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The committed innovator: A discussion with investor Kevin O’Leary

The star of entrepreneur competition *Shark Tank* explains where he sees innovation opportunities in the post-COVID-19 era

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In this episode of the *Inside the Strategy Room* podcast, Erik Roth, who leads McKinsey's work on innovation globally, interviews Kevin O'Leary as part of our ongoing series on innovation. The Canadian entrepreneur, best known as one of the investors featured on the American reality-TV series *Shark Tank*, shares his bets on innovation's next frontier. This is an edited transcript. For more conversations on the strategy issues that matter, subscribe to the series on Apple Podcasts or Google Play.

Erik Roth: Kevin, you have probably already seen more start-up ventures than most of us will see in a lifetime. What do you see new businesses struggling with the most right now and how are they responding?

Kevin O'Leary: Obviously, these are unprecedented times. A full economic shutdown puts tremendous stress on small businesses. If you take a company like Love Pop Cards, which is in my investment portfolio, half of its sales are in retail and, in a matter of 48 hours, it lost 50 percent of its business. Responding to that requires thinking out of the box, which is what you expect an entrepreneur to do. We were preparing to implement draconian cuts in salaries and then the Paycheck Protection Program (PPP) arrives. The bill essentially said that if you take a snapshot of your payroll on February 15 and another on June 30 and those numbers are the same or the June number is higher, the potential of having your government stimulus loan forgiven is very high.

I know the US will debate the merits of this bill for decades to come but this was an extraordinary opportunity. It was helicopter money from the sky. What it told us was we are not cutting anybody's salary, because we do not want to lose the chance of having the loan forgiven. But that money will not come for at least five to eight weeks, so how will we finance operations?

That's when America changed. We had to take out our largest expense, which was rent, so we called our landlord and said we would not pay them. That happened 50 million times all over America that weekend, and it put real-estate investment trusts [REITs] and private owners of real estate in a very difficult position. But these small companies were fighting to survive.

So, to come back to your question, I see a permanent impairment to retail space in the US, for two reasons. One, Love Pop Cards was able to replace all its retail sales by getting into the flower business because flower distribution centers were closed. They have been laser-cutting paper bouquets and selling them directly to customers. Secondly, now that we have been running the business remotely for months, we have decided we do not need all our office space, so we will reduce it by 30 percent.

Erik Roth: So there are dramatic shifts in business models. The irony in some cases is that businesses that started in fixed retail and added online as new channels now find their cost structures unbalanced. The margins are lower online than offline. They also face digital natives that know how to be very agile. How should companies adapt when their business models flip overnight?

Kevin O'Leary: Entrepreneurial companies have an ability to pivot in a way large companies cannot. Primarily, a large company doesn't have the same stress about its survival that a small company has. A start-up has to make its numbers, whatever it takes, and that leads to innovation that is the hallmark of entrepreneurs. I find large-cap companies fight this kind of innovation. I have done lots of joint ventures with large companies only to be disappointed that you can't get anything done at a table with 25 executives. They lost their DNA to pivot. But they have to learn to do it fast now because they have no choice.

This crisis has forced companies to rethink so many things. For example, I would never have implemented remote work at my companies. I would not trust the technology. I would not trust the time shifts. I wouldn't want to rock the boat. But I'm forced to do it now and I am seeing all kinds of opportunities to cut costs, primarily at the expense

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of landlords. I am hiring assistants in other countries at lower cost. I’m working 24 hours a day across multiple time zones. So I am an optimist, Erik. I think American business will come out of this with enhanced efficiency and learn to use technology in ways we would have never done before. I have bought more licenses from companies such as Zoom, Shopify, Microsoft, and Tencent than ever. My capital expenditures in technology have multiplied tenfold over the past three months. To me, that’s good stuff.

Erik Roth: Large companies are cutting costs. We are seeing it across every industry. But they are pulling back on some of the investments you refer to that could enable greater productivity and connectivity. How can companies become more agile and prepare for the next normal rather than just being caught up in what is in front of them today?

Kevin O’Leary: I would tell a large company, “Take advantage of this chaos. In chaos there is opportunity.” I would take this opportunity to steal customers from my competitors by doing everything I could to develop a direct relationship with customers because if you can build that trust, it is almost like a subscription service.

Large companies have been using two-tier distribution, in some cases three tier. Take wine for example: many of those retailers have shut down because they were also serving restaurants and they cannot afford the skinny margins as a result of three tiers of distribution. Then, all of a sudden, QVC starts shipping cases of wine—from the winery to the state right to the customer. QVC has become one of the largest purveyors of wine. Who saw that coming? They pivoted so quickly. There are thousands of examples like that. Large corporations that are not taking advantage of this chaos are poor managers. Tell me who they are. I will sell their stock.

