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McKinsey on Investing is written by practitioners in McKinsey's global investor-focused practices, including those serving asset managers (private equity, real estate, infrastructure, traditional asset/wealth managers) and asset owners (pensions, SWFs, endowments, foundations, family offices).

To send comments or request copies, email us: Investing@McKinsey.com.

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Introduction

Welcome to the sixth volume of *McKinsey on Investing*, developed to share the best of our recent research and thinking relevant to investors. Colleagues from around the world and across several disciplines—including asset management, real estate, institutional investing, and private equity—collaborated to develop these insights. We hope this combination of perspectives will provoke reflection, dialogue, and prove an insightful guide to some of the best current practice in the investment industry.

We begin with a pair of timely articles focused on how investors can contribute to positive societal change. The first piece looks into the role of purpose for asset owners, and the opportunities for investment institutions to use their capital and capabilities to contribute to the communities they serve. The second examines the theme of diversity and inclusion, and the role private equity firms can play in mobilizing change. Given the events of last year, there is fresh urgency to both these issues.

We then offer four articles that explore some of investors' top priorities. These include an interview with Jean Salata setting out a 'playbook' for PE success in China and the results of our recent research on organizational health for institutional investors. Complementing these, we include a perspective on the lessons from the last downturn that are relevant to private equity, as well as an article analysing the perceived 'disconnect' between today's economic realities and the stock market's recent record level.

Next, four articles explore the implications of the pandemic—on the strategies of private equity firms and their portfolio companies, the priorities of institutional investors, the preparation for exits, and office and work life.

Finally, we are pleased to include three articles focused on investor portfolio companies. The first considers the essentials for CFOs in PE-owned portfolio companies to succeed. The second discusses the role of transparency in the management of portfolio companies. And the third looks at patterns of new investments in logistics startups.

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Purpose for asset owners: Climbing a taller mountain

In the wake of the pandemic, the world's long-term investors are reexamining their purpose.

by Duncan Kauffman, Bryce Klempner, and Bruce Simpson

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The world's pension funds, sovereign-wealth funds, and endowments are no strangers to purpose—they intentionally strive to create positive societal impact. After all, they have long been using purpose as a not-so-secret weapon to attract talent while competing with higher-paying private-sector investment managers. As one chief talent officer of a major asset owner put it, "We can't compete with Wall Street head-to-head on compensation, but we can emphasize the mission of the work we do: helping millions of our fellow citizens save for their retirements. That's pretty meaningful." Nevertheless, amid the pandemic, many institutions are redefining, or simply sharpening, their emphasis on purpose, with promising implications for their constituents and the societies in which they operate.

Experienced climbers

For asset owners, purpose begins with their *mandate*, one that many owners have taken great care to define. The mandate informs all strategic choices an asset owner makes, so many CEOs and chief investment officers (CIOs) are careful to align their top teams and board. For example, the website for the Ontario Teachers' Pension Plan states, "Our name captures our purpose: to secure the future for Ontario's teachers." The Abu Dhabi Investment Authority describes its purpose as ". . . to secure and maintain the future welfare of the Emirate." And the Yale Investments Office "seeks to provide high inflation-adjusted returns to support the current and future needs of the university."

These purpose statements typically share a common concept: asset owners commit to investing the capital they have been entrusted to preserve, by enhancing the long-term purchasing power of their beneficiaries. This purpose is noble; it is focused on *helping others*—and, in many cases, doing so on a large scale, for millions of beneficiaries or even an entire nation. It aims to help others by *enhancing their autonomy*. And it is typically cast as helping to orient institutions toward the *long term*—a horizon in which all stakeholders' interests tend to converge.

The power of these three dimensions of purpose has afforded asset owners comfort (and perhaps competitive advantage) in their distinctive purpose vis-à-vis other investment firms and financial institutions.

Many asset-owner executives may thus feel justifiably proud of their progress on organizational purpose. Yet increasingly, partly impelled by the global health crisis and partly by other societal forces, several asset owners are mulling an even taller mountain: using their capital, capabilities, and influence to contribute to the economic and social recovery of the communities in which they operate, so that they can deliver positive social impact beyond what they currently achieve.

Why do more?

