the energy supercycle and overcapacity in materials have hit all four sets of Asian countries, but to differing degrees

Companies operating in the energy and materials sector have come under pressure in all parts of Asia, but more acutely so in some economies.

In Advanced Asia, steel companies account for 60 percent of the South Korean energy and materials firms represented in the G5000, and almost three-quarters of the economic losses in this sector over the past decade. As growth has slowed, consumption of finished steel has been flat in South Korea since 2015 and declined in 2018. This weakness was mirrored in global demand and exports. Automotive and shipbuilding are major sources of South Korean exports, and they have been experiencing a global slowdown in demand. Competition has risen, too. A quarter of South Korea's exports go to Southeast Asia, where Chinese players have captured 55 percent of the import market.

In Japan, nearly 40 percent of its G5000 companies in the energy and materials sector are in steel, and they account for about 60 percent of the loss in economic profit for the sector as a whole. However, steel consumption declined by 4 percent a year between 2014 and 2016 as construction declined. Demand from the automotive industry also weakened because of low sales, a consumption tax hike, and a tax on light automobiles. At the same time, Japanese steel exports fell from their peak of 43 million tonnes per year to 36 million in 2018 because of weaker global demand and global competition.

India and Frontier Asia have 21 energy and materials companies in the G5000, and about half of their economic losses came from steel. Between 2005 and 2011, Indian steel companies significantly expanded capacity from 78 million tonnes per year in 2010 to 122 million in 2016. This represents growth of 8 percent a year. But as demand for steel has weakened, capacity utilization has dropped—from 88 percent in 2010 to 78 percent in 2016. There was some bounceback in 2018 as capacity utilization recovered to 85 percent because of import restrictions, infrastructure projects, and capacity adjustment.

In Emerging Asia, a few energy companies—largely integrated, state-owned players—have been able to protect economic profit through the cycle. These oil and gas companies represent about two-thirds of Asian energy and materials companies in the G5000—and nearly all the economic profit created in the region. Indonesia, Malaysia, and Thailand each have a major integrated energy player that consistently achieves returns on invested capital that are between five and ten percentage points higher than their global peers (Exhibit 21). Being integrated enables these companies to be more flexible in allocating resources, which helps them to maintain performance during different energy cycles. The fact that these companies are state-owned enterprises that tend to be major players in their domestic energy value chains also contributes to their ability to outperform their peers around the world.

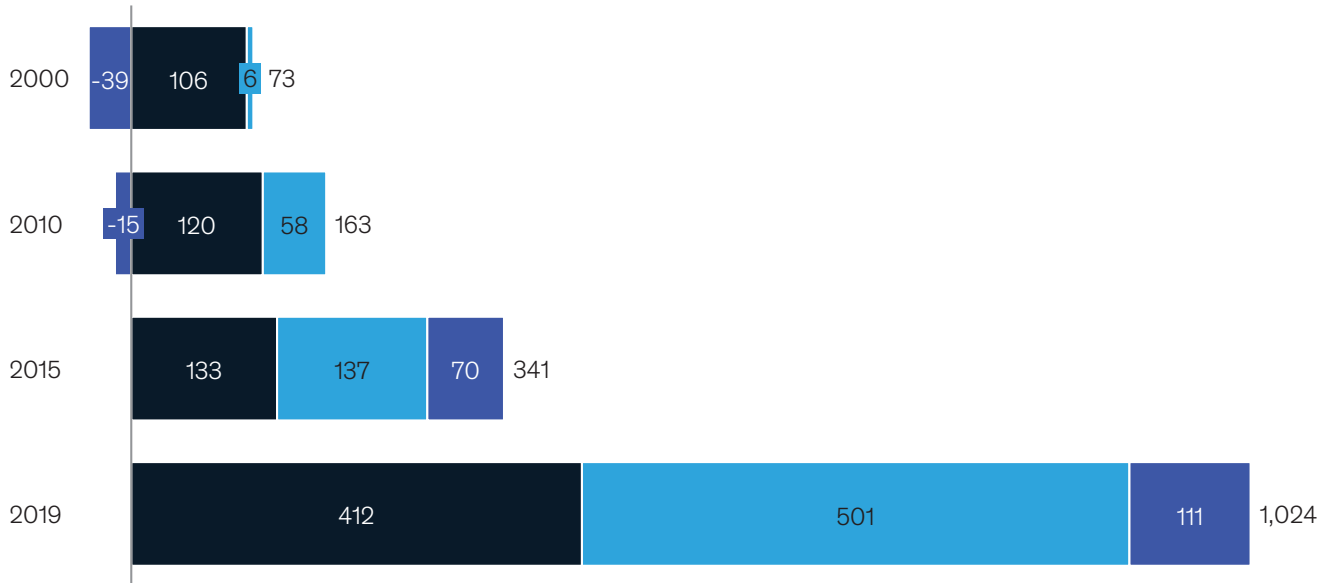
China has a diverse range of players in oil and gas, steel, mining, and coal. They generated annual economic losses of \$88 billion on average in 2015–17. In the energy sector, falling oil prices have put significant pressure on large upstream and integrated energy corporations in China as well as downstream oil and gas players. Their unprecedented growth in recent years has left a legacy of overcapacity in high-value refinery products, including jet fuel, gasoil, and gasoline. Moreover, China's energy industry is becoming more fragmented, with smaller players (beyond PetroChina and Sinopec) increasing their share of the nation's refinery throughput 2.5 times, from just 14 percent in 2008 to 35 percent in 2018.

China's exports of energy products have increased, while integrated Southeast Asian energy firms are outperforming global peers.

