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Asian Issues Management Paper

Corporate performance in Asia

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Material for the Session

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Corporate performance in Asia

Asia – including Japan – looks set to be a major contributor to global performance for many MNCs over the next few years. Based on discussions with clients and research this AIM Paper briefly reviews:

- The performance goals that are being set for regional operations;
- Implementation of performance measures; and
- How Asian operations are tracking on performance goals in Q3 2003.

Asia's focus on global performance goals in 2004

Brief answers to some of the main questions raised in these three areas are:

Global performance goals will dominate in Asia in 2004 – the various factors that allowed some Asian operations to sidestep global performance goals over the last decade (post-Asia Crisis recovery, an undue focus on market share gain, etc) are being given much less weight.

Leading edge systems for performance management are being phased in – Although we have only carried out a small number of interviews so far (14), it was surprising the number of times our clients described current or recent moves to apply the latest performance management systems to Asian businesses. However, we also found examples of companies developing their own in-country performance systems that used many of the same criteria as the global systems from HQ without the support of global ERP systems.

Searching for performance gains through consolidation and outsourcing – One of Asia's great performance barriers is the difficulty of regional consolidation/ rationalisation due to Asia's tangle of tariff and investment barriers. MNCs are entering the 2004 expansion with a very strong commitment to on-going cost reduction and a slight aversion to investment in fixed assets. Companies expect to continue consolidating and rationalising opportunities where they can. Outsourcing is one area that is likely to do well as a result.

Asian performance could exceed expectations in 2004 – Companies are beginning to sense the opportunity for particularly strong performance in 2004 relative to current Asia plans and to performance in all other global regions. This applies as much to Asian firms as to foreign companies, which is why Asian stock markets have surged from Q1 '03 as global equity fund managers have bet on Asia's out-performance by end-2003 and in 2004.

… the exceptions allowed for new ventures will be fewer & shorter

The primary exception that we have noted so far is that Asia still has a relatively large proportion of MNCs in entry strategy mode where regional sales are still relatively small within total global sales. As expected, these firms initially set performance criteria that focus on business establishment goals at the expense of the various global benchmarks for return on capital. However, we expect that even these firms will be influenced by the much tighter focus on global performance goals set by established MNCs in Asia running significant businesses. Launching a new business in China in 1992, when it was widely assumed that very few foreign firms in the domestic market were profitable, is very different from 2003, when a range of indicators suggest some two thirds of foreign firms in China are profitable and around half are achieving their corporate performance goals.

FOUR THEMES

Reviewing the presentations, interviews and on-going discussions with clients, we can suggest four broad themes in corporate performance management in Asia at present. Our clients expect to continue working on these themes through the next few years.

1. Accountability

… a focus on the individual unit

… and individual executives

The most common theme shared by the large, well-established regional businesses that we interviewed, as well as the smaller and more recently established businesses is the continued devolution of accountability for performance to smaller business units as well as to individual executives. We do know that a few clients have managed to retain a single Asia reporting bottom line that gives the regional CEO a much freer hand in managing a portfolio of above and below par businesses. But we would estimated that this system, which was prevalent in the 1970s and 1980s, is followed by fewer than 10-20% of the MNCs in Asia today – and most of these would be regional start-up operations. One important factor in breaking down the old regional bottom line has been the spread of matrix management systems to Asia. For the majority of our clients, individual business units within countries - whether production, sales or support - are now the focal point for varied types of performance measurement. Moreover, coinciding with the downsizing/restructuring wave of the last six years, MNCs have taken the opportunity to directly link individual executive compensation to corporate performance goals. This applies right down to mid-level executives in country operations. This may do a lot to prevent a return of the over-investment that characterised the 1990-96 period in Asia, although China will be an interesting litmus test of whether the lessons have been learned.

2. Unrelenting cost focus

A common theme in many of the interviews is that firms have moved from a crisis-driven focus on cost reduction over the last six years to institutionalising cost reduction as a long-term corporate performance goal. This looks like being maintained over the next two years even as the region moves into a higher growth phase.

3. Market share focus

… looking for consolidation opportunities

Asia, in common with global markets, is still in a situation of excess capacity, whether that be widget making or some service areas such as banking. Coupled with a drive to institutionalise cost reduction there is a strong focus on lifting sales for existing facilities. As one manufacturing client put it the mindset has moved from an investment focus on Asia in the 1990s to a trading focus. Apart from sweating the assets this involves looking for market consolidation opportunities even though these have been slow in coming in Asia.

