Deloitte CFO Signals Report

2023Q1

June 2023

Contents

About Deloitte CFO Signals

Deloitte CFO Signals is a quarterly global survey for investigating the thinking and actions of leading Chief Financial Officers (CFOs). We share the highlights of survey results with analysis from Deloitte Tohmatsu and publish the report as CFOs' Signals.

The survey consists of two sections: the "Survey on the Economic Environment," which is assessed globally in every edition, and the "Survey on Hot Topics," which varies for each country.

In Japan, it was conducted for the first time in August 2015, making this the 32nd edition. In the "Survey on the Economic Environment," we analyze chronological changes in CFOs' thinking as well as the latest forecast at the time of the survey. In addition to recurring questions, we also inquire about the involvement in portfolio management (the appropriate allocation of management resources), this time.

Surveys for this 2023Q1 edition were conducted in May 2023, and we were able to receive responses from 29 CFOs and finance and accounting executives.

Thank you for your cooperation.

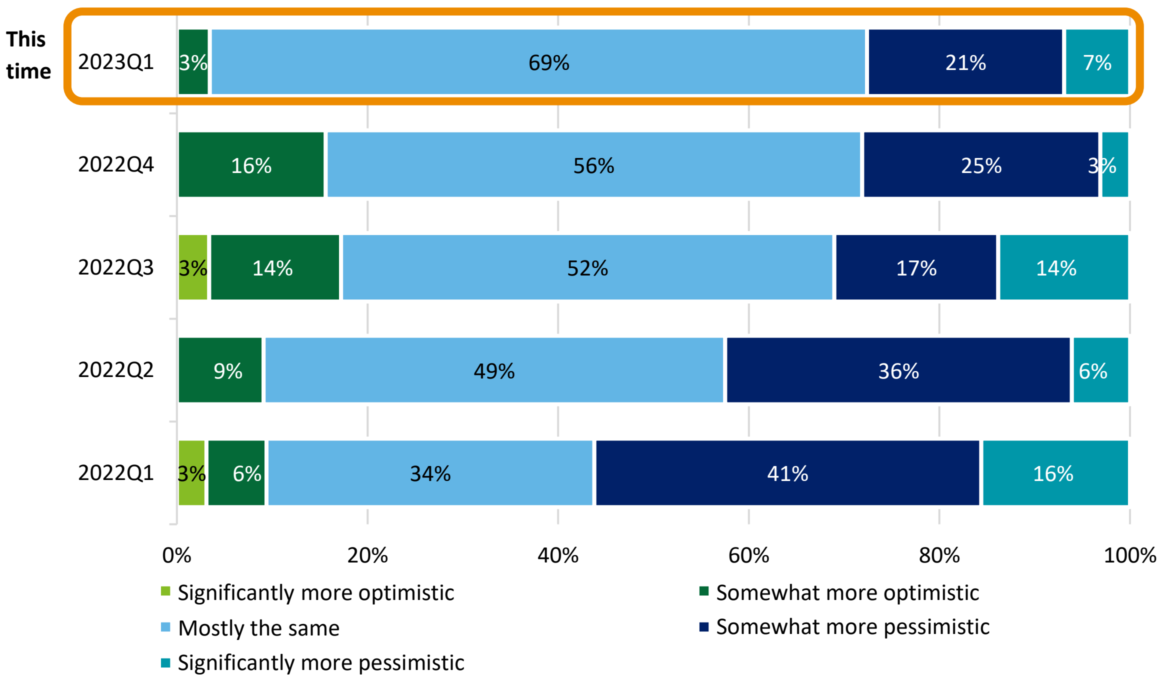
Deloitte Tohmatsu Group
The CFO Program
June 2023

Survey on the Economic Environment

Financial environment prospects

Financial prospects remain unchanged while assessing the global economy and its impact

Graph 1
Compared to three months ago, how do you feel about the financial prospects for your company? Choose the most appropriate answer.