China's net exports of high value-added energy products

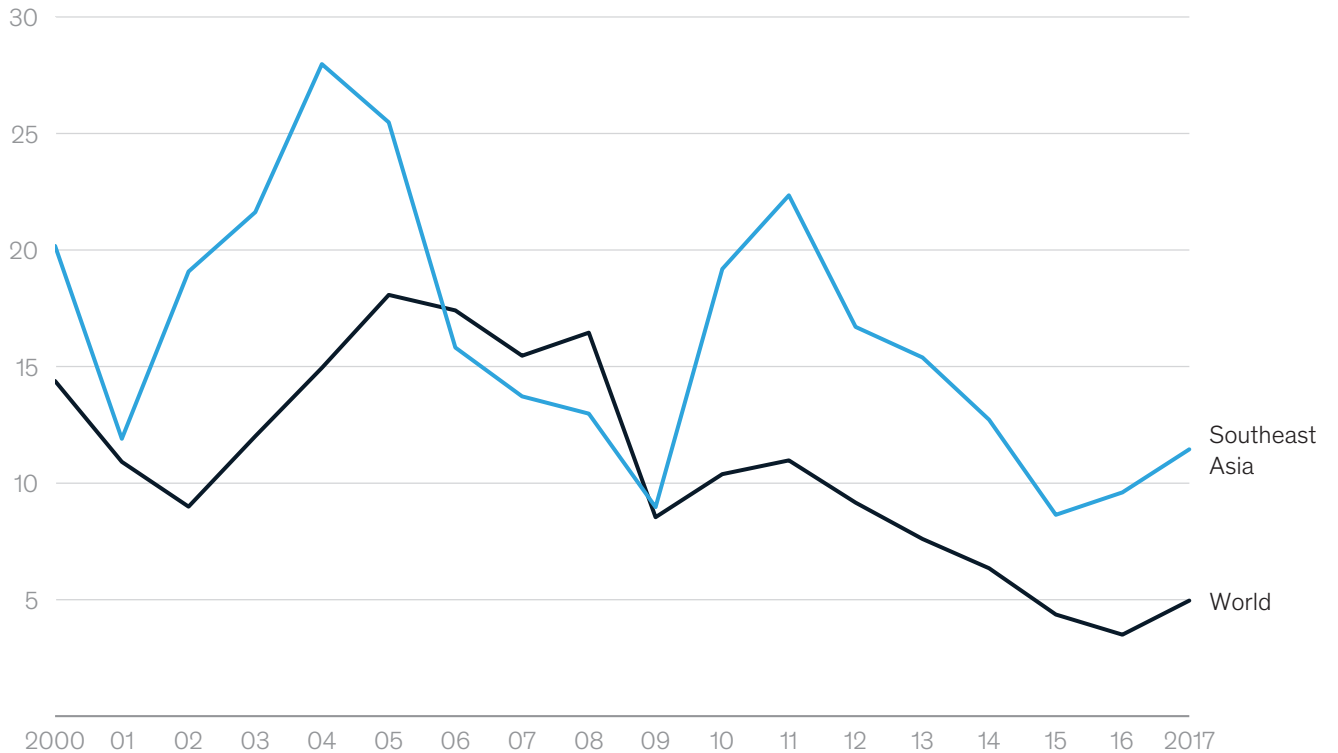
■ Gasoline ■ Gasoil ■ Jet fuel

Thousand barrels a day



Return on invested capital of integrated energy firms

%



Note: Figures may not sum to 100% because of rounding.

Source: FACTS Global Energy; McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Asian companies can unlock value through new growth opportunities, particularly in renewables and electrification, and by using digitization to boost productivity

Taking a forward-looking view, there are notable structural changes ahead, including a significant transition to more sustainable energy sources. Most advanced economies around the world are expected to experience a fall in demand, largely because of gains in energy efficiency. The low oil price and a decline in global energy demand have put significant pressure on the performance of energy companies. In the short term, companies are prioritizing cash preservation and potentially shutting down production. In the long term, considerable restructuring of the industry is likely and companies need to prepare for consolidation. Asia can lead the next global phase in several ways:

— **Ensure economic viability of, and strengthen leadership in, renewable energies.**

Renewables could become cheaper than coal and gas in most regions before 2030, given continued efforts to reduce technology costs for solar photovoltaic (PV) panels, as well as technology advances in wind-based power generation. In India, for instance, renewables are expected to be cheaper than coal by 2030. In Australia, by 2030, reductions in technology costs could cut the weighted average cost of electricity of onshore wind in Australia by roughly 35 percent, of offshore wind by roughly 75 percent, and of solar PV by 65 percent.

Asia still relies heavily on fossil fuels for generating power and transportation, but this is changing. The region is moving rapidly from laggard to enthusiastic adopter of new energy technologies. Asia has particular potential to demonstrate leadership in low-cost innovation and wide deployment. The cost of renewable energy has fallen sharply, with the price of solar PV modules falling by 15 percent a year between 2010 and 2018, partly because of China ramping up production. In India, total rooftop solar PV installed capacity was 3.9 gigawatts in December 2018, with commercial and industrial customers responsible for about three-quarters of growth.

- **Ride a boom in electrification.** Global oil demand is expected to peak in the 2030s. The largest declines in oil demand are expected to occur in the power and road transport industries because of the transition to electric vehicles and wider use of unconventional fuels such as hydrogen. China is the largest electric vehicle market in the world, accounting for 60 percent of global demand. As a result, Chinese players are becoming the global leaders. BYD is one of the world's largest producers of electric vehicles, and CATL is the largest battery manufacturer. The use of hydrogen in transport is gaining momentum in Asia. Japan is setting up 160 hydrogen charging stations. The Chinese government is making hydrogen-fuel stations a priority and is expected to build 50 fueling stations in Shanghai by 2025. South Korea has announced that the "hydrogen economy" is a national priority.

- **Explore new pockets of growth.** During the energy transition, new segments are likely to grow rapidly. Flows of liquefied natural gas (LNG) are expected to change significantly over the next 15 years. LNG demand grew at about 9 percent per year in 2017 and 2018, with China's 15.6 million metric tonnes of incremental demand representing 55 percent of the global total. Southeast Asia and South Asia could match Japan in LNG demand by the early 2030s. Another potential growth area is chemicals. Globally, the chemical sector is expected to account for more than half of growth in oil demand over the next 15 years. Asia has an opportunity to meet that demand and upgrade its offering to include specialty products. Smart grids and storage could also be growth areas. Tomorrow's smart-grid systems will look fundamentally different from today's as decentralized, intermittent power generation will increase. Storage is important in resolving intermittency in renewable-energy supply.
- **Unlock productivity gains through digitization.** The adoption of digital technologies in processes, robotics and automation, and data analytics using AI can vastly improve the productivity of operations across the value chain. Advanced analytics can lead to improvement in EBITDA margins of as much as ten percentage points.⁵⁰ Fast adopters of this suite of technologies have been shown to secure competitive advantage—even for companies struggling with overcapacity—by using these tools constantly to improve the way they manage their production systems and reallocate resources in real time. In order to fund new digital opportunities, companies will need to address structural factors such as overcapacity. Traditional lean approaches will need to be combined with newer digital levers.

Real estate: Asian firms can benefit from urbanization trends by developing new competencies and enhancing productivity through technology

Real estate underperforms globally in terms of generation of economic profit. Indeed, between 2015 and 2017, the worldwide sector posted a loss of \$69 billion.

This relatively poor performance has to be considered in light of several factors, however. First, the real value of real estate companies may be discounted in financial metrics because of land bank accumulation and long cash cycles. Real estate businesses are project-driven, and companies experience fluctuation in cash flows. Projects often take years, and companies also use cash to build “land banks” for future projects that may not materialize in the short term. Appreciation in the value of land often doesn't show up in official financial statements. In early 2020, the COVID-19 outbreak appeared significantly to have significantly slowed investment activity in real estate. Asia-Pacific commercial real estate investment was down 23 percent year-on-year in the first quarter of 2020. Residential housing has also been affected. In Hong Kong, for example, March 2020 property sales were 26 percent lower than in March 2019.⁵¹ However, as China appeared to bring the COVID-19 outbreak under control, there was a surge in the purchase of land. The top 100 developers spent 388.2 billion renminbi on land purchases in April 2020, a jump of more than 100 percent from the previous month.⁵²

Some investors may still favor real estate because of the broadly favorable macroeconomic context that keeps the sector in Asia buoyant: continuing urbanization. Asia's urban population is expected to expand from 2.1 billion in 2020 to 2.8 billion in 2040 (Exhibit 22).