Like many industries with a noble purpose, asset owners have a long history of harnessing some of the advantages that come from a strong shared sense of purpose—in talent (recruitment, retention, motivation, productivity), external engagement (policy and regulatory freedom), and risk management (in their own organizations and portfolios). Yet there are three reasons why asset owners are increasingly seeking to do more.

First, expectations for asset owners are evolving rapidly among stakeholders and society at large. In the face of the economic volatility wrought by the pandemic, for example, policy makers and citizens alike are searching for levers to kick-start economic activity. That involves asking more of those that are able, since the pandemic has exacerbated inequality. Asset owners, therefore—who collectively control more than $20 trillion in assets—are increasingly expected to provide positive societal impact, especially given their considerable (direct and indirect) influence on companies' conduct globally and their close relationship to governments and public stakeholders. During the pandemic, some institutions have begun receiving more requests along these lines, with speculation that asset owners may be asked to prop up companies of social or political significance through equity injections—hardly an appealing prospect for these institutions, which guard their decision-making independence fiercely. A proactive approach may be the surest way to navigate this fluid situation.

Second, engaging employees and other stakeholders on spirited discussions of purpose tend to increase feelings of organizational connectedness, engagement, and loyalty. Infusing purpose is essential for developing and maintaining an engaged workforce, as well as for providing a powerful motivator for those (especially millennials) who seek "more than a paycheck."[1] Across institutions, employees who feel that meaning is clearly articulated, aligned with top-management behaviors, and embedded into daily decision making are up to four times more engaged and three times more excited about work. This is particularly relevant for asset owners, many of whom are internalizing their investment programs by hiring and retaining top talent from a scarce pool—and more often than not competing against private-sector employers that are able to offer higher compensation.

Third, there is emerging evidence that investors can "do well by doing good." Rather than trading high returns for social impact, as is commonly assumed, strategies designed to deliver positive social impact may be performance-neutral or even deliver higher risk-adjusted returns. Asset owners' collective size affords them a built-in incentive to strive for broad-based improvements in the economies and societies in which they invest. As Hiromichi Mizuno, former CIO of Japan's Government Pension Investment Fund, noted: "Our portfolio performance, particularly long term, is actually the product of what happens in the global economy. So we just need to make sure that the global economy and global capital market remain sustainable." Asset owners' efforts to contribute to society can thereby support their ability to deliver returns.

Therefore, failing to set ambitious aspirations for their purpose carries a substantial risk for asset owners—the lost opportunity to help tackle some of our societies' greatest challenges, with attendant consequences for the fulfilment of their formal purpose.

How to decide what more to do

Purpose is a journey for all organizations, one in which the destination should not be predictable or generic. Positive societal impact can manifest in a multitude of ways, and asset owners enjoy great versatility and flexibility in their choice of where to channel their power. In our experience, there are several commonalities among institutions most satisfied with their progress to date.

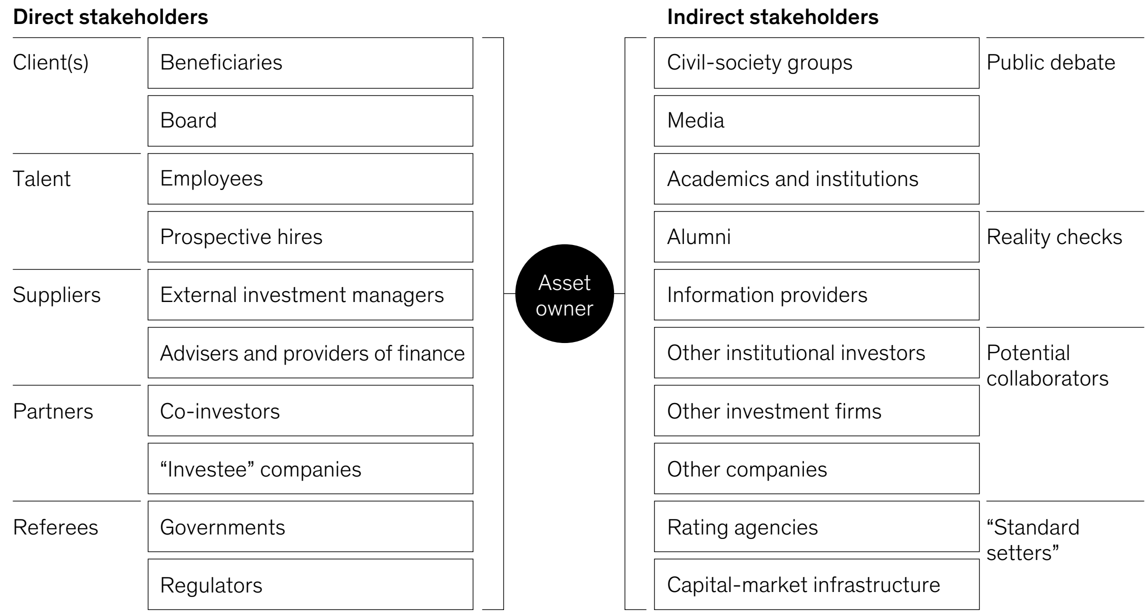
[1] Naina Dhingra, Jonathan Emmett, Andrew Samo, and Bill Schaninger, "Igniting individual purpose in times of crisis," *McKinsey Quarterly*, August 2020, McKinsey.com.