4. An above-plan focus for 2004

Here we are sticking our neck out as only a few clients have mentioned this so far, though we expect more to consider this option by year-end. By Q3 ’03 most companies had established their corporate performance goals for 2004. Yet demand trends by the end of Q3 are stronger than expected and this trend may well continue into 2004. As a result, a few clients have started considering easing head count restrictions in certain areas for 2004 as well as providing scope for opportunistic investments above the current plan. As highlighted in our September regional forecasting session, one risk that may be confronted in 2004 is that of much stronger than expected demand. Apart from supply and cost control problems there is also the risk of failing to pick up the money that is put on the table.

The relevant regional and global trends

During the interviews, clients noted a number of regional or global trends that are influencing the management of corporate performance in Asia. The most notable trends that are helping move the corporate performance goal posts in Asia are:

The advent of global IT-based performance management systems – a critical factor in the shifting of the performance goal posts in Asia has been the arrival of IT-based systems that enable real-time global corporate performance management. The brief case studies in the following pages touch on how some companies are implementing these systems. However, some of the smaller regional operations that we spoke to that lack access to benchmarking via a global ERP system appear to be making good performance gains by taking on EVA analysis as a discipline or benchmark for business decisions.

Greater public debate in Asia on corporate performance – this is being led by a handful of restructured Asian corporates, most notably Nissan (the poster boy for corporate restructuring and performance in Japan), and surveys of foreign MNC subsidiary performance in Asia, particularly in China, where reports suggest a sharp lift in the incidence of profitability for foreign firms. In Q3, regional press reports it is clearly the battle for profitability between a reformed Matsushita (with a 45% surge in net profit for the September quarter) and Sony (with a 25% decline in September quarter net profit and about to embark on a major restructuring).

A closer alignment on corporate performance goals between local and foreign firms – given the trends mentioned in this paper, we think it likely that the disparity in performance goals typically set by Western MNCs and Asian firms will narrow quickly in the next few years. Among other things this should speed market consolidation.

A health warning to our readers

Surveys of MNC corporate performance in Asia are very subjective and based on generalised statements. Few MNC operations in Asia are locally listed on exchanges so information on performance and goals is often closely guarded. In addition global financial and trade structures may mask performance of some country ventures (transfer pricing and related issues). We have attempted to avoid the challenges of comparative performance analysis by focusing the discussions with clients on their own evaluation of whether company goals were being achieved.

Setting performance goals in Asia

The issues examined in this section include:

- The extent to which Asia is allowed, for whatever reason, to be an exception to global performance benchmarks; and
- The extent to which the region is broken down into countries and functions for performance evaluation.

Factors that can typically affect performance of Asian operations

We have selected three brief case studies that illustrate typical positions for many of our clients. Several of the themes that stand out in terms of performance management in these three case studies are:

Asia's scale within global business – As might be expected where Asian business is small within global turnover (typically under 10%), performance tends to lag global standards. This is typical of start up operations in the region. By contrast, our clients with Asian sales exceeding 15% of global turnover tend to have better performance. The difficulty of consolidating/rationalising small country operations in Asia is one of the major barriers to improving performance.

Small market share positions – Also, as might be expected, firms with small market share positions in some countries face below average performance. This has led many of our clients to withdraw from some markets in Asia over the last five years and focus attention on a few high growth markets, like China, where they aim to build or hold strong market share positions.

Regional structure – A number of our clients with high performance Asian businesses have globalised management structures in Asia. This usually coincides with Asian turnover reaching a significant share of global turnover (over 15-20%). By contrast, clients working with country based performance systems tend to have a "mixed bag" of results across the region. Structure within countries also has a major impact on performance, an issue that will be picked up in the last section.