Erik Roth: If we think about the large corporations that have pivoted, such as auto manufacturers pivoting to making ventilators, you could say, “If you can make ventilators, why not become a medical-device company?” That is a better market than cars today, so why not just continue to pivot? How can large companies get the confidence to make turns to new opportunity spaces and then apply their scale and resources to turn those opportunities into something great?

Kevin O’Leary: You have brought up something interesting. I have investments in the automotive and auto parts–manufacturing industry. In the US, we have learned that we cannot rely on foreign suppliers of healthcare products. Why would you not take half of your capacity and start making things in the US, Canada, and Mexico? The Canadian dollar has collapsed, so why would you not set up manufacturing there for US suppliers of masks and other personal-protection items? By the way, Love Pop Cards is now laser-cutting face masks for Mount Sinai Hospital in New York. Great leaders can go to their managers or their boards and convince them it is time to pivot. Those leaders will emerge from this crisis as stars. Those just sticking their heads in the sand will lose their jobs in about 18 months. I predict that will happen all over the S&P 500.

Erik Roth: Let's flip the argument and go from big to small. Unfortunately, one of the consequences of this crisis will be employment displacement. We could take this talent and, hopefully, some entrepreneurialism in the mix and turn it to creating new ventures that respond to the changes. The United States was born on invention and innovation. Could we unlock the next wave of innovation that way?

Kevin O'Leary: The big question to me is will there be enough innovation in this cycle to replace all the jobs that will be lost? I would argue that we will see many retail-clerk jobs lost permanently. At the same time, distribution centers that support direct sales to customers will grow. Think about a big-box retailer: if the customers now want to have products sent to them instead of going to the store, the retailer may cut half its retail space and turn the other half into a distribution center. I think we will see that all over America as a result of behavioral changes. That is not a bad thing. It's innovation.

But is that a perfect displacement, one to one? The analogy, to me, is what happened in the transition from print to digital publishing. When the Internet had just started, investors said, "If a dollar of print ads is worth a dollar on paper, it will be worth $1.20 online because you will reach more people easier and faster." That is not what happened. A dollar of print ads turned into one cent on the Internet because the distribution was ubiquitous and there was a ton of competition. Is that the transition we will have? At *Shark Tank*, we are looking at the applications being sent in and see people are interested in their health in a way they had never been before. It's not just about eating granola instead of hot dogs; it's "How can I live my life so I never even catch a cold? What have you got that can help me do that?"

Erik Roth: So it is not just the end of handshakes—social distancing will have some permanence and new businesses will help make that happen?

Kevin O'Leary: Yeah. I believe the population will emerge from this saying, "I want to live out the rest of my life a much healthier person." That will include not catching the next virus. Think of all products and services and modifications. Think about an airline. I want it to have UV lighting. I want the plane to automatically spray disinfectant that kills viruses. I do not want to sit beside anybody, and I'm willing to pay for that. Reconfigure that plane and show me a testing system at the airport that makes sure no one with a fever gets on board.

Erik Roth: Should we expect those solutions to come from future episodes of *Shark Tank* or from corporate America?

Kevin O'Leary: They will come from *Shark Tank* first because corporate America can never move as fast as an entrepreneur with a good idea. After that entrepreneur builds sales to $250 million, that firm will be bought by a big company. If you are a large company, maybe it's time to start thinking like an entrepreneur.

Erik Roth: In today's world, many businesses are rethinking how they operate and where their future might lie. If we look back at the financial crisis, many new companies and business models emerged. What big ideas are you seeing now?

Kevin O'Leary: I am a bit of a history buff and use examples of what occurred in like situations to determine what might happen going forward. In the case of innovation, the lifeblood of entrepreneurs is the ability to raise capital. In 2007 and 2008, the markets for growth capital dried up. Nobody would give anybody any money for a start-up that had any risk whatsoever. Out of that necessity came two platforms: Indiegogo and Kickstarter. And they became behemoths worldwide.

The same thing is happening now with a different category: crowdfunded equity. Instead of just funding inventory of a new product, you can raise equity capital through crowdfunding. This is partly the result of the government democratizing venture investing. A few years ago, US regulators said, "Why do only sophisticated venture capitalists get to invest in companies like Google or Uber? Why isn't the common man given a chance to buy into the next big disrupter?" The Jumpstart Our Business Startups (JOBS) Act was passed to provide for that. The idea is that you can list your company on a crowdfunding platform, and people—including your customers—can buy $50, $100, $1,000 worth of equity.