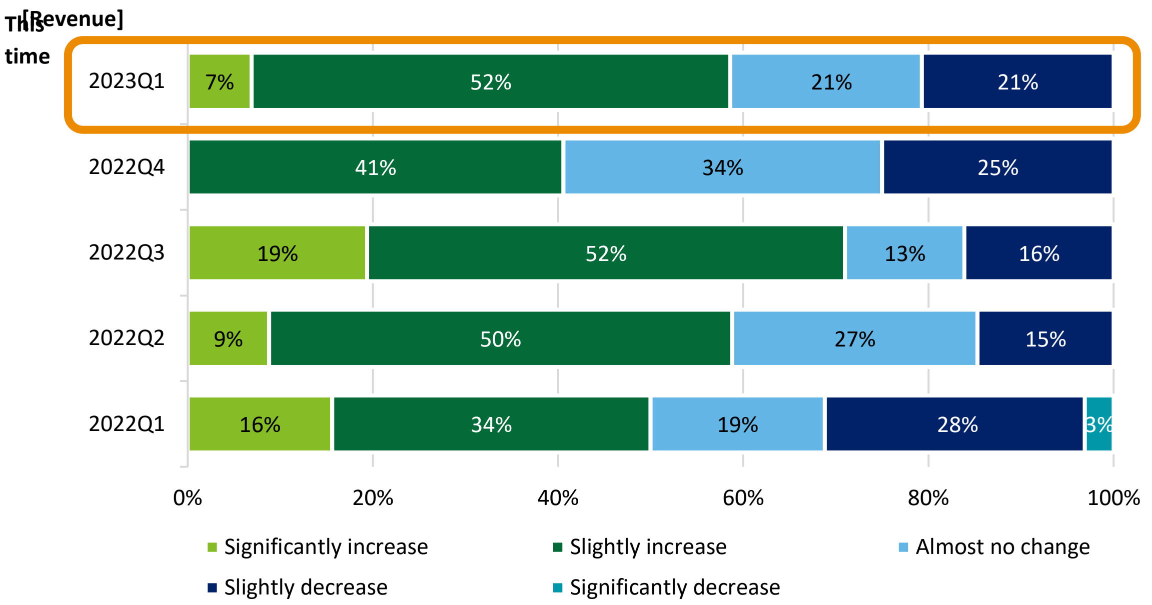


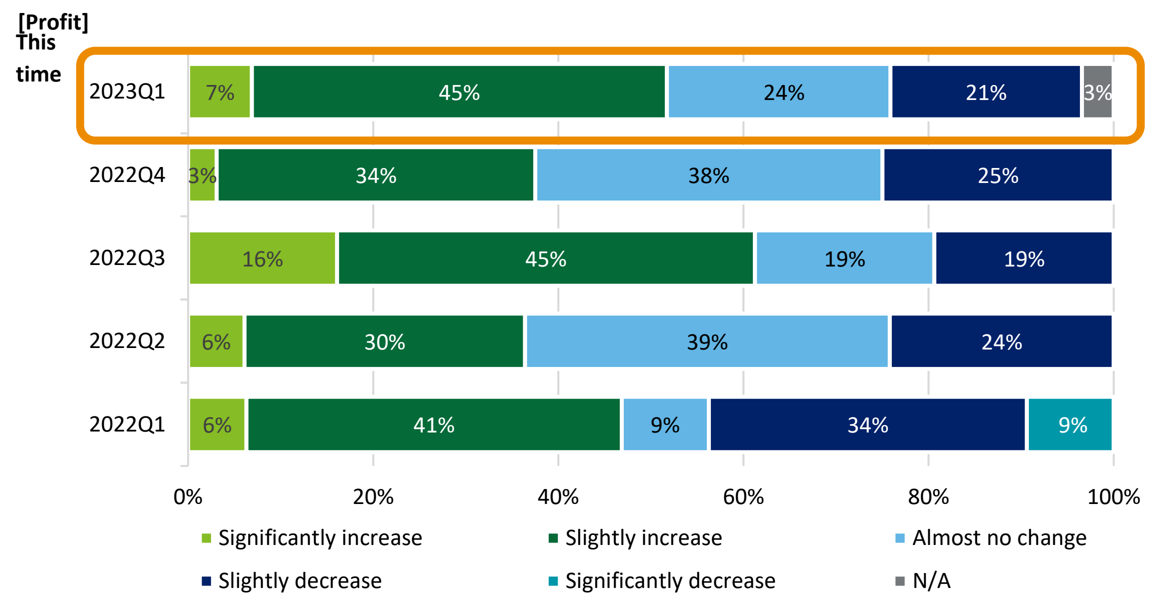
Graph 1 shows how the financial prospects of the respondents' businesses have changed over the last three months. Overall, the financial prospects of this 2023Q1 survey were unchanged from the previous survey - 69% of the respondents said that it was "Mostly the same," accounting for about two-thirds of the total. During the survey period of March to May, there were no major changes in the global economy and political situations affecting Japan's business situation. The financial uncertainty caused by the US banking bankruptcy in March receded and while the US and European Central Banks continued to raise interest rates, the economy generally followed a moderate expansionary trend. The severe Russia-Ukraine situation and the intensification of the US-China conflict continued, however, it was not to the extent that it would necessarily affect the financial prospects. The Japanese economy recovered steadily as the lifting of COVID-19 restrictions led to a resumption of economic activities and a solid expansion of the inbound demand, along with the trend of yen depreciation in the foreign exchange market. On the other hand, concerns about the deterioration of the Chinese economy and the stagnation of export due to the slowdown of overseas economies (e.g. China) is becoming a tough challenge for Japan's further growth. For CFOs, it can be said that this was a period to assess the changes in the economic environment, including the interest rate hikes in the US and Europe. The financial environment going forward will depend on how US and European interest rate hikes may affect inflation and the economy. Deloitte expects the US and European economies to enter a shallow recession in the latter half of the year, and if this may become true, the view of financial prospects among CFOs may also slightly deteriorate.

Business performance outlook

Revenue and profit outlook is improving, but sales slowdown and pressure on rising costs are likely to be strong

Graph 2
How do you expect your key operating metrics to change over the next 12 months? Choose the most appropriate answer.