Company A: European personal care products

Intra-regional trade barriers can curb performance

Although sales in Asia have grown from 5% of global sales in 1995 to 10% today, the company is still very Euro-centric, with less than 5% of its product sourced from outside Europe and very little regional R&D except in Japan. At present, Asia is considered a "developing region" and delivers about half the global benchmark in EBIT and sales/headcount. Cross-border consolidation of businesses and regional integration has been limited so far, with country heads reporting back to the main board in Europe. The goal is to get Asia to global performance levels as quickly as possible with basic steps that most companies would use:

… the steps to moving to global performance levels

- *Prioritising key performance areas within each function on global KPIs.*
- *Ensuring that the global standard is clearly understood.*
- *Measuring to ensure the gap to global standards is narrowing.*
- *Ensuring that responsibility, accountability and autonomy are aligned with global performance goals rather than any temporary local goals.*

Company B: European auto components company

Market share also affects performance

While A/P has high sales growth, it is still under 10% of global sales. The high growth automotive markets like China and Thailand are very profitable and the company holds good market share positions in both. Both these markets, particularly China, are seen as key strategic growth opportunities. By contrast, profits are weak in Japan, a traditional key strategic market, because of high manufacturing costs and stiff competition, which has limited market share to 5%.

Good performance for bigger Asian ops with globalised structures

Company C: European food ingredients company

A/P accounts for 16-18% of global turnover and a higher proportion of profit. Asia is both a global supply centre, with more production being switched from Europe to Asia, and also is considered the main region for global sales *growth. Five years ago Asia was treated as a stand-alone region but today it is increasingly integrated into global operations. The region was also divided into 4-5 subregions but this division has faded. Some of the factors that have helped Asia become a global performance leader are:*

… focusing investment on HR and customers

- *Running leaner operations than other regions.*
- *Investment in new capacity is incremental and carefully aligned with sales growth.*
- *Strong investment in high quality staff.*
- *Better customer loyalty through a focus on adding value for customers.*
- *Circulating key staff in the region to spread knowledge.*

MNCs Vs Asian firms … a clash of goals in the 1990s

One of the great challenges of doing business in Asia for MNCs is that frequently local competitors have had radically different corporate performance goals. Apart from the problems of questionable accounting, this made benchmarking irrelevant and competitive strategies tricky. Western companies have typically sought a balance between market share gain and return on capital goals. Among the main variations in goals set by Asian firms over the last decade several stand out:

A sole focus on market share gains – South Korean and Japanese firms were famous for a single-minded focus on market share gains at the expense of profitability in the 1990s. Some Western firms also attempted this in Asia, most notably Pepsi, which acknowledges that its 27-year long expansion in China has yet to break even.

Asset plays – The boom in Asian stock markets from 1990 to the onset of the Asia Crisis in mid-1997 led many local firms, particularly in Southeast Asia, to abandon margin management in favour of simple asset plays.

No cost of capital strategies – Chinese state-owned enterprises exemplified this strategy by making non-repayment of bank loans a key component of business strategy (China is still coping with the glut of production capacity and surge in NPLs that this produced). Some Korean, Japanese and SE Asia firms also followed this path because of captive bank relationships (and their markets face similar NPL and asset/capacity glut problems as a result).

… with common goals from 2003?

The tantalising prospect exists of closer alignment between the performance goals of Asian and Western firms in Asia over the rest of this decade. Three factors are pushing Asian firms towards greater attention to return on capital:

- **Regulatory and corporate governance reforms** – not great so far but moving in the right direction;
- **A flood of offshore money back into Asian stock markets** seeking specific opportunities that reward firms with transparent accounts and profits from recurring business rather than asset plays; and
- **A handful of high profile case examples** of Asian firms shifting their strategic focus to return on capital.

Asian firms setting new performance benchmarks

Undoubtedly the most prominent example of an Asian firm refocusing corporate performance on return on capital is the turnaround achieved at Nissan under Carlos Ghosn, the CEO installed by strategic partner Renault (which took a 37% stake in 1999 and now holds 44%). The Nissan case example has dominated Japanese discussion of corporate performance management over the last two years.