Purpose is a journey for all organizations, one in which the destination should not be predictable or generic.

Exhibit

Asset owners have many stakeholders.

Stakeholder map—both direct and indirect



Source: McKinsey analysis

First, they listen so that they can surface and explore expectations. They identify relevant stakeholders (exhibit) and seek out input on what positive societal impact the institution could and should create. This process is intimidating, precisely because many of these stakeholders have traditionally joined with the institutions themselves in framing purpose narrowly, and in variations on the theme of “delivering returns.” Skillful moderation is important to draw out nuanced perspectives. For example, asking stakeholders what they think *others* expect—or what *society at large* expects—can sometimes be more fruitful than asking what they *themselves* expect.

Second, satisfied institutions reflect on ways to use their strengths, particularly the subset that is unique or differentiating. Large asset owners can command billions of dollars in financial capital and an arsenal of talented human capital, and tap into a reservoir of social capital in the form of influence among the companies and societies in which they invest. Together, these hallmarks distinguish asset owners and can form the basis for collective action on important issues such as corporate governance, diversity and inclusion, and climate change. Witness the creation of FCLTGlobal to encourage long-term orientation among companies and, more recently, the Investor Leadership Network to pursue concrete sustainability initiatives.

The most potent capabilities are often the rarest. This may pertain to the specific source of an institution’s assets (for example, its beneficiaries). Asset owners should therefore ask, “What makes us different, and what does that mean for the

Successful leaders neither settle for generic or vague articulations of purpose, nor do they allow debate about their organizational purpose to drift indefinitely.

societal contribution we can make?" Sovereign-wealth funds can naturally ask, "What more can we do for the country?" University endowments might ask, "How else can we contribute to learning—on our campus and beyond?" For example, the Yale Investments Office spurred a seismic shift in institutional investing, beyond its contribution to the university's capital works and operating budget, by popularizing the use of illiquid asset classes among asset owners; in doing so, it changed the way asset owners undertake portfolio construction.[2] Pension funds, many of which have a membership base with a shared affinity (such as a profession or a place of residence), might ask, "How can we help our members beyond being good stewards of their capital?"

For example, Cbus is Australia's primary superannuation fund for workers in the building and construction industries. Its wholly owned subsidiary, Cbus Property, is dedicated to making direct investments in Australian properties, which in turn create jobs and shape conditions in the building and construction industry. That helps members not only in the long term, by contributing to the portfolio's risk/return characteristics, but also more immediately, by mobilizing capital for tangible impact. Similarly, Aware Super, which has its origins as the superannuation fund for nurses in the Australian state of New South Wales, is active in investing in healthcare infrastructure, such as regional hospitals. In this way, these institutions fulfill their purpose of helping their members—not only in retirement but also during their working lives—by investing in the industries in which they work.