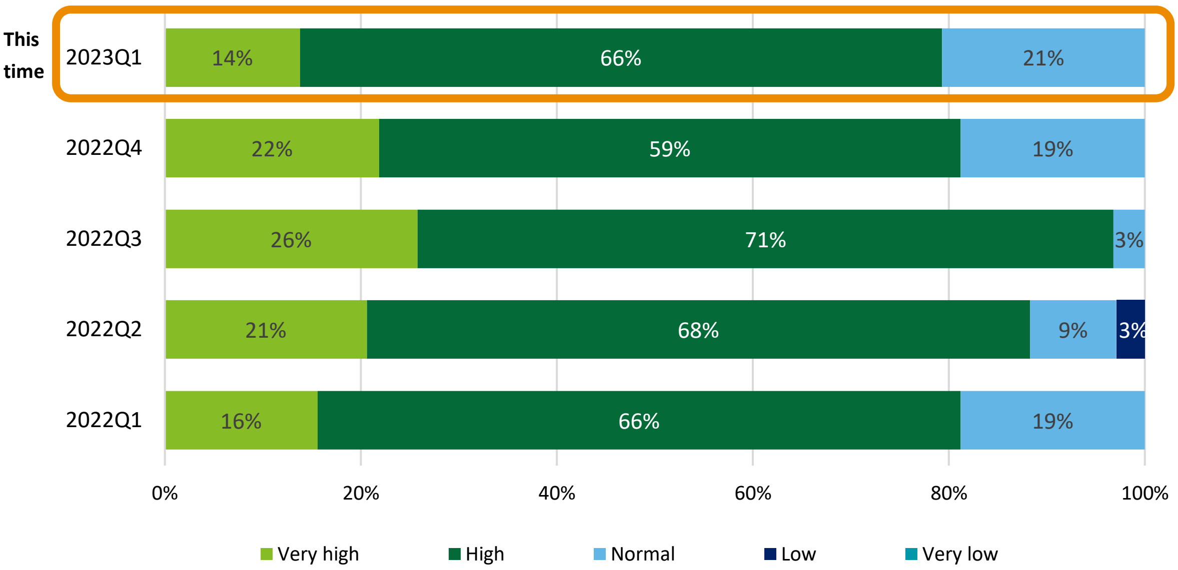
Graph 2 shows the CFOs' prospects for each company's financial performance (revenue and profit) for the coming year. This time, prospects for both revenue and profit improved from the previous survey. A total of 59% of respondents said that they expected the revenue to "Significantly increase" or "Slightly increase," showing a great increase from the previous 41%.

Likewise, 52% of respondents expected profit to increase, sharply up from 37% last time; both results exceeded the majority this time. It can be assumed that this improvement in the outlook is driven by the steady recovery in domestic economic activities and inbound consumption, as well as the fact that energy prices have begun to stabilize. On the other hand, the slump in export growth due to the global economic slowdown, concerns about the slowdown of the Chinese economy, and restrictions on transactions with Chinese companies due to the US-China conflict may be considered factors that suppress corporate profits. In addition, production costs including labor costs are still on the rise (as seen in the base salary increase at the annual labor talks), and without further increases in sales prices, corporate profits will shrink. It can be presumed that the revenue outlook will be unstable for the time being. According to government statistics, corporate revenue and profit increased and ordinary profit hit the highest ever in the 2022 calendar year, but the Bank of Japan’s TANKAN (Short-Term Economic Survey of Enterprises in Japan) survey in March indicated that sales growth is expected to slow down in FY2023 compared with the previous year, and ordinary profit is expected to decline.

Uncertainty

High level of uncertainty in both geopolitical risks and economic trends

Graph 3
How would you rate the level of financial and economic uncertainty faced by your business? Choose the most appropriate answer.