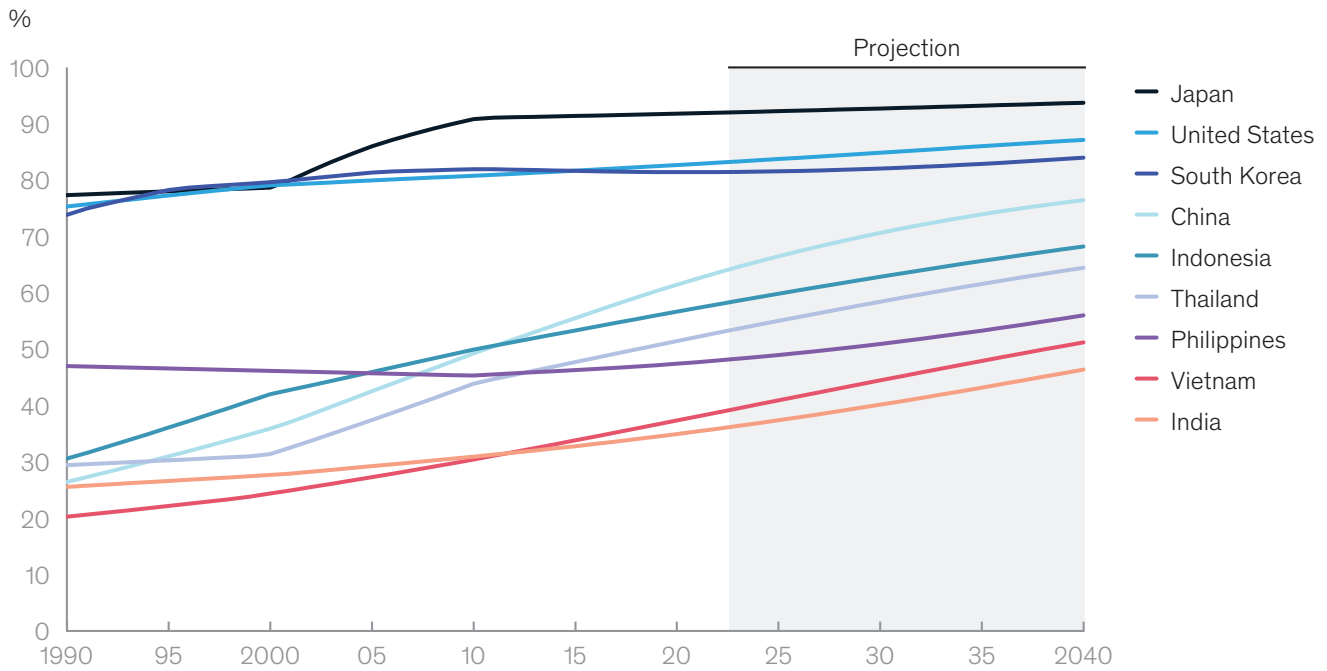
⁵⁰ Valerio Dilda, Lapo Mori, Olivier Noterdaeme, and Joris van Niel, *Using advanced analytics to boost productivity and profitability in chemical manufacturing*, McKinsey & Company, February 2018, McKinsey.com.

⁵¹ Hugo Cox, *Coronavirus: Why property markets in Asia are struggling to recover*, *Financial Times*, April 14, 2020; and *Commercial real estate volume slides as COVID-19 hits the brakes on investment activity*, Asia Pacific MarketFlash, CBRE, March 19, 2020.

⁵² Wang Jing and Tang Ziyi, *China's property developers go on a shopping spree*, *Caixin*, May 5, 2020.

Asia's ongoing urbanization means that real estate continues to be an attractive sector.

Urbanization rate by country



Urban population in Asia



Source: Oxford Economics; World Bank; McKinsey Global Institute analysis

The four Asias are at varying stages of urbanization, which affects their real estate sectors

The real estate sector in general—and residential housing in particular—is highly affected by the urbanization rate of each economy. The four Asias are at different stages. Advanced Asia is more than 80 percent urban, compared with China at around 60 percent. Emerging Asia, India, and Frontier Asia are rapidly urbanizing from a lower baseline.

China's urban share of the population is expected to continue to increase from 61 percent in 2020 to 70 percent in 2030, but the market for real estate has been changing. In the earlier phase of China's urban journey, the revenue of real estate players benefited from a favorable financing environment and enabling land policy. However, these twin benefits have started to dissipate. The land area purchased in China's 35 largest cities peaked in 2004 at 175 million square meters and had declined to 83 million square meters in 2018 (Exhibit 23). In 2010, the government tightened rules around the purchase of second homes in large cities. In recent years regulations have been relaxed, especially in second-tier cities such as Suzhou and Wenzhou, although they are still in effect in the large cities; indeed, the relaxation in policy reflects declining demand. The nature of the residential market may also shift from volume growth toward quality upgrades to cater to the rising middle class. For example, some developers are collaborating with technology companies to create mobile apps that allow residents to request various services, from paying bills to reserving a car wash. Demographic changes can also affect demand. China's working-age population peaked in 2013, and the overall population is expected to contract in the 2020s. The proportion of the population aged 64 years and over is expected to increase from 15 percent today to 26 percent in 2050, according to the United Nations. This may imply some headwinds slowing growth in the long term. One study found a positive effect on house prices from the working-age population ratio but a negative influence from a higher share of aged people.⁵³

The Chinese government has been generally supportive of commercial real estate development, especially projects driven by large-scale and high-quality developers, with an eye toward increasing domestic consumption. But the sector is not without challenges, including oversupply and a shortage of management capabilities in the post-construction phase. In the first five months of 2019, new development in commercial real estate increased by 0.4 percent compared with the previous period, but sales declined by 13 percent.⁵⁴ The flood of new supply over the past few years, coupled with weak demand from slowing economic growth, has put downward pressure on rents and driven up vacancy rates. Developers are therefore finding it necessary to improve the quality of commercial real estate projects and to develop capabilities in managing properties after they have been constructed. Although the Chinese real estate market boomed over the past decade or so and gave rise to a new group of behemoth companies, Chinese real estate players are still relative newcomers when compared with the leaders in Advanced Asia.

⁵³ Yongrui Zheng, "The impact of population age structure on real estates price—evidence from China provincial panel data," *Open Journal of Social Sciences*, March 2017, Volume 5, Number 3, pp. 212–22.

⁵⁴ *2019 China commercial real estate development white paper: Market pressure, innovation, and change*, Fang.com, July 16, 2019, <https://fdc.fang.com/news/2019-07-16/32910857.htm>.

Chinese land purchases have been declining; structural shifts are under way in Japan and South Korea.

Real estate structural shifts

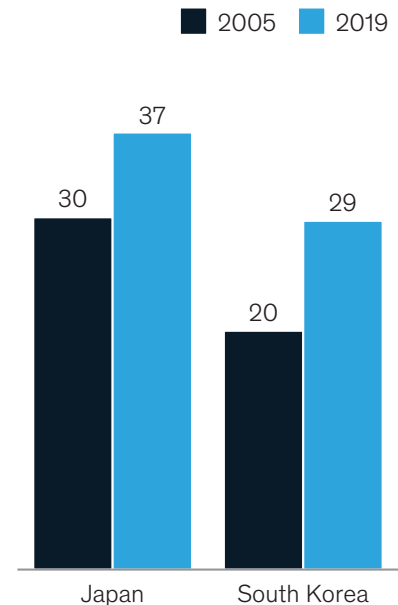
Land area purchased in China, 35 cities

Million square meters



Single-person households

% of total households



Source: CEIC; McKinsey Global Institute analysis

In Advanced Asia, the largest economies are highly urban, but other demographic shifts such as aging and a rising number of single-person households will influence the real estate sector. From 2005 to 2019, the share of single-person households rose from 30 to 37 percent in Japan, and 20 to 29 percent in South Korea. This increase is occurring as more young people remain unmarried, but it is also taking place among seniors. This suggests potential demand for new housing models, including co-living and smaller spaces optimized for a single person. The government of South Korea has responded to these trends with plans to change housing policy from using a four-person household as the standard to offering specialized housing supply to one-person households.⁵⁵ In addition, beyond the traditional business of real estate, several of these companies have diversified their offerings with creative services. For example, Mori Building, a leading Japanese real estate company founded in the 1990s, partnered with the digital art collective teamLab to build the world’s most popular museum of digital art, teamLab Borderless. In 2018, its first year of operation, it attracted more than 2.3 million visitors, half of whom were from other countries. Not only has its interactive *Infinite Crystal Universe* exhibit become popular on Instagram, but the venture has expanded to Shanghai and Macau.