Third, institutions strong on purpose tend to synthesize expectations and strengths to craft a purpose statement that is specific, authentic, and consequential. In other words, they determine their "institutional genius." That involves integrating a cacophony of opinions, during a process that can (and should) feel contested and uncertain. Successful leaders neither settle for generic or vague articulations of purpose, nor do they allow debate about their organizational purpose to drift indefinitely. Instead, they lay out a structured process, build consensus, and drive toward a landing. More important, they embed the resulting purpose into the "5Ps" of the institution's DNA: portfolio strategy, people and culture, processes and systems, performance metrics, and positions in external engagement. For instance, on portfolio strategy, some institutions have elected not to invest in certain sectors deemed inconsistent with their purpose. Asset owners might amplify their impact further by challenging their investee companies to declare a corporate purpose, and to embed it with specific metrics and targets. The International Integrated Reporting Council (IIRC) seeks to help companies report a holistic view of their overall impact, beyond traditional financial statements.

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[2] David F. Swensen, *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment*, first edition, Glencoe, IL: Free Press, 2000.

Its forthcoming merger with the Sustainability Accounting Standards Board (SASB) aims to simplify the challenges companies face in this regard.

Successful integration of purpose into the organizational DNA is ultimately what distinguishes institutional purpose from corporate social responsibility (CSR): it should be the "golden thread" that pervades the institution, not a sideshow—no matter how worthy.

Initiating a discussion about purpose can feel uncomfortable. It can elicit nervousness, cynicism, or even hostility, particularly among organizations with a well-honed sense of their mandate. As a result, many asset owners risk pigeonholing discussions of purpose as CSR or dismissing them outright. To do so may miss a great opportunity—to have transformational societal impact—which many would agree may be needed now more than ever.

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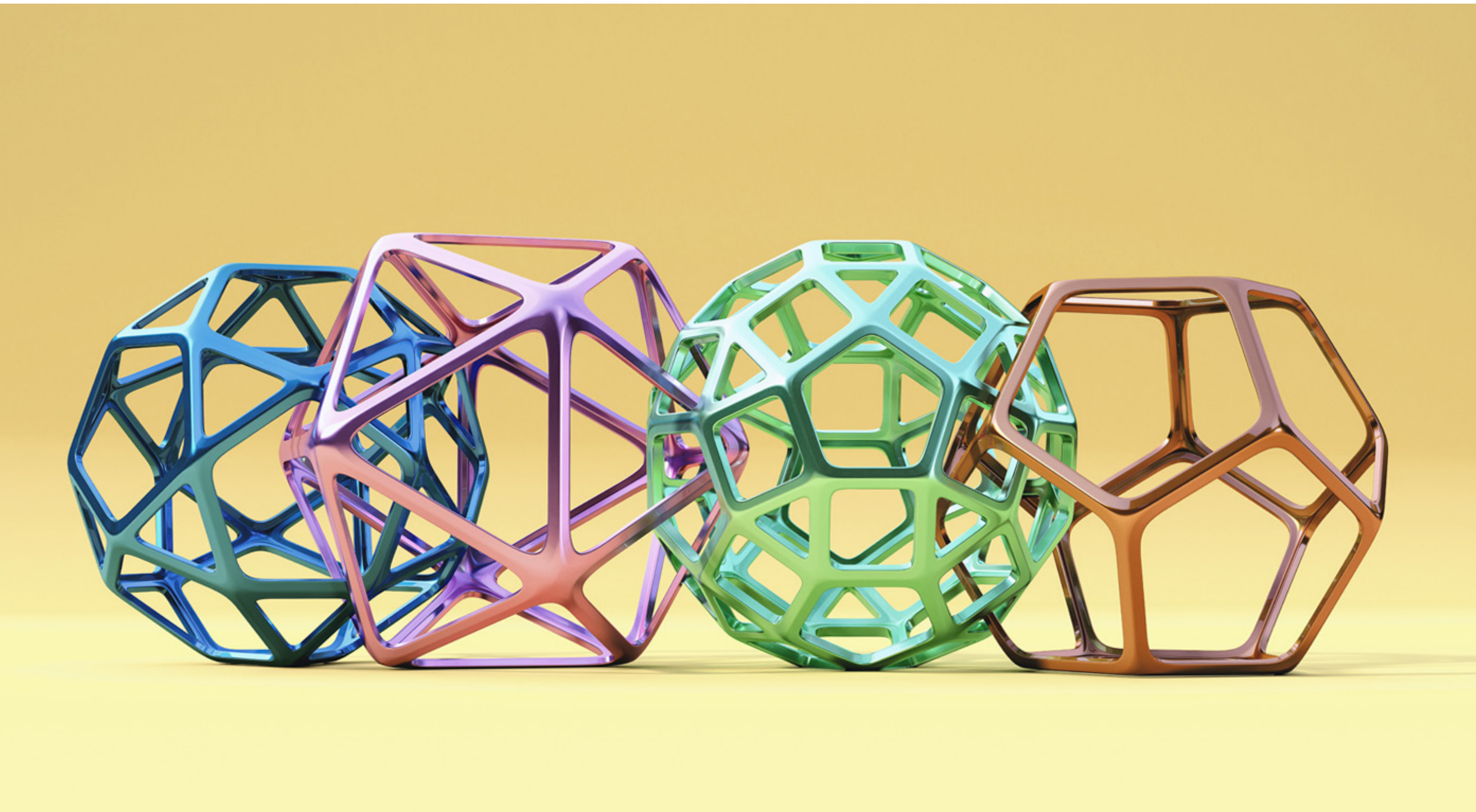
How private equity can catalyze diversity, equity, and inclusion in the workplace