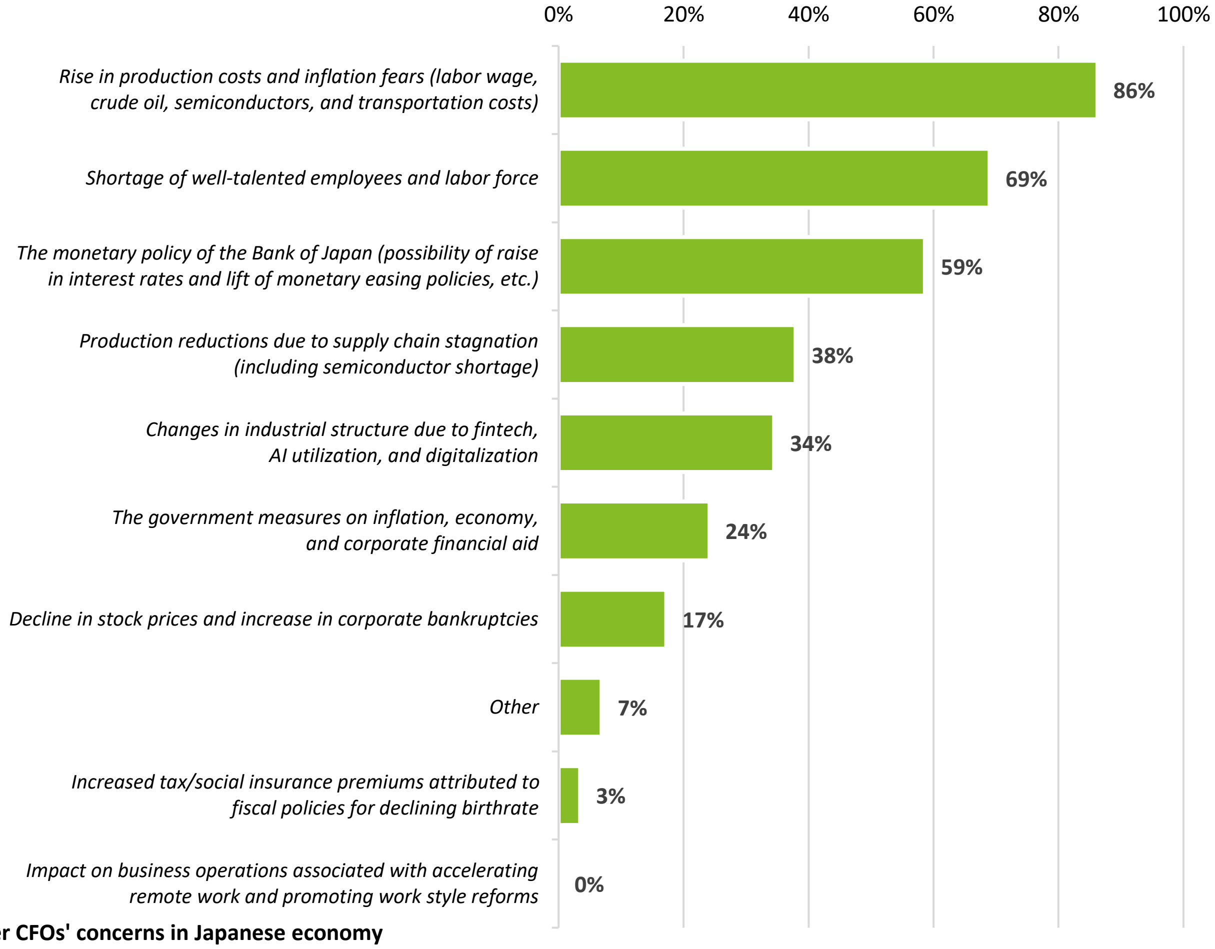


Graph 3 shows the CFO's perceptions of financial and economic uncertainty. The uncertainty from the CFOs' perception remains high, with a total of 80% of respondents describing uncertainty as "Very high" or "High." The result continues to mark over 80% since the 2022Q1 survey, for five consecutive quarters since the outbreak of the Russia-Ukraine situation. The end of the Russia-Ukraine situation still cannot be foreseen, and while the US-China conflict is intensifying, concerns about trade constraints and geopolitical risks remain high. From an economic perspective, there is a wide range of factors for uncertainty, such as deep-rooted concerns about the Chinese economic deterioration and the complicated views on the interest rate hikes by Western central banks and inflation. In particular, trade constraints associated with the US-China conflict and the concern for the Taiwan contingency will affect companies' geography-based strategies and supply chain strategies. It can be assumed that many companies are likely to consider and develop various scenarios that take into account economic security and geopolitical risks. Companies have probably realized once again the high level of uncertainty and its factors. Such a high level of uncertainty will remain to this extent as long as the international order continues to be in the realignment stage.

Key change factors in the Japanese economy

Inflation, talents, and monetary policy remain as key change factors, and AI likely to emerge

Graph 4
For the items below, please choose up to four possible changes affecting the Japanese economy that you believe need particular attention based on their likelihood and expected impact on business development prospects over the next one-year period.



Other CFOs' concerns in Japanese economy

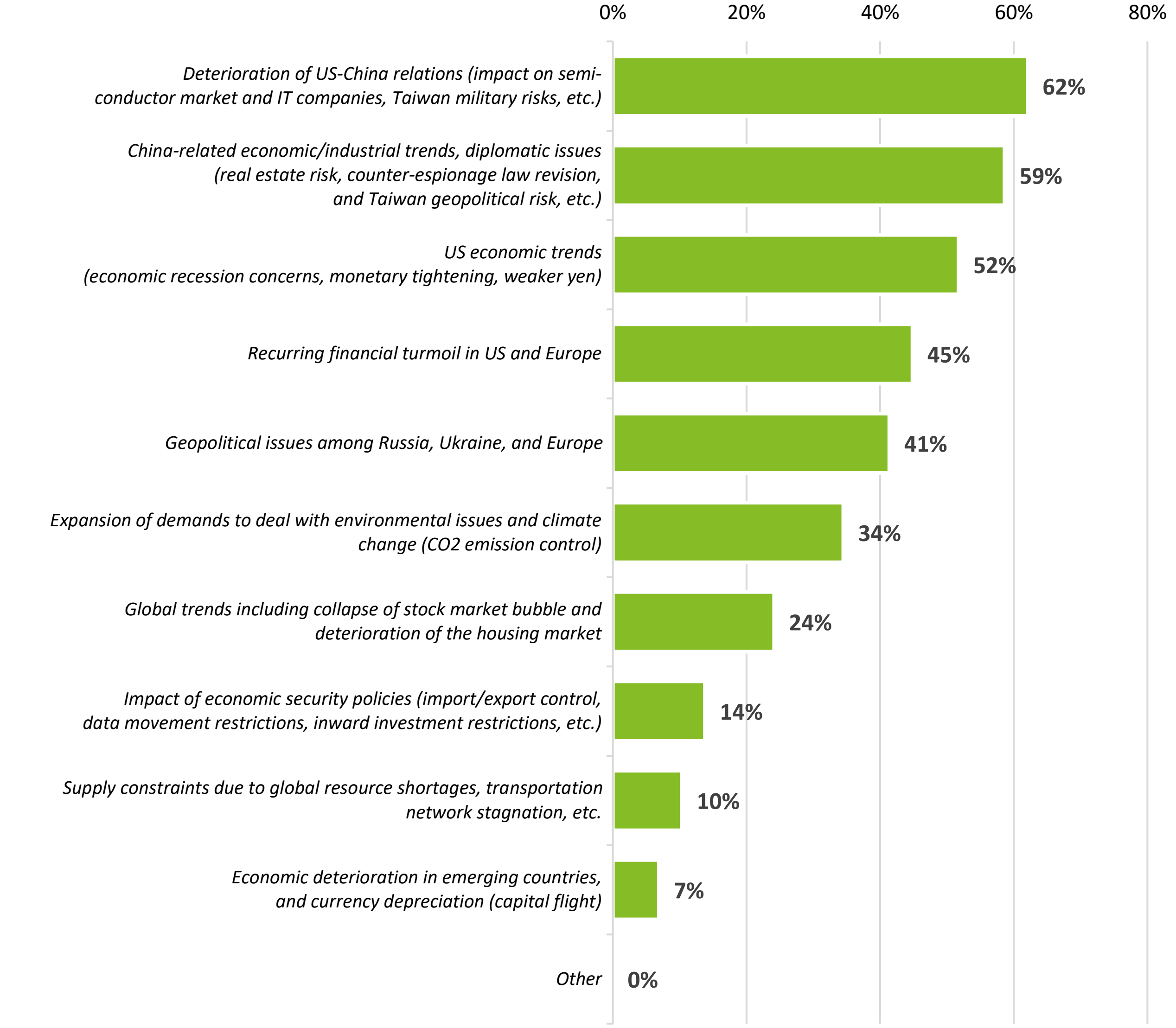
・Effects of tth dept ceiling issue　　・the FX rate is becoming a real challenge as importer