The Nissan Revival Plan

After many years of mounting losses, Ghosn returned Nissan to strong growth in profitability within a remarkably short time (an initial profit of Y250bn in 2000; Y490bn in 2001; Y348bn in 1H '03). Although Renault sent 20 French managers to Nissan in 1999, including Ghosn (who was made CEO in 2001), a key advantage was that Nissan's own managers had already done much of the preliminary work on a revival strategy. The main components of the Nissan Revival Plan were:

***Internally driven** – no outside consultants were used. A top-level team of 200 Nissan managers, with the support of the 20 secondary Renault staff, carried out the planning and implementation.*

***Goal commitment and accountability** – the top management team committed to resign if the goals were not achieved.*

***Management clarity** – nine priority areas for action were established with some cross-functional teams being established to break down internal barriers to change. Management clarity and accountability standards were set.*

***Major cuts** – dramatic across the board cuts were made to restore profitability and the balance sheet, including by 2003:*

- *21,000 headcount cut*
- *Five plant closures*
- *Divesting non-core assets (mainly stakes in suppliers)*
- *Halving debt from Y1.4trn*
- *Cutting the board from 37 to 10*

***New products** – Again, relying on work already done by Nissan, the new management team focused on a handful of much-needed new designs and models to propel growth in sales, particularly in the US.*

Implementation of performance measures in Asia

In this section we briefly look at the diversity of approaches to lifting corporate performance in Asia. Large companies with global ERP systems have access to wonderful benchmarking opportunities for lifting performance in Asia. However, we also noted that smaller companies without such systems can achieve similar results with EVA systems that allow return on capital decisions (easily benchmarked globally) to guide local performance and investment decisions.

Rebuilding from the Asia Crisis

COMPANY D: GLOBAL BUILDING PRODUCTS FIRM IN SOUTHEAST ASIA

Like may of our clients in the last six years, this company faced a crisis for recently launched manufacturing operations in late 1997. Their industry sector quickly became awash with excess capacity and much of it remains six years later. Like other clients facing similar situations, the performance goals were constantly shifted over the last six years. In the first part of the recovery process the goals were country specific and were an exception to the parent's global performance goals:

… break even

… EBIT positive

… EVA positive

1. *Return to cash break even – the first 18 months after the crisis.*
2. *Return to profitability on EBIT – within two years.*
3. *Become EVA positive – the established global goal now set as the goal for Southeast Asian operations.*

Sweating the fixed assets

Although the EVA gap is not fully closed yet, setting this as a goal brought a sharp focus to efforts over the last few years to dramatically boost sales from the existing plant in Southeast Asia. As Asia is slow on industry consolidation, senior managers in this company have developed a strong trading focus, looking for new geographic markets and new product applications in areas not previously considered.

… while investing in non-fixed assets

Investment is being done where it is EVA positive, but interestingly, the investment is generally not in fixed assets. Recent investments have been in:

- *Long-term trading/marketing structures in new markets that can capture and hold market share without necessarily leading to new capacity investment in that market.*
- *Extra HR spending on upgrading staff.*

Institutionalising the search for leaner operations

Although major staff cuts were made in several waves over the last six years, the focus is still on becoming leaner, with a particular attention on cutting managerial headcount this year. The main steps in this process have included:

- *Eliminating unnecessary management processes and procedures.*

- *Increasing management span.*
- *Negotiating head count cuts with departmental heads.*
- *Monitoring of progress.*

The client notes that after 5-6 years of painful restructuring it is difficult to continually talk to the management team about the need for another round of improvements. This challenge is being handled by sending the message that the search for leaner and more productive systems is a permanent feature of business strategy.

The process for Company D (above) was very much one of HQ allowing a temporary exception from global performance benchmarks and then ensuring that the regional management team were putting in place a process to drive Asian operations back to global performance standards. The steps for delivering on this goal were largely left up to the regional management team. This is typical of quite a few of our clients. By contrast a smaller number of our clients, virtually always with major global MNCs, now rely on global ERP systems to guide performance management in Asia.

ERP systems

COMPANY E: GLOBAL LEADER IN SPECIFIC BUILDING PRODUCTS

This client has 80+ factories and 60+ sales operations worldwide. The three key components of global performance management are:

… providing an array of global benchmarks

- ***Measurement** – using the real time enterprise software that provides dozens of possible benchmarks for all operations updated monthly. There is complete global transparency on how every operating entity – including all those in Asia – is performing.*

… a basis for compensation

- ***Compensation** – 20-30% of gross salary is variable and based on agreed measures for the various sales or manufacturing operations.*

… and a move toward people skills metrics

- ***Productivity/personal performance** – people skills metrics are being developed with ratings for the various functions to enable identification of skills gaps.*

The enterprise system software provides a wide range of variables across financial, internal processes, marketing, HR and customer areas. You can, for example, drill down to benchmark - with appropriate graphics support - any of the 60+ sales operations according to the drivers. For example, in the area of demand growth the system breaks out demand from existing products, existing customers, pricing growth, new products, new customers, and new channels.