⁵⁵ Lee Suh-Yoon, “Public housing to be increased for singles,” *Korea Times*, December 19, 2019.

As urbanization ramps up in Emerging Asia and in India and Frontier Asia, both overall GDP and the real estate sector in particular are in the growth phase, with governmental policy changing to support the development. In India, for example, real estate is expected to grow from \$120 billion in 2017 to \$1 trillion in 2030, accounting for roughly 13 percent of GDP.⁵⁶ Historically, foreign direct investment in real estate was limited, but reforms over the past decade have created opportunities for foreign investors. Global investors have been enthusiastic, especially with regard to office space that has been buoyed by strong demand in the IT-services sector. In 2019, India's real estate sector attracted investment of \$6.2 billion, an 8.7 percent increase from 2018, and foreign funds accounted for more than three-quarters of this investment.⁵⁷ Blackstone, for instance, is now the largest owner of Class A office space in India, with a portfolio of more than 70 million square feet across key office markets and IT hubs.⁵⁸

Asian real estate players can acquire new competencies, venture into real estate as a service, use technology to boost efficiency, and potentially brace for consolidation

Real estate markets are highly local—and their challenges and opportunities are, too. However, we see three broad opportunities for real estate players in the Asian market:

- **Acquire new competencies.** Companies will need to adjust to changing market demand and industry structures. In Advanced Asia, addressing demographic change, such as the rise of single-person units in Japan and South Korea, is becoming a necessity. In South Korea, electronics players have started offering solo-friendly home appliances such as small-load washing machines.⁵⁹ In China, developers may need to build nonresidential development capabilities. Vanke, a leading real estate developer in China that used to focus on residential property, started a commercial property business including urban infrastructure, shopping malls, office buildings, industrial parks, senior-care housing, and leisure resorts.⁶⁰ Developers are finding it increasingly important to master the management of completed projects rather than exclusively constructing buildings. McKinsey has found that instead of offering similar services in each building, developers need to tailor services toward local demand.⁶¹ For example, large shopping malls need to use advertising that can attract diverse consumers, while smaller-scale community real estate projects need to understand local consumers and provide services that meet their desires, including restaurants, childcare facilities, and entertainment. In the rest of Asia, building residential housing may remain the primary focus, and fundamental capabilities in land acquisition and project management will continue to be important. Across Asia, the prolonged effects of COVID-19 may push companies to develop their digital competencies and handle more of the real estate customer journey remotely. For example, the Evergrande Real Estate Group, China's second-largest real estate developer, responded to the pandemic by creating a digital-only experience that enables customers to engage entirely online, including making refundable deposits on properties. This overturned long-held assumptions about the need for in-person meetings.⁶²
- **Move toward real estate as a service.** Companies need to be aware of structural changes in real estate development. In China and Emerging Asian economies, there may not be a straightforward progression from residential to commercial as observed in advanced economies. With the rapid development of e-commerce and other digital solutions, demand for physical commercial stores and spaces may take on an entirely different shape, affecting the character of the real estate market and the trajectory of development.

⁵⁶ *Indian real estate industry*, India Brand Equity Foundation, December 2019, <https://www.ibef.org/industry/real-estate-india.aspx>.

⁵⁷ "Investment in India's real estate sector to rise 5 pc to \$6.5 bn: report," *Economic Times*, January 1, 2020.

⁵⁸ Madhurima Nandy, "Blackstone set to become India's largest office assets owner," *LiveMint*, October 8, 2014.

⁵⁹ Mareike Dornhege, "Going solo: The Japanese preference for living alone," *Rethink Tokyo*, March 27, 2019; and "Single-person households surge in South Korea," *Straits Times*, February 18, 2016.

⁶⁰ "Vanke 'is' transformed into commercial real estate," *Beijing Commercial Daily*, June 15, 2011, <http://finance.ifeng.com/news/house/20110615/4154733.shtml>.

⁶¹ *Building new capability in nonresidential real estate*, McKinsey & Company China, June 6, 2018.

⁶² Jason Bello, Shaun Collins, Ralf Dreischmeier, and Ari Libarikian, *Innovating from necessity: The business-building imperative in the current crisis*, April 2020, McKinsey.com.

Indeed, early evidence from China suggests staying power in the coronavirus-driven increase in e-commerce penetration.⁶³ In addition, creative solutions for client services can expand business models.

As Asian economies advance, real estate may emerge as an asset class across Asia, which may require new types of capabilities for developers to work with institutional investors and focus more on financial returns. Players may need to be able to package real estate as an asset class, embrace broader sources of capital, and consider adding services. Less developed regions such as Emerging Asia and Frontier Asia typically use funding from households and banks for financing, while in advanced economies, insurance and retirement funds often allocate a higher portion of funds to real estate.

- **Adopt technology-enabled solutions for end-to-end process improvement.** Firms need to improve their operational efficiency by leveraging technology and earning higher returns. According to MGI's Industry Digitization Index, real estate as a sector only has low to moderate digitization overall and therefore has an opportunity to develop further.⁶⁴ Companies can leverage existing solutions such as Building Information Modeling (BIM) and Prefabricated Prefinished Volumetric Construction (PPVC) to optimize design and reduce construction time, therefore improving productivity.⁶⁵ In many cases, companies find it challenging to digitize end-to-end. According to research by Dongxing Securities, only about 10 percent of companies are using BIM on a large scale. In addition, real estate companies can potentially explore more frontier technologies. Chinese company Country Garden, for instance, has started to incorporate artificial intelligence (AI) technology into its design of "smart communities."⁶⁶ The company has invested 500 million renminbi (about \$71 million) in developing AI technologies in recent years and aims to use AI to improve productivity and upgrade its services.
- **Build scale through programmatic M&A.** Given the nature of the industry, the sector tends to be highly fragmented. China, for instance, has about 97,000 real estate players.⁶⁷ But consolidation is underway. Between 2012 and 2017, M&A deals in Chinese real estate quadrupled. China's Sunac, for instance, used M&A to propel its rapid recent expansion. In 2019, its sales increased by 21 percent compared with the year before to hit 556 billion renminbi (about \$80 billion).⁶⁸ It is not only fragmentation that may drive consolidation. Another factor is shrinking real estate margins that could lead to liquidity issues, given the high levels of leverage in some economies. In India, an estimated \$47 billion of housing projects have experienced delays of anywhere between two and eight years. This is proving to be another factor spurring consolidation, with less well-financed players facing long delays selling projects to better-financed developers.⁶⁹ Mergers can help smaller firms solve liquidity issues and lower the cost of capital, as larger firms have more buying power. However, this requires developers to build systematic management capabilities in M&A, especially in identifying good targets and then handling post-merger challenges ranging from managing complex asset portfolios to adapting organizational structures.

