Five priorities for corporate India in the next normal after COVID-19

The COVID-19 crisis has highlighted the weaknesses and the strengths of India’s large businesses. Now executives have an opportunity to make changes that will see their companies through the downturn and position them for long-term success.

by Rajat Dhawan
The coronavirus pandemic has had a serious effect on the lives and livelihoods of people in India. Daily counts of new confirmed COVID-19 cases and COVID-19 deaths have continued to rise, although lockdown measures imposed in late March helped slow the spread of the disease. As in other countries, these lockdown measures have curtailed economic activity and increased unemployment. McKinsey estimates that India’s GDP in the first quarter of the 2020–21 fiscal year could shrink by 20 percent, compared with the same quarter last year. The World Bank projects that full-year GDP will contract by more than 3 percent. India’s unemployment rate, which stood at 8.4 percent before the lockdown, rose to 27.1 percent in April.

The beginning of May saw the government cautiously lift certain restrictions so that some businesses could reopen. This helped bring the unemployment rate down to 24 percent by mid-May. And when McKinsey surveyed global executives on their economic views in early May, almost half of respondents in India said that they expect economic conditions in India to be substantially or moderately better in six months’ time.

Nevertheless, a sober, pragmatic outlook emerges from our discussions with dozens of CEOs and senior executives in recent weeks. Executives are planning for a prolonged economic downturn—and for an uncertain “next normal” that could follow an eventual recovery. They also observed that the COVID-19 crisis has brought new urgency to some of corporate India’s longstanding challenges, and that companies which act now to address these priorities could emerge stronger from the crisis. In this article, we offer a closer look at these priorities, which are as follows:

— making balance sheets and cost structures more resilient
— reshaping business portfolios for greater value creation
— embedding digital and analytics to transform legacy businesses and build new ones
— building greater safety, flexibility, and productivity into operations
— embracing systems thinking in corporate decisions

### Making balance sheets and cost structures more resilient

In conversations with promoters and CEOs of large businesses in India, one big challenge kept coming up: it has become risky to finance growth mostly with debt. McKinsey research published last year showed that 43 percent of India’s long-term debt is held by companies with an interest coverage ratio (earnings before interest and taxes over interest expense) of less than 1.5. At these levels, companies spend a predominant share of their earnings on debt service. The high cost of debt in India has something to do with this. Another factor is that large numbers of small and medium-size companies compete fiercely for profits in many industries, leaving each company with a smaller profit share that it can use to service debt or scale up operations.

Now the COVID-19 crisis has made debt financing even more difficult, by creating uncertainty about companies’ revenue prospects even as their costs remain the same. Many CEOs stated that the crisis has knocked their companies back to revenue levels of three to five years ago. The dual pressure of falling revenues and diminished ability to service debt has weakened corporate India’s balance sheets. These were shaky to begin with: non-performing loans held by India’s banks amounted to some 10 lakh crore Indian rupees ($130 billion) at the end of 2019. As a result, the quarters or even years ahead could see considerable deleveraging.

Executives told us that equity financing stands out as their best option. While financial investors are

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one potential source, promoters and boards are also searching for strategic investors with the know-how, scale, and global networks to expand India’s companies. Such investors will most likely be found outside India. Some $50 billion of foreign direct investment (FDI) equity flowed into India during the year that ended in March 2020, and several high-profile FDI investments have been announced in the past six weeks. Strategic partnerships to expand India’s large companies could shore up their balance sheets and sustain industry-level profitability by reducing the number of companies competing in the Indian market.

Whether these companies remain domestically focused or set their sights overseas, one thing is clear: many would benefit from shrinking their cost bases. The fixed costs of large Indian companies amount to 49 percent of their cost base on average across sectors. In service sectors the proportion can be as high as 60 to 70 percent; in manufacturing, it is around 20 to 30 percent (Exhibit 1). Leaders said that they have begun exploring ways to achieve a leaner fixed-cost model. Many said they plan to downsize by 30 to 40 percent and shift fixed costs to variable costs through outsourcing and the use of digital technologies (a topic we will explore further below).

Slimmer cost structures could lower companies’ breakeven levels (revenues required to cover fixed costs) by 30 percentage points, which would make them more resilient to demand shocks in the market. This is especially important for start-ups which are seeing their revenue streams evaporate.