Graph 4 shows the key factors in the Japanese economy that CFOs will most closely watch when preparing business plans over the next year. The top key change factor was “Rise in production costs and inflation fears,” the second was “Shortage of well-talented employees and labor force,” and the third “The monetary policy of the Bank of Japan.” These top three key change factors were the same compared to the previous 2022Q4 survey. Although the global inflation rate has declined, it remains at a high level, and the rise in labor costs has become significant as seen in an agreement on the base salary increase at the annual labor talks. It can be said that the cost of production is still expected to rise, and companies are confronted to make accurate decisions about the extent and timing of increasing the selling price. Governor Ueda took office at the Bank of Japan in April and has so far indicated his intention to continue the monetary easing policy. However, due to the ongoing inflation and with receiving reviews of the monetary policy, there is still a possibility of shifting toward the normalization of the monetary policy. Japan started its zero-interest rate about 30 years ago, and Japanese companies have rarely experienced financial operations in an environment other than zero-interest rates. Regardless of the feasibility of raising Japanese yen interest rates, it can be said that companies should consider identifying the impact and prepare countermeasures, which could become a great risk factor that will affect corporate management. “Changes in industrial structure due to fintech, AI utilization, and digitalization” ranked fifth this time, but given the rapid and practical application of generative AI, there is a possibility that this will emerge as an important key change factor for companies going forward.

Key change factors in the global economy

US-China relations, the Chinese economy, and the US economy were the top key change factors, and concern about Russia-Ukraine conflict declined slightly

Graph 5
Please select up to four of the following risk events related to the international economy that you feel are noteworthy in terms of probability and impact on business development over the next one-year period.



Graph 5 shows what key factors in the global economy CFOs will most closely watch when preparing their business plans over the next year. Same as the previous survey, the first place was “Deterioration of US-China relations.” Coming in second place was “China-related economic/industrial trends,” and third “US economic trends,” both moving up from third and fourth places respectively. Meanwhile “Geopolitical issues among Russia, Ukraine, and Europe,” fell from second to fifth place this time. It can be said that the situation in Russia and Ukraine remains stagnant and is becoming a less concerning factor, while the US-China relationship, the Chinese economy, and US economic trends continue to be key change factors. The degree of US-China relations impact transactions and supply chain-related business with Chinese companies, and the Chinese economy is a great key factor, especially for exporters. The US economic trend can be said that it is one of the largest factors affecting the Japanese economy, to name some specific concerns such as the FRB's interest rate hike impact on the US economy and the possible recurrence of financial uncertainty. For the time being, it can be assumed that these trends will continue to be the major concerns for CFOs. In addition, although the rank has declined slightly, "Expansion of demands to deal with environmental issues and climate change," "Supply constraints due to global resource shortages" and "Impact of economic security policies" are also factors that will force companies to restructure their supply chains and review their strategies in the medium term, and may gain more attention in the future.

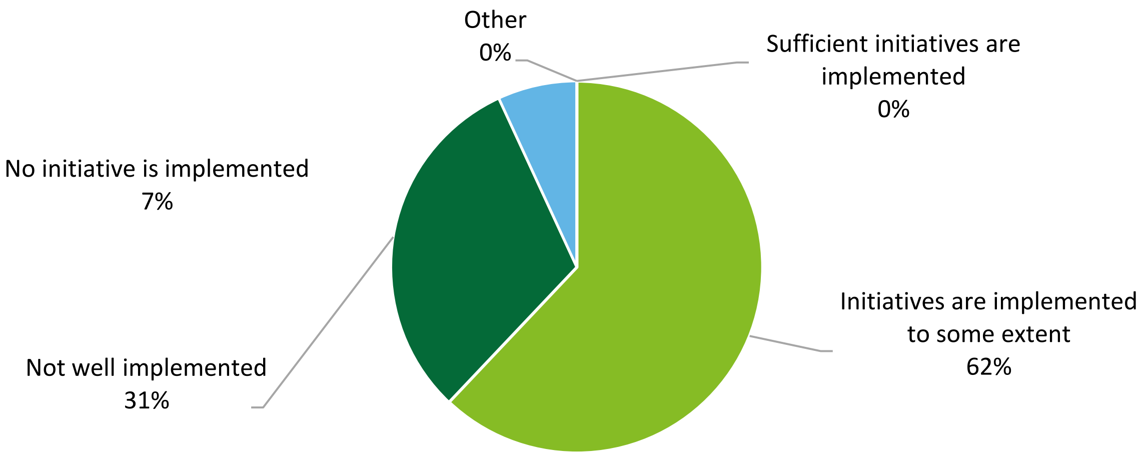
Survey on the Involvement in Portfolio Management
(The appropriate allocation of management resources)

In the latter section of this survey, we inquired about "involvement in portfolio management (the appropriate allocation of management resources)," which was the number one initiative that finance departments said they wanted to focus on in the future in the previous 2022Q4 survey.

The status of portfolio management initiatives

None responded as "Sufficient initiatives are implemented"

Graph 6
Please select the appropriate option regarding the status of your company's portfolio management initiatives.



Although more than half of the companies responded that "Initiatives are implemented to some extent," none answered that "Sufficient initiatives are implemented." It was a little surprising to see that more than half of the companies said "Initiatives are implemented to some extent", since it was shown in subsequent questions that there are areas with low maturity levels and also are facing challenges in securing enough talents.