⁶³ Vaibhav Gujral, Robert Palter, Aditya Sanghvi, and Brian Vickery, *Commercial real estate must do more than merely adapt to coronavirus*, McKinsey & Company, April 2020.

⁶⁴ See *Digital America: A tale of the haves and have-mores*, McKinsey Global Institute, December 2015; *Digital Europe: Pushing the frontier, capturing the benefits*, McKinsey Global Institute, June 2016; and *Digital China: Powering the economy to global competitiveness*, McKinsey Global Institute, December 2017.

⁶⁵ For a broad discussion of such techniques in construction, see *Reinventing construction: A route to higher productivity*, McKinsey Global Institute and the McKinsey Capital Projects & Infrastructure Practice, February 2017.

⁶⁶ *Country Garden Service appears at the 2019 Shanghai World Expo: AI technology leads the intelligent upgrade of the industry*, October 22, 2019, http://www.bgyfw.com/news/compnews_10000062754357.html.

⁶⁷ "Huang Qifan: In the next ten years, the number of Chinese housing companies will decrease by more than two-thirds," *Xinhua*, July 21, 2019, <https://finance.sina.com.cn/roll/2019-07-21/doc-ihytcitm3574318.shtml>.

⁶⁸ *Top Chinese real estate companies by sales*, Fang.com, January 7, 2020, <https://sh.news.fang.com/open/34460181.html>.

⁶⁹ Richard Meyer, *\$47B in India residential projects still stalled despite market rebound*, Mingtiandi Asia Real Estate Intelligence, August 9, 2018.

Banking: The environment has become more challenging for Asian banks, creating pressure to scale up and continue digital innovation

Asia has been the world's largest regional banking market for a decade.⁷⁰ In 2018, players generated pretax profits in excess of \$700 billion and accounted for 37 percent of global banking profit pools. More than 40 of the world's 100 largest banks by assets are Asian, and they account for about 50 percent of the market capitalization of the top 100 banks globally. The banking sector is likely to continue growing as incomes rise and the middle classes expand in the long term. However, following the pandemic, banks could face a prolonged period of lower profits and tighter balance sheets, reduced interest rates due to regulatory pressure, and increased operational costs due to new safety measures.⁷¹ Personal financial assets in the region are projected to total \$69 trillion by 2025, about three-quarters of the global total.

However, returns on equity have been declining and the pandemic's immediate aftermath has reduced margins and volumes.⁷² The region's banks achieved double-digit annual growth in revenue from 2010 to 2014, but that growth rate slowed to 5 percent from 2014 to 2018. While there was a slight recovery in banking profit pools in certain markets from 2017 to 2018, the longer trend of slowing GDP growth in China and India, the Asia–Pacific region's two largest emerging economies, has weakened economic expansion for the entire region and dampened demand for banking services. On the equity front, average return on equity in Asia–Pacific fell from 12.4 percent in 2010 to 10.1 percent in 2018, compared with the global average of 9.5 percent. The deterioration has been pronounced in China, where return on equity dropped from 17.4 percent to 12.4 percent, and India, where it fell from 11.3 percent to negative 2.0 percent. In several markets, loans and deposits are the remaining drivers of profit, given that margins are declining. Nonperforming loans have been rising. The average risk-cost provision in Asia–Pacific was around 0.30 percent in 2018, the highest level of loan losses since 2002. In China, the nonperforming loan ratio climbed in the first quarter of 2020 to 2.04 percent according to the China Banking and Insurance Regulatory Commission, and was predicted to rise at a moderate pace in the second quarter. Asia–Pacific's share of global profits from banking has fallen (Exhibit 24). While many banks have improved efficiency through infrastructure improvements and extensive digitization among other measures, this has not been sufficient to reverse the general decline in return on equity.

In addition, open banking is taking hold, with diverse markets moving toward broader participation in the banking system. India, for example, allows nonbank service providers direct access to its new infrastructure, the Unified Payments Interface. Hong Kong and Singapore recently introduced new procedures for licensing digital-only banks. Australia and Singapore, among others, have adopted open banking rules requiring banks to allow qualified third-party service providers to link to banking systems to access account information and initiate transactions on behalf of customers. This will undoubtedly increase pressure on margins and the market share of incumbent banks as fintech players challenge them in payments, lending, and investments.

Forward-looking indicators suggest that many banks will be under pressure because of a combination of low growth, thinning margins, potentially higher costs related to risk, and the need for scale efficiencies. All these factors point to consolidation of the sector.

⁷⁰ For an extensive discussion of banking in Asia, see *Asia–Pacific Banking Review 2019 – Bracing for consolidation: The quest for scale*, McKinsey & Company, July 2019, [McKinsey.com](#); and *Future of Asia: How Asia is reinventing banking for the digital age*, McKinsey & Company, January 2020, [McKinsey.com](#).

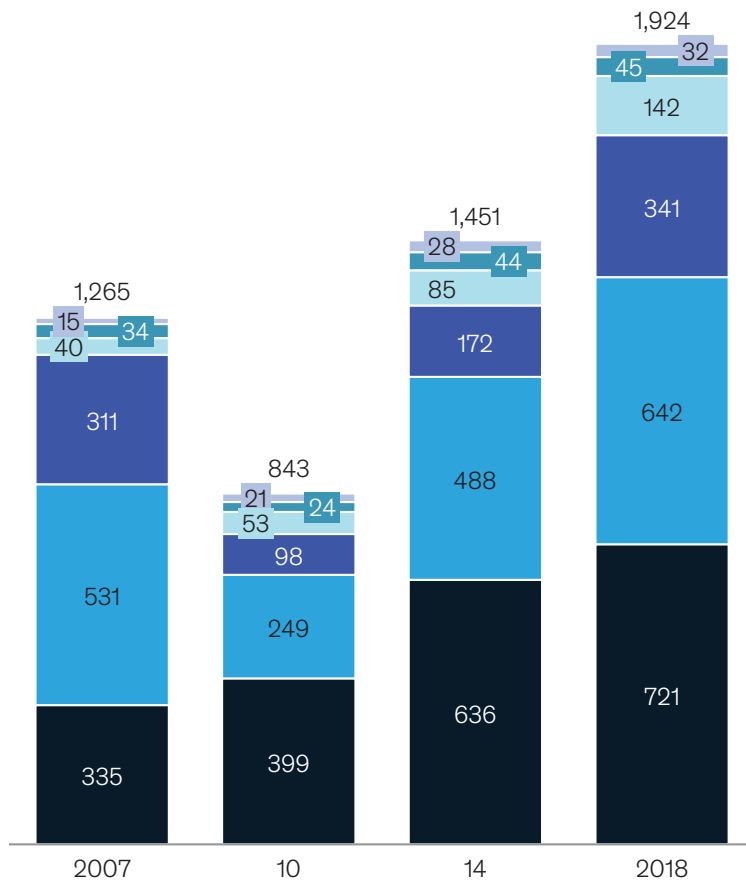
⁷¹ Jacob Dahl, Vito Giudici, Sameer Kumar, Vishal Patwari, and Gabriele Vigo, *Lessons from Asian banks on their coronavirus response*, McKinsey & Company, March 2020.