**Reshaping business portfolios for greater value creation**

Corporate India, like the rest of corporate Asia, allocates much of its capital to sectors which lose value (those in which returns on invested capital are lower than the weighted average cost of capital). Of India’s $1.1 trillion of invested capital over the last decade, the lion’s share, 84 percent, is concentrated in three value-losing sectors: energy and materials (37 percent), domestic services (30 percent), and financial services (17 percent). Only 16 percent of invested capital went into value-creating sectors: knowledge-intensive sectors (IT, pharmaceuticals, medical products), consumer goods and services, and capital goods (Exhibit 2).

In every industry, the returns of value-creating and value-losing companies are spread widely apart, and the differential is growing. To put this

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**Exhibit 1**

**Large companies in India tend to have high fixed costs, which make them less resilient to demand shocks.**

<table>
<thead>
<tr>
<th>Fixed costs of large Indian companies, %</th>
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</thead>
<tbody>
<tr>
<td>Cross-sector average</td>
</tr>
<tr>
<td>Service sectors</td>
</tr>
<tr>
<td>Manufacturing</td>
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</tbody>
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Reducing fixed costs could lower companies’ breakeven levels by up to 30 percentage points.

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another way: the top companies in each sector are capturing a greater share of the available value, and the value-creating sectors are widening their lead over the value-losing ones. A key reason is that capacity utilization levels for Indian manufacturers had declined to a low rate of 65 to 70 percent before the COVID-19 crisis. The crisis itself could reduce capacity utilization even more.

One overall result of these developments is that the combined return on invested capital (ROIC) of the top 2,500 listed companies in India slid downward over the past decade, from 12 percent in 2008 to 8 percent in 2018. The executives we spoke with opined that the private investment cycle has been delayed by three years, and possibly more.

While it is too soon to say whether the COVID-19 crisis and the economic downturn will change the value-creation profile of corporate India, or by how much, Indian executives will continue to face the challenge of reallocating capital away from businesses and sectors that create less value and toward those that create more. The infrastructure sector holds particular promise: the government has announced plans to spend $1.4 trillion on infrastructure over the next five years. Agriculture and the associated rural economy, too, appear primed for rapid growth on the back of the reforms announced in May.

In general, the allocation of capital and resources toward value-creating sectors should be aided by the shift toward knowledge and innovation-led businesses with minimal capital requirements. These businesses, which include customer-facing digital ventures, health and wellness, insurance, renewables, and advanced mobility, are well positioned to capitalize on changing consumer preferences, regulatory shifts, and environmental imperatives.
Embedding digital and analytics to transform legacy businesses and build new ones

At the level of consumer activity, the COVID-19 pandemic has powerfully accelerated the uptake of digital technologies. Consumers in India have reported major increases in the use of digital and low-touch activities across categories like delivery services, at-home entertainment, education, food, staples, shopping, communications, health, and fitness. New and increased users of digital services in India also indicated high levels of intent to continue using digital services such as remote learning, digital payments, and curbside pickup of orders from stores.5

It’s clear that digital technology can generate enormous value. The McKinsey Global Institute estimated in 2019 that such technologies could create some $1 trillion of value in India alone. For example, equipping the IT-BPM industry with digital technologies such as artificial intelligence (AI), analytics, cloud, and cybersecurity could yield $205 billion to $250 billion of gross value added (GVA) in 2025, roughly twice the $115 billion achieved in 2017–18.6

Executives we spoke with pointed to opportunities for their companies, as well as small businesses and start-ups. Indeed, several expressed the view that the pandemic has come as a wake-up call to embrace advanced technologies. While there are countless potential applications, CEOs told us that they are especially interested in three domains.

First, they are keen to digitize sales and customer experiences in both the business-to-consumer context and the business-to-business context. This can help Indian companies meet increased customer engagement and satisfaction, while lowering the cost of sales by replacing in-person experiences with virtual ones. Over time, companies with strong digital channels can also cut back on physical locations, which further reduces overhead and insulates them from economic slowdowns. Across sectors, CEOs told us that they believe 60 to 100 percent of sales processes and tasks can be digitized.