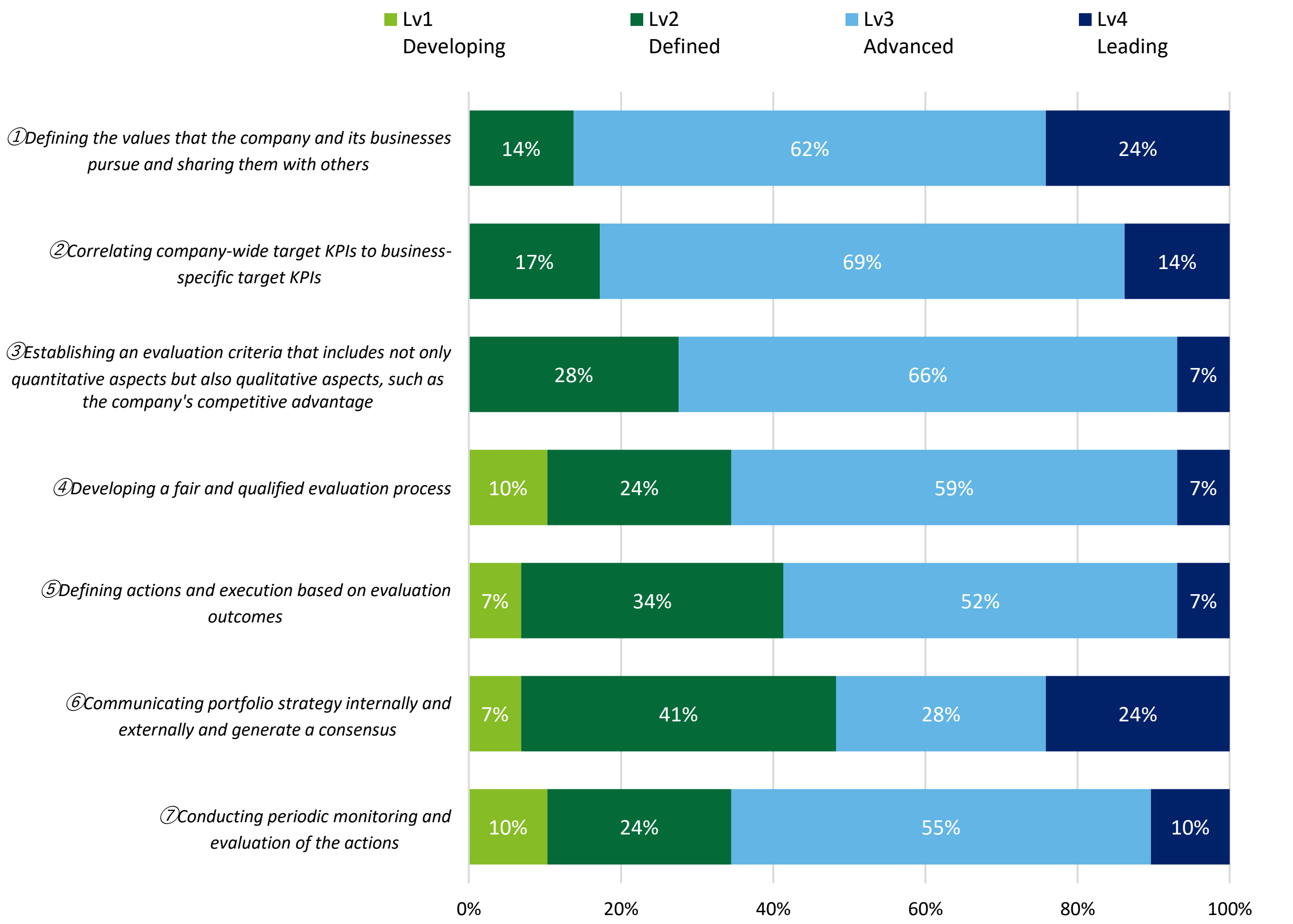
On the other hand, the zero respondents of "Sufficient initiatives are implemented" indicates that the current situation is not at a sufficient level and needs more brushing up in the portfolio management initiatives, even though many companies are working on the initiative as their company strategy. To conclude this, it can be inferred that there is room for further improvement in portfolio management if companies are eager to achieve a competitive advantage through portfolio management.

Maturity level of portfolio management processes

Many companies are able to define and share the values, but many are struggling in establishing evaluable criteria and definition of actions

Graph 7

Please select your current maturity level for each of the processes in portfolio management.



In terms of maturity level for each process, only a few CFO responded “Leading” for <u>(3) Establishing an evaluation criteria</u>, <u>(4) Developing an evaluation process,</u> and <u>(5) Defining actions and execution based on evaluation outcomes</u>. A cross-business evaluation is required in portfolio management, but this result indicates it is limited to individual business evaluations, and ensuring fairness in cross-business evaluations and reviews by subject-matter professionals has not been yet achieved.