⁷² *Ibid.*

Asia-Pacific’s share of global banking pretax profit pools has declined because of slower growth and post-crisis recovery in other regions.

Pretax profit¹

% billion (fixed 2018 foreign-exchange rate) \$



Compound annual growth rate

%

	2007–10	2010–14	2014–18
World	-13	15	7
Africa	11	8	3
Middle East	-11	-16	1
Latin America	10	13	14
Europe ²	-32	15	19
North America	-22	18	7
Asia-Pacific	6	12	3

1. Total pretax profit pools of all customer-driven banking activities, including retail and institutional management.

2. Includes Western and Eastern Europe.

Note: Figures may not sum to 100% because of rounding.

Source: McKinsey Global Banking Pools; McKinsey Global Institute analysis

The imperative is to build scale, and Asia's strength in fintech can help

Larger banks in Asia have typically generated the highest returns. Across the region, return on equity between the largest and smallest banks ranges from 140 basis points to 700. This suggests that scale matters. For example, in Australia, the four largest banks handle practically all mortgage lending, which not only represents a large share of total bank assets in the country but also has become even more profitable with the adoption of high-powered credit-underwriting models.

Volume has been key to improving productivity in the banking sector. However, as growth in volume slows, it will become more important to embrace innovative technology such as machine learning in know-your-customer processes. In the past, there was a limit to how large an operation could become and still capture scale advantages, but innovations in machine learning, artificial intelligence, and robotics have lifted this limit, launching a new wave of productivity growth.

Asia has been leading innovation in fintech, reflecting not only a high degree of digitization in Asian economies but also the digital savviness of citizens. According to McKinsey's Global Payments Map, digital payments in China account for about 99 percent of noncash transaction volumes and 45 percent of digital payments worldwide. China is home to seven of the world's top ten fintech companies, including Alibaba's Ant Financial, Ping An's Lufax, and Tencent's WeBank. It is notable that these major fintech players are the financial arms of three of China's digital giants. Considerable investment is going into fintech. In India, for instance, Paytm received investment of \$1.7 billion in 2019, the most of any fintech globally. In 2018, Ant Financial received \$14 billion of investment, representing 35 percent of all global fintech deals and financing in that year. The pandemic has also served to force the acceleration toward digital channels. Banks in Asia have both increased use of existing digital channels and moved forward with digitizing additional banking processes, including electronic know your customer, digital signature collection, and online document submission.

Many banks have expanded their range of online services to reduce in-person banking. For example, Ping An Bank introduced the Do It At Home campaign to offer contactless and smart services. Using the Ping An Pocket Bank app, customers could complete a variety of financial services spanning basic banking transactions, wealth management, insurance, foreign exchange, private bank or family trust, investor education, and more.⁷³

In the digital era, regulators are playing a more active role in overseeing the industry, often encouraging its development (for instance, by taking a test-and-learn approach that allows fintechs to experiment without affecting the entire financial system). Whether regulatory efforts to encourage innovation lead to more direct competition or voluntary collaboration between banks and nonbanks, mounting competition between traditional banks and digital innovators will almost surely cut even deeper into bank margins in the coming years. In turn, Asian banks have led the dialogue among regulators and government officials to shape the economic response to the pandemic.

For example, State Bank of India research has been working to analyze COVID-19's economic impact and propose a set of interventions to stabilize the economy. In monetary policy, SBI recommended a rate cut to accommodate the expected surge in liquidity demand and shock-related price increases.⁷⁴

⁷³ Jacob Dahl, Vito Giudici, Sameer Kumar, Vishal Patwari, and Gabriele Vigo, *Lessons from Asian banks on their coronavirus response*, McKinsey & Company, March 2020.

⁷⁴ *Ibid.*

Nimble digital-platform providers (armed with data-centric business models that entail relatively low capital and operating expenditures) are positioning themselves to challenge incumbent banks with increasing force. Depending on regulators' postures toward innovation, these attackers may extend their deposit-taking and lending activities, cutting further into the market share of incumbent banks.

The role of regulation will be an important factor in whether and to what extent Asian banks can leverage fintech to improve their performance. Aiming to speed up innovation and modernization through competition, regulators across the region are gradually opening up banking systems to broader participation. Australia has mandated that its four largest banks adopt open-banking standards for a broad range of transactions.

The increasing scale and global prominence of Asian companies have generated a great deal of interest around the world, but the full picture is more complex than often appreciated—even before the new challenge of COVID-19 dramatically altered the global economic and social order. The significant influx of capital into corporate Asia over the past ten years has enabled many companies to build scale, but not necessarily higher profits. The next challenge is not simply growth but productivity. Asia will need to propel more firms into the highest-performing ranks and turn around some of its large underperformers to capture a greater share of the global economic profit pool—and across sectors and geographies, there are plenty of opportunities to do so. Overlaying that imperative is the unprecedented challenge of dealing with life after COVID-19. The post-pandemic world will be a proving ground for agility and adaptability. Because of their scale, leading Asian companies may play a pivotal role in defining the next normal.

3. Positioning for the post-pandemic world

Within weeks of its outbreak, the COVID-19 pandemic had already had a profound impact on global economic activity. Parts of Asia, the first region to be affected, may be emerging from the crisis before other regions that, at the time of writing in May 2020, were still grappling with high—and in some cases—rising numbers of infections. In China, for instance, high frequency indicators such as the urban traffic congestion and, residential-property sales were close to where they had been in early January. McKinsey pulse surveys of Chinese and Indian consumers indicated that a majority are optimistic that their countries' economies will rebound quickly to reach or exceed pre-COVID-19 strength. On the other hand, in Emerging Asia (Indonesia) and Australia, Japan, South Korea, most consumers remain unsure or relatively pessimistic about the lasting economic impact of COVID-19. In any case, the period ahead is likely to be characterized by turbulence and uncertainty. While Corporate Asia as a whole has been resilient to periods of volatility and has maintained a high rate of growth, there are huge variations in the performance of individual companies. In this section, we briefly explore three opportunities as Asia positions itself for a post-pandemic world.

As we have noted earlier, corporate Asia as a whole—the entire ecosystem—has been resilient to crises in the past and driven robust rates of Asian economic growth. Large firms, which now account for 43 percent of G5000 companies play an important role in driving productivity growth, innovation, and talent development and in serving markets within the region and around the world. Top performers have had to show considerable resilience. That resilience has been honed in highly competitive markets characterized by fiercely contested leadership. Less than 40 percent of the top quintile of firms have stayed at the top over the past decade. The strength of the corporate ecosystem offers hope that Asia will be able to weather the pandemic shock and take the region's economies forward in what may well be a volatile post-pandemic world. There will inevitably be tradeoffs ahead between fostering competitive corporate dynamism and providing the support that economies may well need in terms of demand and employment. Both are important agendas for stability.

There is no question that Asian corporations will come under more stress. While Corporate Asia has been resilient overall, there are huge variations in the performance of individual Asian companies. As noted in Chapter 1, Asian corporations are over-represented in the bottom quintile of global companies (24 percent versus 17 percent in North America). They tend to be more capital-intensive with heavier balance sheets that can be a burden in periods when liquidity is tight and demand shrinks well below its expected trajectory. Asian companies will need to address challenges related to the survival in the short term.