Private equity has an opportunity to transform the global business community and improve returns.

by David Baboolall, Alexandra Nee, and Lareina Yee



Business leaders hear a lot about disruption. But 2020 redefined the term. By March, the novel coronavirus had completely changed ways of life and work for billions of people. In May, the death of George Floyd produced an equally seismic shift in cultural awareness of systemic racism and set in motion urgent calls for racial equity—globally. And today, second and third waves of COVID-19 cases are tearing through many countries, exacerbating socioeconomic, gender, and racial inequities.

This article discusses how—in the current moment of upheaval—private equity (PE) has the ability and imperative to improve diversity, equity, and inclusion (DE&I) in the workplace; and in so doing, provide additional levers for financial outperformance. Our long-running research on diversity across industries shows that companies with greater diversity in leadership ranks are more likely than those with less diverse leadership to perform better than industry average on margin growth.[1] Applying this analysis to PE suggests an additional lever for value creation within firms' portfolios. Improving DE&I will not only provide an additional opportunity for financial outperformance, but DE&I commitments may also help firms raise capital.

By focusing on DE&I, the PE industry can create more equitable and inclusive places to work, attract better talent, redefine corporate culture, and set a standard for businesses everywhere.

The opportunity for PE

While the Fortune Global 500 comes first to mind when thinking about the corporate leaders of the economy, PE firms and their portfolio companies have an outsize ability to influence the status quo of the business community. Globally, about 10,000 PE firms have more than $3.9 trillion in assets under management (AUM).[2] In North America alone, about 4,700 firms own more than 18,800 companies.[3] With that kind of influence, if PE firms were to continue to reduce gender and racial inequalities across the companies they control, they could change the face of business.

McKinsey and LeanIn.org's new report, *Women in the Workplace 2020*, confirms that PE lags corporate America on gender and diversity in senior ranks. Our analysis presents overall trends and averages for the industry, and we fully recognize that some PE firms have made advancements on DE&I. On the whole, gender and racial diversity at PE firms are stronger in entry-level positions than at the top (exhibit). On average at the start of 2020, about 20 percent of senior leaders at PE firms (managing-director level) were women while the share of women on executive teams in the rest of corporate America was about 30 percent.[4] PE also trails on ethnic diversity. In 2020, investment deal teams are about 1 to 2 percent[5] Black in the United States, with other people of color comprising the remaining 11 to 12 percent of diversity at the managing-director level.[6] Public companies do better, with approximately 13 percent Black and Latinx executives.[7] But that's still far below the US demographic composition (about 30 percent Black and Latinx in 2019) and also lags behind the ethnic-minority population that holds a graduate degree (about 23 percent of the total workforce with relevant graduate degrees in 2019). PE portfolio companies' management teams and boards of directors represent a further area of opportunity.