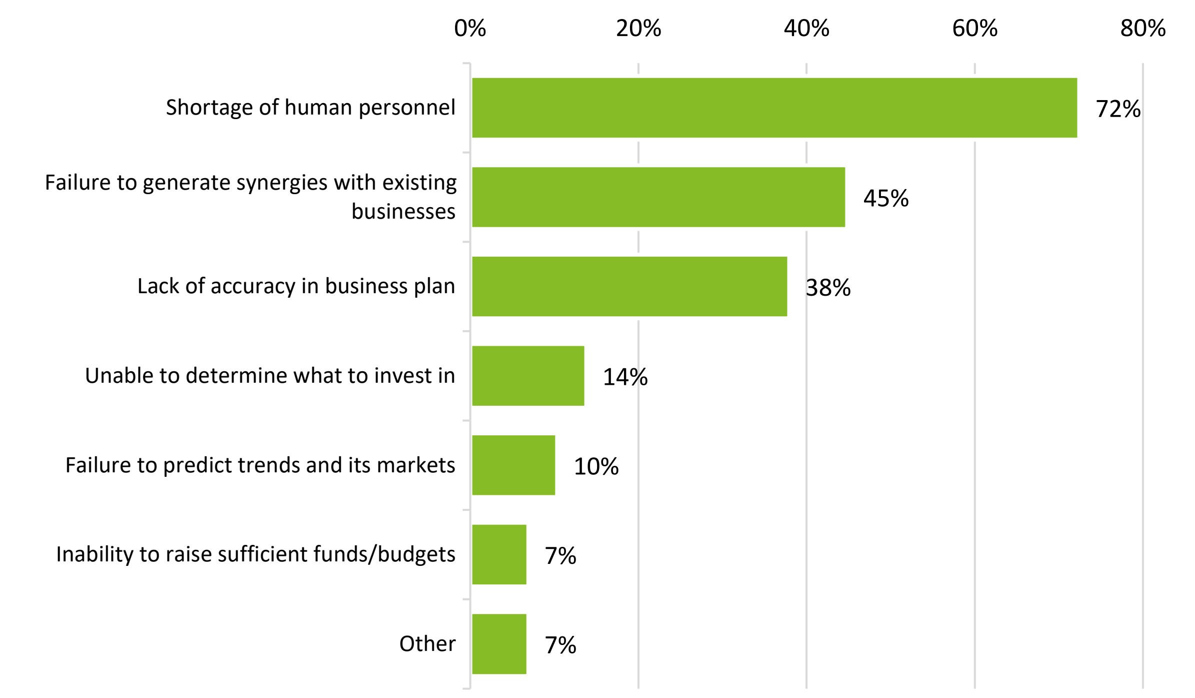
For <u>(6) Communicating portfolio strategy internally and externally and generate a consensus</u>, it shows a half split of CFOs responding “Developing/Defined” and “Advanced/Leading.” The total response for “Developing/Defined” was high compared to other processes, which many companies somewhat feel that there is a challenge, especially in external communications.

It can also be said that many companies feel that they are able to implement the upstream phase (1) and (2) in portfolio management, which are related to the corporate overall strategy and the value to be provided. However, for the execution phase of (3) and the latter processes, many companies feel that are not readily prepared.

Challenges in acquisitions and new business development

Shortage of human personnel is the top challenge in acquisitions and new business development

Graph 8
With regard to challenges in acquisitions and new business development, please select all that apply.



The number one challenge in acquisitions and new business development by far was "Shortage of human personnel." This can be inferred in both aspects – shortage of employees in quantity and also in qualitative aspects, such as lack of skills that are required to perform new types of tasks in this area. This can be said for both, corporate-side personnel to support the CFO in making and executing investment decisions in new businesses, and for the business-side personnel who can drive the new businesses.

Next, the challenge of "Failure to generate synergies with existing businesses" was raised. This is presumably due to insufficient action and monitoring of achieving the expected synergies. This can be seen to be related to the result in Graph 7 – a few companies answered that they are "Leading" in <u>(5) Defining actions and execution based on evaluation outcomes</u>, and <u>(7) Conducting periodic monitoring and evaluation of the actions.</u>

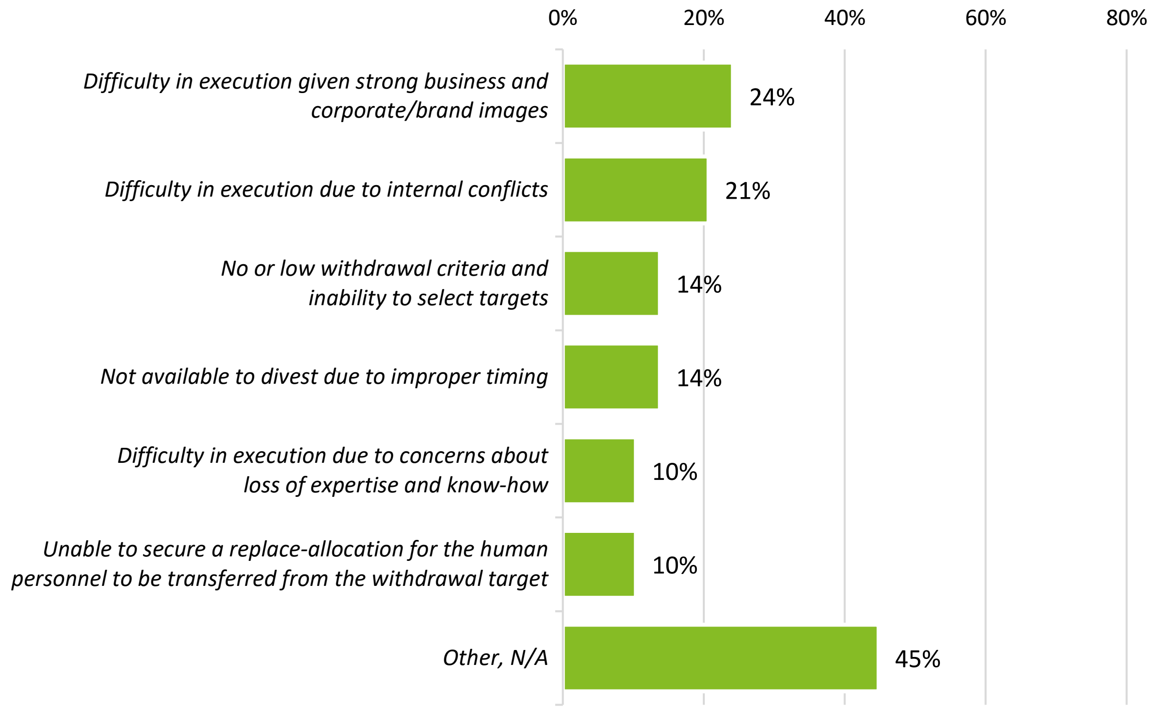
The same can be said for "Lack of accuracy in business plan," and the need to verify why the accuracy is low may be also a challenge. It can be inferred that there are companies that have put off post-investment monitoring although evaluations and reviews are done repeatedly until investments are made. Companies need to track the growth of businesses after the investment and not leave them unmonitored, review the outcomes compared to the original plan to improve the accuracy of the business plan for the next project.