Exploring opportunities ahead

At the same time, as discussed in Chapter 2, there are plenty of opportunities for individual Asian corporations to build the capabilities to sustain long-term growth in a more volatile context. In the wake of the economic and social shock of COVID-19, supply chains will be disrupted. Consumer behavior that was forced to change because of physical distancing—notably adopting remote working and even heavier use of digital technologies—may represent a lasting step change. Many companies may, in response, need to rethink their business models and strategies. These changes can in turn lead to an even stronger Asian corporate sector:

- **Innovation and digitization—accelerating digital adoption and leveraging technology to unlock productivity.** Whether it's the emergence of digital health solutions such as telehealth or unlocking productivity gains through robotics and automation for energy companies, digitization is a key lever in all sectors as discussed in Chapter 2. In the context of the COVID-19 pandemic, digital capabilities have proven to be even more critical, and there was an acceleration in digital adoption. One general manager in China's pharmaceutical industry spoke of “doing in two months what would have taken two years” as the company moved all of its reps onto a digital platform.⁷⁵ Digital tools and technologies were at the heart of efforts to track and trace the infection, and enabled the remote delivery of goods and services on an unprecedented scale. Physical distancing and quarantining forced even more innovation. Many companies ramped up their ability to serve customers digitally. For instance, a real estate player in China moved online with virtual showrooms powered by augmented reality. Rizal Commercial Banking Corporation in the Philippines experienced a 259 percent increase in new sign-ups to its “bank from home” online banking service in the first three days after quarantine measures were put in place on March 17, 2020.⁷⁶ In early 2020, the government of Australia invested 669 million Australian dollars (about \$434 million) to expand Medicare-subsidized telehealth services. Many insurers and providers expanded their capacity in order to enable medical consultations via telephone or videoconferencing.
- **Scale, scale, scale—exploring M&A opportunities and continued regionalization.** Several factors lie behind the gap in the performance of Asian companies and global leaders including gaps in brands, technology, and global footprint. The demand and supply shock caused by COVID-19 could facilitate consolidation and restructuring at the global level, potentially creating opportunities for firms in Asia to explore. McKinsey research showed that firms that proved to be resilient during turbulent times had tended to prepare their balance sheets before crises hit, and then were more acquisitive once the pressure eased. These resilient companies tend to shift to M&A and use their superior cash levels to acquire assets that less well prepared companies are selling off to survive. Overall, resilient companies were about 10 percent more acquisitive early in the recovery.⁷⁷ As discussed in Chapter 1, programmatic M&A is considered one of the big moves that companies can make. According to the Global M&A Sentiment Tracker, published by White & Case, 82 percent of interviewees in Asia said they expected an increase in M&A activity in 2020.⁷⁸ Companies with the capabilities to manage a strategic M&A program will be well positioned to acquire new capabilities where they have shortfalls. At the same time, there may be a shift toward regionalization and localization. In a previous discussion paper on this series on the Future of Asia, we had discussed the possibility that the next phase of globalization could be regionalization; the COVID-19 pandemic may accelerate that trend.⁷⁹ Even before the pandemic, a trend toward regionalization was already evident as Asian economies more than ever were driven by domestic and regional consumption. For

⁷⁵ Sizhe Chen, Franck Le Deu, Gaobo Zhou, and Josie Zhou, *How COVID-19 changes the game for biopharma in China*, McKinsey & Company, April 2020.

⁷⁶ “More Filipinos turn to digital banking amidst COVID-19 lockdown,” *Fintech News*, March 24, 2020.

⁷⁷ Martin Hirt, Kevin Laczkowski, and Mihir Mysore, *Bubbles pop, downturns stop*, *McKinsey Quarterly*, May 2019.

⁷⁸ White & Case, *M&A is top of mind: Will dealmakers actually double down in a downturn?*, Global M&A Sentiment Tracker, <https://www.whitecase.com/sites/default/files/2020-03/global-ma-sentiment-tracker-ma-is-top-of-mind-web-final.pdf>.

⁷⁹ *The future of Asia: Asian flows and networks are defining the next phase of globalization*, McKinsey Global Institute, September 2019.

instance, 60 percent of goods traded by Asian economies and 59 percent of foreign direct investments (FDI) are intraregional. Dynamic Asia-for-Asia supply chains have developed and the pandemic may reinforce these trends. COVID-19 has exposed how deeply dependent the world is on global supply chains. Given the disruption across economies, companies may now opt to shorten and localize their supply chains to be closer to the end-consumer and insulate themselves to a degree against similar shocks in the future. In the face of the COVID-19 outbreak, some companies were considering diversifying their supply chains beyond China. Nevertheless, it may be that many will remain in Asia.

- **Portfolio management—making bold moves and staying agile.** Asian firms are already excelling in dynamically reallocating resources. However, they also need to start diversifying and scaling their portfolios in new ways, especially in response to COVID-19. For example, the need for real estate companies to pivot to becoming service providers may become more pressing as transaction volumes decline and mobility within the cities is paused. Energy companies, which are hit the hardest, may need to reconsider the composition of their portfolios. Pharmaceutical companies, which are at the center of the current public health crisis, may need to reassess their pipeline and resources in order to speed up their development and production of vaccines and treatments. The flexibility of Asian companies and their ability to react nimbly is necessary if they are to respond to changing market demand.

Manage multiple time horizons through “plan-ahead” teams

Amid current uncertainties and the disruption caused by COVID-19, business leaders will doubtless spend a great deal of their time navigating through day-to-day challenges. Crisis management will be critical. The various flows on which Asia’s economies depended have been seriously disrupted. For instance, in 2018 Asia accounted for 40 percent of the world’s air travelers and nearly 50 percent of all student travelers.⁸⁰ Those flows have largely dried up, posing very serious challenges to many businesses in the travel, tourism, and hospitality sectors; for such businesses, survival is the first priority.

But Asia’s companies need also to look further out, planning how to deal with challenges ahead in order to tap successfully into opportunities for long-term growth that are clearly still on offer. As outlined in Chapter 2, before the pandemic there was a range of opportunities for Asian companies in different key sectors. All companies could consider taking two steps: (1) launching a plan-ahead team, and (2) ensuring that this team works across multiple time horizons:⁸¹

- **Put in place a plan-ahead team.** A dedicated team that looks beyond day-to-day crisis response can play the vital role of seeing the big picture and delivering a strategic action plan that guides thinking and hopefully accelerates decision making. Such teams are often used in the military to deal with often-complex crises. In an uncertain economic and business environment, having a team that compiles forward-looking intelligence, develops scenarios, and generates ideas for future tactics can be effective. As new information becomes available, the team can update plans.

⁸⁰ *The future of Asia: Asian flows and networks are defining the next phase of globalization*, McKinsey Global Institute, September 2019.

⁸¹ Martin Hirt, Sven Smit, Chris Bradley, Robert Uhlener, Mihir Mysore, Yuval Atsmon, and Nicholas Northcote, *Getting ahead of the next stage of the coronavirus crisis*, McKinsey & Company, April 2020.