For years, no single platform had the critical mass of investors to attract deals. It's the chicken-or-egg problem. Then StartEngine comes along. Its founders said, "Why don't we try to get investors by bringing really good deals to the table first?" Now they have more than 200,000 investors and raise hundreds of millions of dollars. And it is not the only platform.

Erik Roth: That's a good example of a new business model emerging in response to a clear shift in the overall investor space. Should venture capitalists worry that their days are numbered?

Kevin O'Leary: One reason I took an equity position in StartEngine is that the one thing equity crowdfunding does that a typical venture capital firm can never do is sell equity to the business's customers. A typical VC takes a third of the company, has a five- to seven-year investment horizon, and puts all kinds of covenants on their equity, preferred shares, ratchets. With crowdfunding, you can create tens of thousands of investor/customers who are advocates for your company and have no timeline on their investment. Entrepreneurs can go to a VC and have a very concentrated investment, or they can go to their customers and offer them the opportunity to share their vision, share the ride, and become shareholders. Which one would they choose?

I bet you that five years out, equity crowdfunding will be a vicious competitor to private equity and venture capital because VCs and private-equity companies will never be able to provide that. You will see a rapid erosion of their place in the pecking order of capitalization. I am betting on it. I have invested in it. And I'm going play both sides of the fence.

Erik Roth: You mentioned earlier the impairment of real estate. Should owners of commercial real estate start thinking about new business models too?

Kevin O'Leary: I always try to be a realist about the impact of major changes on the investment thesis. The operator of the real-estate portfolio at one of the sovereign funds said to me, "We have done incredibly well over the past 22 years. And now we are going to give some back." I said, "That's it? There is no pivot? There is no optimism?" He said, "No. That is my answer."

And that is a realistic answer. Consider an AAA office tower in New York City or Boston, the best real-estate assets in the world, cap rates of 3 to 4 percent at the peak, only a year ago. The valuations

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were insane. So we come out of this crisis perhaps sometime next year and you have 7,000 people jammed in that Boston office tower. They will have to change how many people can go on an elevator. No one will want to touch the buttons. The office space will have to have small cubicles with special ventilation.

It's not the temporary health-driven impairment I am worried about. It's the fact that we allowed companies to go through a remarkable experiment that taught them that probably 20 percent of their employees never have to come back to the office. Technology will enable them to stay at home for all the reasons people may want to stay at home—raising children, taking care of parents, not wanting to commute—and they simply will not go back to those towers. I am not optimistic about real estate.

Erik Roth: So we possibly have two large opportunity platforms: reconfiguring people's homes to turn them into effective work spaces and repurposing maybe 25 to 50 percent of current top-end office space. What would that look like?

Kevin O'Leary: Traditionally, the repurposing was into condominiums, but if I can be one of the 20 percent of workers who don't have to come into the office, I'm not sure I want live in a tower when I can live outside the city and have a backyard. You have to think about the big picture. The capital expense to convert an office tower into condos is high, so you had better make sure the demand for condo living is there. Maybe it is not a permanent impairment, but this is an asset-allocation issue. I used to have almost a third of my net worth in real estate because it was stable, it appreciated at 5 to 7 percent a year, and it produced cash flow. I have reduced that to 8 percent, and I am going to wait.

There is another concern I have about long-duration assets—the thousand-pound gorilla in the room. When you helicopter $2 trillion into an economy in 11 months, and then perhaps another $2 trillion, remember that old-world concept called inflation? Maybe that will come back. You do not want to be in long-duration assets amid high inflation, and particularly not at a time when unemployment may be an issue. Just because real estate was great for the past 30 years does not mean it will be great for the next ten.

Erik Roth: Assuming something that worked in the past will be true in the future is probably one of the biggest mistakes we see in innovation. As you think about future entrepreneurs, what advice would you give them about how they should bring their businesses to life amid the current uncertainty?

Kevin O'Leary: There are tools we could be using more efficiently. As people sit at home, all around the world, captivated by streaming video, spending hours on social media or gaming, there has never been a better opportunity to speak to them. When we used to solicit our customers with direct-mail offers, our response rates were 2 percent. That constituted a great campaign. We have campaigns going on now at 15 to 17 percent response rates. People want to support products and services they like, brands they trust. That is unprecedented in my lifetime. So get hip to social media, get hip to a direct relationship with customers, and build a business.

Erik Roth: So even though we are physically distant, the digital tools keeping us closer could be the keys to unlocking the next wave of entrepreneurship?

Kevin O'Leary: I would be even more concrete. The genie is out of the bottle and we are never getting her back in. I bet you that when we come out of this, we will have gone from 16 percent of retail online to 25 percent—and it is never going to be lower.

Kevin O'Leary is a businessman and investor based in Toronto. **Erik Roth** is a McKinsey senior partner based in the Stamford, Connecticut, office.

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