Companies also hope to rapidly digitize their supply chains and manufacturing operations. New supply-chain technologies can deliver significant benefits: greater visibility, faster and better decision making, and more effective collaboration among workers.

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and between companies and their supply-chain partners. The adoption of contactless technologies, in particular, can mitigate the health risks associated with activities that otherwise require person-to-person interactions.

Last, executives see opportunities to create digitized ecosystems of customers and influencers. Both large companies and start-ups can establish digital platforms which serve multiple groups. Over time, such platforms can integrate an ever-widening range of technology and physical offerings in ways that address more customer needs.

Building greater safety, flexibility, and productivity into operations

India, like every other country touched by the pandemic, faces the immense challenge of bringing people back to work in a way that prevents a recurrence of the coronavirus outbreak. According to the executives we spoke with at large companies, restarting operations and then having to stop them if the spread of the virus picks up pace again could be as problematic, in certain respects, as not restarting operations at all in the near term. Executives worry that a continual start–stop cycle could define the remainder of 2020. As it is, with some workers having relocated, companies may have to run their plants with 50 to 70 percent of their usual workforce.

In some workplaces, such as factories and densely occupied service facilities, going back to work will mean implementing new safety measures across a wide range of activities, not just on-site operations. Recent McKinsey research on how hospitals and medical clinics, grocery stories, banks, and other essential businesses remained open during the COVID-19 outbreak points to useful practices for companies in any sector. These practices apply across pre-entry, travel to and from work, at work, in common spaces, and even post-infection. Implementing these protocols, in line with local rules and advisories, could go a long way toward providing greater safety at work.

Measures to protect worker health are especially important for India’s manufacturing companies, given the financial pressure that many will face to boost productivity, which all but requires bringing more workers into plants. Our research on the productivity of manufacturing sectors in India, China, and South Korea bears this out: China’s manufacturing industries rate as four times as productive (measured in terms of the ratio between GVA and number of employees) as India’s, and South Korea’s are nearly 16 times as productive. Gains in manufacturing productivity could allow India’s manufacturers to increase their production of goods for export, and to pursue contract-manufacturing opportunities in areas such as capital goods, automotive components, and pharmaceuticals.

Embracing systems thinking in corporate decisions

As CEOs and executives talked to us about India’s experience to date with COVID-19, they observed that their companies have become tightly connected with institutions around the world and with global flows of goods, information, and capital—yet they still have not factored the implications of system-level connectivity into their decisions. On the contrary, CEOs admitted that most of their recent decisions have sought to improve outcomes for certain stakeholders but have had unintended and adverse consequences for others.

For example, executives tell us they’ve realized how effective remote meetings, even for large groups, can be. This has prompted them to wonder about the adverse effects of frequent business travel for people’s lifestyles and for the environment. As another example, companies in India have sought to create people systems that reward employees for strong performance. One result of these systems has been that senior management reaps greater and greater rewards, while the gap between executive and worker pay widens each year, creating adverse social consequences. In other areas, the cost of inertia has been highlighted. Efforts to make workforces more diverse, and particularly to

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increase the representation of women, have brought about negligible improvements in part because companies are reluctant to disturb their seemingly efficient hiring, development, and advancement processes.

Now the coronavirus pandemic has jolted executives out of their customary ways of thinking and making decisions. CEOs told us they are seeing how responses to the crisis, both in India and worldwide, have required various stakeholders to act in unison, and sometimes to unify across sector or competitive lines. One aspect of the response is that central and state governments, municipal bodies, companies, nonprofit organizations, and innumerable individuals have come together to find ingenious solutions at the local level.

Now, executives we spoke with say they are inclined to broaden their decision-making envelopes and think about the system-level effects on stakeholders across three spheres: their organizations, their communities, and the global environment. Their hope is that accounting for systemic impacts in these three spheres can help them make decisions that advance the interests of their organizations as well as the wider public.

By causing unexpected shocks and by accelerating changes that were already unfolding, the COVID-19 crisis has spurred Indian executives to rethink their organizations’ processes and priorities. Their task now is to address perennial challenges that the crisis has made more urgent: to strengthen balance sheets, allocate resources to valuable uses, embrace digital technologies, make operations safer and more productive, and adopt systems thinking. Companies that do this can become healthier and more resilient, and more likely to persist through the downturn and thrive in the next normal.

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