- **Work across multiple time horizons.** McKinsey has outlined five key aspects that plan-ahead teams need to get right. First, gain a realistic view of the company’s “baseline” starting position. When a business is dealing with extreme levels of uncertainty, it is vital to stake stock of its financial assumptions, ongoing initiatives, and strategic choices. Second, those tasked with planning ahead need to develop scenarios including for potential macroeconomic outcomes, and then stress-test the company’s performance in each, judging where the business is most resilient or vulnerable. Third, companies need to establish their strategic posture and direction of travel. For instance, some firms may rebuild slowly while others may act boldly to seize new opportunities that the crisis has created. Fourth, companies need to decide on a portfolio of strategic moves that are robust across scenarios. Finally, company leaders working with the plan-ahead team need to decide on trigger points for strategic decisions so that there is some clarity about when actions are taken and measures are taken at the right time.
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Technical appendix

Ten levers for improved corporate performance

McKinsey has previously identified ten levers that are the strongest factors in firm performance.⁸² They fall into three categories. First is endowment, which is essentially a firm's starting point. This includes its size measured by revenue, its debt level or leverage, and innovation, measured by looking at past investment in R&D. The second category consists of five moves that, if adopted in a sustained manner—and especially in combination—can dramatically improve a firm's performance: programmatic M&A, dynamic allocation of resources, strong capital expenditure, productivity, and differentiation. The final category is where a company plays—whether it operates in an industry that is expanding or declining, and in a geography that is thriving economically or struggling.

1. **Size of revenue.** Our research found that the larger the company, the more likely it is to improve its position on the power curve. For this reason, size is not only the qualifier to join the G5000, but also a key lever of performance. Firms in Advanced Asia and China match the global average on revenue size, unsurprising given that they have added scale over the past 20 years. Companies in Emerging Asia generally lack scale but are beginning to develop it and, as noted, gain representation in the G5000 for the first time.
2. **Debt capacity.** The level of leverage determines how much headroom a company has to invest in growth opportunities and is a key determinant of whether companies are able to move up the power curve. It is not a major differentiator between firms in different parts of Asia and the rest of the world. It is, however, notable that a significant share of Asian firms have negative net debt-to-equity ratios, signaling that they have more cash on hand than debt.
3. **Past R&D investment.** On past R&D investment, measured by R&D as a percentage of sales, Asia overall lags behind the rest of the world. In Advanced Asia, there is R&D investment in all sectors. In China, however, R&D investment is more patchy, with most of it in sectors such as technology hardware and equipment, but less in pharmaceuticals and biotechnology. It is difficult to discern what is happening in the rest of Asia as the sample size is too small.
4. **Programmatic M&A.** A programmatic approach to M&A is one in which companies have a steady stream of small deals that add up to significant market capitalization and synergies over a number of years, which creates more value for companies than a few (larger) transactions that are more spaced out.⁸³ On the whole, Asian firms have less programmatic M&A activity than companies in the rest of the world. Over the past decade, Asia's share of global M&A has almost doubled from 16 to 31 percent, but it still lower than the region's 39 percent share of global revenue and its 43 percent share of G5000 companies.

⁸² Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick*, Hoboken, New Jersey: Wiley, 2018.

⁸³ Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small M&A deals add up to big value," *McKinsey Quarterly*, July 2019, McKinsey.com.

5. **Resource allocation.** This move relates to whether firms are being dynamic in their capital expenditure, actively reallocating capital to promising existing businesses as well as new units. Overall, Asian firms are more dynamic than their counterparts in the rest of the world. Factors such as degree of corporatization and ownership structure may mean that Asian firms are able to move with more agility and speed.
6. **Capital expenditure.** The capital expenditure lever is the key to enabling firms to expand faster than their sector average. However, capital expenditure needs to go to the right projects. Investing in viable and profit-making projects will help push companies up the power curve, while investing in loss-making profits could drive firms down the curve.
7. **Productivity programs (including operational and labor improvements).** All companies strive to improve operational and labor productivity; therefore, what is important for performance is whether they achieve faster productivity improvements than the average of the sector or sectors in which they are operating. Within the four Asias, operational productivity levels appear to be relatively consistent with the global average, although firms in China, Emerging Asia, and India and Frontier Asia tend to beat that average by a small margin. Variations on labor productivity, however, are marked. Chinese firms have made significant improvements in this respect.
8. **Differentiation improvement.** This measure reflects whether a company has been able to develop a sustainable cost advantage or charge premium prices because it offers a range of products and innovations. On this measure, China lags behind the global average while other parts of Asia are in line with that average.
9. **Geography.** The key here is to be in markets that generate economic profit. Today, companies are more global than ever and often operate in more than one geography. Instead of average economic profit, the geo-score is calculated based on revenue by operating geography. A higher score is assigned to countries that generate more economic profit.
10. **Industry.** Which industry a firm operates in is an important attribute determining growth and profitability. Like companies, industries, too, can be top-performing or bottom-performing. The metric used is average growth in economic profit across all companies in each industry.

Acknowledgments

This paper is one of a series on the future of Asia, prepared in collaboration with the Asia offices of McKinsey & Company, which will all be available at mckinsey.com/featured-insights/future-of-asia.

The research was led by Oliver Tonby, McKinsey senior partner in Singapore, and chairman, McKinsey Asia; Chris Bradley, McKinsey senior partner in Sydney and leader of McKinsey's Strategy & Corporate Finance service line in Asia; Jonathan Woetzel, McKinsey senior partner and a director of the McKinsey Global Institute (MGI) in Shanghai; Wonsik Choi, McKinsey senior partner and managing partner, Korea, based in Seoul; Jeongmin Seong, MGI partner in Shanghai; and Ben Stretch, a McKinsey associate partner and leader in McKinsey's Strategy & Corporate Finance service line based in Sydney. We are indebted to MGI partners Anu Madgavkar and Sree Ramaswamy for their guidance and input. Patti Wang led the project team, which comprised Jan Bockstiegel, Lin Chen, Tiago Devesa, Jordi Lokanata, Lily Ma, Kelly McLeod and Raye Qin.

We thank our academic advisers who challenged our thinking and provided valuable guidance. We thank Rakesh Mohan, a senior fellow at the Jackson Institute for Global Affairs at Yale University and distinguished fellow at Brookings India; Gordon Orr, director emeritus and senior adviser to McKinsey; Andrew Sheng, distinguished fellow of the Asia Global Institute; and Matthew Slaughter, the Paul Danos Dean of the Tuck School of Business at Dartmouth College and the Earl C. Daum 1924 Professor of International Business.

We are grateful to many McKinsey colleagues who contributed their industry expertise and perspectives, namely Axel Baur, Giovanni Bruni, Kanmani Chockalingam, Jacob Dahl, Karel Eloot, Patrick Green, Anuj Gupta, Rahul Gupta, Daniel Hui, Vinayak HV, Franck Le Deu, Azam Mohammad, Fan Montgomery, Sathya Prathipati, Paul McNerney, Rohit Razdan, Joydeep Sengupta, Sheng Hong, Paul Sheng, Serina Tang, Bess Teng, Renny Thomas, Simon Wintels, Naomi Yamakawa, Fangning Zhang, Haimeng Zhang, and Daniel Zipser.

We thank MGI senior editor Janet Bush for producing this paper; Lauren Meling, MGI's digital editor; Cathy Gui, head of MGI external relations in Asia; and Kathryn Hanes and Kate Hegarty in McKinsey's Asia external relations team.

This paper contributes to MGI's mission to help business and policy leaders understand the forces transforming the global economy and prepare for the next wave of growth. As with all MGI research, this work is independent, reflects our own views, and has not been commissioned by any business, government, or other institution. We welcome your comments on the research at MGI@mckinsey.com.

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McKinsey Global Institute
May 2020
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