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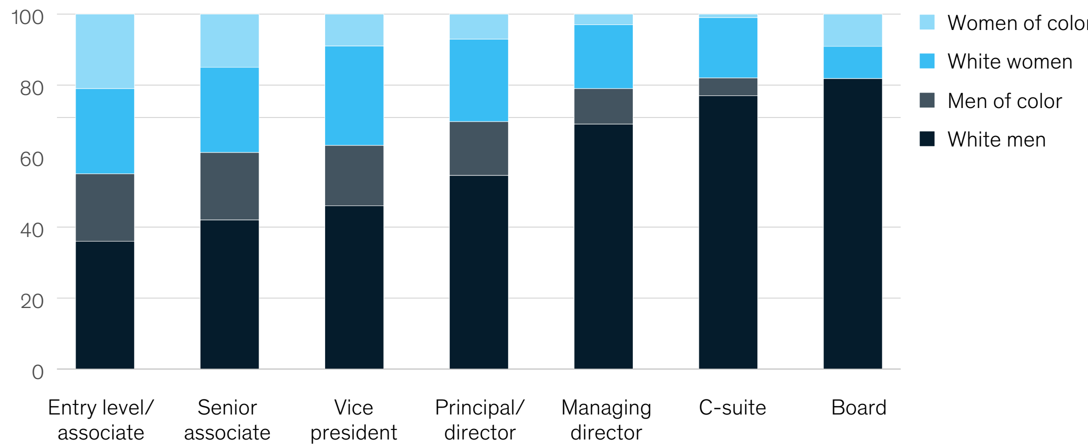
[1] Sundiatu Dixon-Fyle, Kevin Dolan, Vivian Hunt, and Sara Prince, *Diversity wins: How inclusion matters*, May 2020, McKinsey.com.
[2] PitchBook Data, October 2020, pitchbook.com.
[3] Ibid.
[4] *Women in the Workplace 2020*, McKinsey and LeanIn.Org, September 2020, womenintheworkplace.com.
[5] Based on active members in the 2020 McKinsey Black Investor Professionals Forum Database. Weighted average of active members as a percentage of all investment professionals in the more than 150 North American firms represented in the database.
[6] Figures from *Women in the Workplace 2020* dataset.
[7] Ibid.

Exhibit

Gender and racial diversity in North American private equity decrease with career advancement.

Private equity[1] employees by level, 2019, %



[1]Survey covered companies in Canada and the United States. Eleven PE firms participated in the survey.
Source: *Women in the Workplace 2020* dataset

How PE can catalyze DE&I advancements

Over the past five years, McKinsey has studied the strengthening business case for gender and ethnic diversity: companies with greater diversity within their leadership team correlate to stronger financial results.[8] Companies in the top quartile for gender diversity were 25 percent more likely to outperform industry-median EBIT growth than bottom-quartile companies.[9] Similarly, executive teams in the top quartile of ethnic diversity were 36 percent more likely to financially outperform the industry median.

If this business case were to hold for PE-backed companies, beyond the increased likelihood of financial outperformance for the portfolio company itself, a PE fund focused on driving significant change across the portfolio would produce significant enterprise value for the fund. While it is still early days for PE on improving diversity, and the correlation remains to be validated for privately held companies, the scale of potential value creation is significant.

Firms are already moving ahead. Since May 2020, we have seen an uptick in the number of PE firms focused on DE&I. Much of that is because the energy gathering around gender and racial equity is raising expectations for employers. But institutional investors and other limited partners (LPs) are also beginning to bring DE&I criteria into their thinking as they allocate funds to general partners (GPs). Furthermore, as the data show, the push for increased DE&I could also make financial sense for PE firms.

While the standard tactics to improve DE&I—including early recruitment and interview prep for underrepresented minorities, unconscious bias training, and inclusivity surveys—are helpful to any company, some PE firms are beginning to assert that they can and should do more. A set of tailored and unique actions can help GPs and their portfolio companies improve DE&I in their organizations and lead across the business community. Here's a small sample of those actions.

[8] *Diversity wins*, May 2020.
[9] Ibid.

PE firms can do the following:

— *Make a public commitment.* Firms can, for example, establish an internal council on DE&I for themselves and their portfolio, with a C-level chair to signal that this matters. The council can develop metrics, set goals, and monitor progress on targets for both the firm and the portfolio.

— *Conduct diversity assessments of targets.* Firms can include DE&I throughout the deal life cycle. Building DE&I criteria into due diligence of targets and investment-committee reviews can help not only to assess risk but also to understand the value-creation opportunity inherent from improving DE&I. Once targets are acquired, owners should include DE&I in the 100-day value-creation plan. And they should revisit DE&I as one of the value-creation levers highlighted for buyers upon exit.