Unexpectedly, “Failure to predict trends and its markets” marked low, but perhaps this was because this area was not as seen as being in the control of the CFO.

Challenges in divestiture and withdrawal of business

The results dispersed for challenges related to divestiture and withdrawal of business

Graph 9
With regard to challenges in divestiture and withdrawal of business, please select all that apply.



Other challenges in divestiture and withdrawal of business

- It takes time to build consensus wih partners
- Conflicts with clients who are related to the withdrawal business is a big hurdle
- Extreme labor protection laws (employees will not transfer)
- No specific target for divestiture and withdrawal

Nearly half of the companies answered “Other, N/A” for challenges related to divestiture and withdrawal of business. It is not clear whether this is because companies are well-skilled in this area and have no challenges, or whether there are not enough occasions to identify such challenges, but given the high level of uncertain environment, it can be assumed that CFOs will face more divestiture and withdrawal of business frequently. Even though there may not be any plans to divest or withdraw a business at the moment, it may be beneficial to identify what the challenges would be for the company in advance.

While the “Difficulty in execution given strong business and corporate/brand images” ranked first, it is evident that some companies, to a certain extent, have once considered withdrawing from a business that leads to the company’s brand image.

The next most common problems were "Inability to take action due to internal conflicts" and "Lack of thoroughness standards or low standards, making it impossible to select targets." To tackle these challenges, CFOs will need to establish a fair and appropriate evaluation process and define actions based on evaluation results, which can help improve internal - and external - persuasiveness and ensure its fairness.

Initiatives wanted to be implemented for portfolio management

The majority want to implement strategic planning and business portfolio selection from a long-term perspective

Graph 10
Please select initiatives you would like to implement as part of your portfolio management (multiple choice).

The highest initiatives that CFOs want to implement as part of portfolio management was "Strategic planning and business portfolio selection from a long-term perspective." The fact that more companies responded "Advanced/Leading" for <u>(1) Defining the values that the company and its businesses pursue and sharing them with others</u> than other options in Graph 7, which CFOs emphasize the importance of planning the path to be taken from a long-term perspective and considering the portfolio to achieve the goal.

It can be reasonably inferred that the challenges of shortage of human personnel, which was ranked first in Graph 8, contributed to the second place ranking of "Reallocation of human personnel, including reskilling". This is obvious that companies face the challenge of how to make effective utilization of human personnel, both in securing human personnel to support the CFO when investing in new businesses, and in reallocating personnel to the new portfolio after setting the investment.

In regard to "Assessing and judging businesses from multiple perspectives" and "Redefinition of revenue criteria for investment and withdrawal," the fact that few companies responded that they are “Leading” in (3) Establishing evaluation criteria and (4) Developing the evaluation process in Graph 7 may also be correlated.

Less than 30% of respondents answered that they would like to implement “Improved capabilities in Market Intelligence” and “Build a diversified governance structure” for portfolio management. Although this may be because these initiatives are not carried out solely under the CFO's control, these will become initiatives necessary for implementing portfolio management going forward.

To conclude this section…

In this 2023Q1 CFO Signals survey, we inquired about portfolio management, which was the number one initiative that finance departments said they want to focus on in the future based on the previous 2022Q4 survey regarding “Initiatives of Transforming the Finance Function”.

The results showed that although many companies have implemented initiatives for the upstream phase such as laying out the corporate overall strategy and setting the value to be provided, many of them also see that there is room for improvement in terms of “Developing a fair and qualified evaluation process,” “Defining actions and execution based on evaluation outcomes,” and “Communicating portfolio strategy internally and externally and generate a consensus,” which are required at the execution phase. It can be said that the key is to evaluate business portfolio management not only by profitability but also by how it aligns with the company’s vision and strategy. This requires fair evaluations and actions, and organizing the structure/system in each of these processes will be essential.

In addition, the challenge of “Shortage of human personnel” was also raised by many companies. The lack of resources is not only limited to portfolio management but is faced by many companies in various situations. Nevertheless, it will be necessary for companies to plan ahead in securing both corporate and business resources to invest in new businesses, and to work on reskilling/reallocating personnel after the new business is added to the portfolio.

It is assumed that many companies have not been able to take a step in divestiture and withdrawal of businesses yet, but given the highly uncertain environment, it may be valuable to identify their challenges in the early stage for preparing for it being a nearly-future possibility.

What is CFO Program?

The Deloitte Tohmatsu Group's CFO Program is a comprehensive program to revitalize the Japanese economy by supporting the CFOs of companies that it rests on and contributing to improving the capabilities of CFO organizations. As a Trusted Advisor, we bring together professionals from all walks of life to help CFOs solve challenges. In addition, we aim to improve the competitiveness of Japanese companies by providing the latest information, including global trends, and CFO-networking beyond corporate and industry boundaries.

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