The basic goals remain EBIT and inventory turns

The short-term focus is the same as for most companies and gives priority to a few basics, such as:

- *Speed of delivery to customer.*
- *EBIT, return on capital employed, receivables mgt. (Asia lags a bit on EBIT)*

… plus HR

The new measures being introduced focus on the development and implementation of skills metrics to support HR development.

Aiming to improve asset utilisation

The long-term focus in Asia is about rapidly building volume and channels by boosting asset utilisation and also looking for market consolidation opportunities via:

- *Aggressive M&A strategy – buying local market leaders*
- *Bringing in sister company products*

… while getting closer to customers

The global performance focus over the next 12 months will focus on getting close to the customer. This suggests changes to the traditional distribution channels in favour of going direct to the customer.

Care needs to be taken in seeking performance via IT investment in Asia

While the performance of Company E's operations in Asia clearly benefits from a substantial global investment in IT, this does not automatically mean that there is a direct link between IT investment and performance in Asia. David Hovenden from A.T. Kearney noted that the strong correlation (70-80%) between IT spending and improved performance for banks in Australia was weaker when applied to Asian bank IT implementation projects (a correlation of 50-60%). A wide variety of factors appear to be at work including the smaller scale of Asian operations, lower labour costs, and poorer infrastructure (making IT connections between branches and ATMs difficult).

How well are Asian ops performing in Q3 2003?

By Q3 2003, a dramatic shift was underway in corporate HQ perceptions of performance parameters in Asia. This shift has a basis in both general reports on overall corporate performance in Asia as well as the reports of individual MNCs. Portfolio investors have anticipated the improved profitability of Asian operations since March, resulting in a surge in regional stock exchanges.

China – the story swings from losses to profits for foreign firms

During the 1990s the China market developed a reputation for unprofitable operations for nearly all MNCs. The problems where either market based (cut throat competition against local firms with no cost of capital etc), strategy based (over investment or too many commitments to manage), or regulatory and structural (poor JV partners). This has changed dramatically in the last year.

The shift in foreign company perceptions of profitability in China can partly be traced to a series of reports on profitability and/or performance:

By 1999 some 45% of China operations were profitable

1999 – a joint A.T. Kearney/EIU survey of 70 MNCs

While 52% reported that China operations had failed to reach performance goals, a surprising 45% indicated their operations were profitable and another 25% indicated operations had reached break-even.

… rising to 65-75% by 2003

2003 (October) – AMCHAM survey of 254 US firms in China

Four years later, AMCHAM in Beijing reported some 75% of surveyed firms were profitable, which included 10% that characterised their China operations as "very profitable". Moreover, 42% reported that China profit margins were higher than their worldwide profit margins in 2002. The strong lift in profitability was attributed to easier regulatory barriers and the ability of foreign firms to shed their local JV partners.

… helped by a move to 100% foreign ownership

2003 (October) JETRO survey of 1,330 Japanese firms in China

This survey found that 64.3% of firms were running at an operating profit with 11.2% at break even. Like the AMCHAM report, the JETRO study made a connection between structure and profitability by noting that since China's WTO entry, 75.5% of new Japanese ventures have been 100% foreign owned versus 48% for Japanese firms in 1999.

McKinsey's 2003 study

… suggests the steps to strong performance in China can be applied to alliances

McKinsey also released a study in 2003 of 31 MNCs in China with some 359 alliances that found 48% of the alliances were meeting financial and strategic expectations with another 18% exceeding those expectations. The report also noted that 68% of the alliances were characterised as profitable. Among the factors that accounted for the lift in profitability and performance, McKinsey identified two that are very much in accord with the comments made by clients in developing this AIM Paper:

Closely monitor financial and operational progress

- Set financial targets immediately.
- Require the same depth and range of performance reporting data as for operations in other countries.
- Schedule regular performance reviews.

Restructure alliances quickly if they need it

- While partnerships need time to develop, adjustments need to be made quickly if targets are not being met (ownership splits, capital contributions, board & management composition, assets, third-party contracts, operational targets).