— *Focus on diversity performance.* Leadership can review firm and portfolio-company diversity metrics at all partner meetings, and even link a portion of compensation to deal teams' or portfolio companies' performance on these DE&I metrics.

Within *portfolio companies*, advancing DE&I includes the following steps:

— *Set diversity targets for boards.* PE firms have seats on the boards of most of their investments. They can use those to position qualified, diverse candidates; they can also add seats to create a diverse board of directors with relevant skill sets for their companies.

— *Establish diverse management teams.* Firms can review the diversity of each portfolio company's workforce and management and identify areas where increased DE&I could lead to improved culture and performance.

— *Remove structural racism from all corporate policies portfolio-wide.* Firms can examine current benefits and corporate policies and restructure them as needed to improve retention and promote equity in advancement of underrepresented minorities.

These levers are not exhaustive; instead, they are a few of the tangible ways that PE firms can lead in the creation of a more diverse, equitable, and inclusive workplace.

It is increasingly clear that PE's push on DE&I in this moment can serve as a catalyst, with outsize impact across the business community, while also increasing the likelihood of outperformance for early adopters.

In the coming months, we will continue to share steps the industry can take to improve racial and gender diversity within its firms, portfolio companies, and as an industry.

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A playbook for private equity success: An interview with Jean Salata, CEO and Founding Partner, Baring Private Equity Asia

by Ivo Naumann and Wouter Baan

Jean Salata has watched China liberalize and open up from his office in Hong Kong for more than 30 years, in the process turning Baring Private Equity Asia (BPEA) from a small private equity firm with about $300 million in its first fund to a $20-billion business.

Over that period, BPEA has evolved a distinctive operational approach involving deep sectoral knowledge of the healthcare, logistics, media, education, financial services, and retail businesses it invests in, controlled development of scale, cross-border expansions, and bolt-on acquisitions.

Amid a shifting geopolitical environment in Hong Kong and the unwinding of the COVID-19 crisis across Asia, Salata spoke with Ivo Naumann, a Shanghai-based Partner who heads McKinsey's private equity practice in Greater China, and Wouter Baan, an Associate Partner in Hong Kong, about the state of PE in China, including the development of an increasingly active secondary market for private assets.

The conversation covers key trends in the evolution of PE deal flow, how digitalization is affecting not just invested businesses but PE firms themselves, and why leadership and talent are key to unlocking outsized returns.

McKinsey: Private equity has risen rapidly in China, which is now the third-largest PE market in the world, but as a percentage of GDP it remains relatively small. What is your view on the future of the market?

Jean Salata: We're seeing more buyout transactions and larger deals. Digital transformation and technology are growing in importance, reflecting the Chinese government's embrace of the internet, mobile, data, and artificial intelligence — technologies that are transforming the way people do business. China is at the forefront of adapting technology to just about every business in the marketplace.

China is the source of the majority of global growth at the moment, and is still attractive for investors if you want to be exposed to growth in earnings, productivity, innovation, and capital formation, as well as returns on invested capital. This is all building momentum as the economy further liberalizes, and as more of the rural economy transforms into the urban economy, amid a focus on consumption and the consumer sector.

Previously, the economy was largely driven by government investment, but now consumption has a much more important role. That is a long-term theme that will continue to play out: growth in consumption, growth in the middle class, in technology, and transformation. There's also a lot of capital chasing these ideas in China. The challenge for businesses and PE investors is figuring out how to invest in an environment where you need to react very quickly to changes, and locating the intersection between growth, opportunity, valuations, and returns on capital.

McKinsey: There's a lot of dry powder in the market. Is the industry disciplined enough to avoid driving up prices as it deploys that capital?

Jean Salata: Most GPs are very disciplined investors. It's a Darwinian business. If you're not disciplined, it shows up in your returns and you go out of business. The world today is different in that we have a very low interest rate environment. The returns on capital are low. The US Treasury market, something like a $20 trillion market, is generating about a 1 percent return for investors. There's a lot of capital that used to earn, say, 4–5 percent that's now getting 1 percent, and so is looking for other places to invest. That filters through the entire chain of investors, and the investment returns that people are seeking to generate.

The way you generate that return needs to be suited to the environment that we're in today, where valuations are high. It needs to encompass buying the right company in the right sector with the right profile and growth, but also a plan to drive extra growth, margin, and exit multiple once you own and have repositioned the business. Investors need to consider how they can benefit from placing better leadership into a company, or by implementing digital transformation.

Overall, the industry will continue to thrive because there is such demand for generating returns above

Jean Eric Salata

Vital statistics

Education
Received a Bachelor of Business Administration from the Wharton School of the University of Pennsylvania

Career highlights
Oversees all investment and divestment decisions, as well as strategic direction, as CEO of Baring Private Equity Asia (BPEA), a firm he started as the regional Asian private equity investment program for UK-based Baring Private Equity Partners in 1997.

Took Nord Anglia Education private in 2008 and over eight years drove a 20 times expansion in EBITDA to more than $200 million, before relisting the company in the US, and privatizing it once again in a $4.3 billion deal that involved multiple BPEA funds.

Led a managemen buyout of Baring Private Equity Partners' Asia program to establish BPEA in 2000.

Served as a director of Hong Kong based AIG Global Investment Corporation (Asia) Ltd., the Asian private equity investment arm of AIG.

Acted as Executive Vice President of Finance of Shiu Wing Steel, a Hong Kong based industrial concern.

Consulted with Bain & Company based in Hong Kong, Sydney and Boston.

and beyond what is available to public market investors. If PE can continue to add value to the companies that they invest in, then investors will still benefit from the kind of illiquidity and alpha creation that happens through a PE strategy, provided it's done in a disciplined way. The industry in Asia is far more sophisticated and advanced than it was 20-30 years ago, when it was really a cottage industry. Today, we have all the tools, as well as experienced GPs and service providers, that help support our investment decisions. We have a very well-developed financing market to provide, the financing for the investments. We're also seeing the emergence of more control-type investments where, as an investor, you can really have an impact on the business, rather than being a passive investor.

McKinsey: Over the past decade we've seen more control groups and majority stakes, compared with the previous decade. What are some of the other differences or opportunities you expect to see?

Jean Salata: We're very paranoid about falling behind, and making sure that we're doing things as well as anyone else, particularly if you look at global benchmarking. Historically, PE investing was very passive in Asia. That moved on from being minority-type passive investing to more activist, majority-type investment. The logical first thing was putting financial leverage into deals and companies where you can control cashflows and generate a better equity return than was previously the case.

People then developed capabilities to work with companies and improve operations, or shape the strategy of the business, including through better leadership. A lot of this boils down to who is running the company, what kind of management teams, independent chairman of the board, or non-executive directors do you have to help guide these companies? Leadership has been an area where we've seen a lot of development and improvements.

The other related point is we're seeing more CEOs and management teams that have previously worked for sponsor-backed companies. This is their second or third deal. It's refreshing to work with people like that, because they understand the drill. They understand our playbook, and what our objectives are. They're totally aligned. Many of these people have already become fairly wealthy as management or successful CEOs, so they're able to co-invest with us in our deals as principals. We're all thinking about the same issues. That's been a big change that will continue.

We're already seeing more trade sales rather than IPOs, alongside the impact of digitalization. COVID-19 has accelerated what was already an ongoing digital transformation in the US, and the rest of the world, including Asia. That's going to continue. You're probably going to see more use of data and data analytics in both the way we run our business, as well as the way that companies run their businesses.

We've recently brought onboard internal resources that understand both the data analytics side, but also the infrastructure, the piping that's required in order to collect the correct data, and to evaluate a company when you're buying it, and whether or not you have the systems in place to collect the information that you need to be competitive.

It's that transformation from being just a digital business where you sell stuff online, to actually using information that you're collecting from your customers, suppliers, and competitors in a way that enables you to make better decisions. We're at the very infant stages of that as an industry, and we are pushing ourselves to do more.

Sector focus is also becoming increasingly important. The generalist approach is the logical way to start a business in our industry. But as we become more sophisticated, as the businesses become more competitive, you need to have those deep insights that you get from being a sector specialist, as well as the industry relationships that enable you to quickly bring in the right management teams, advisors, and diligence experts; all the people that help you make the decisions in order to be competitive in buying a company, and to hit the ground running once you have bought the business.

McKinsey: How well equipped are firms to deal with these shifting requirements?

Jean Salata: We're in a difficult environment now, as we were in 2008-09 and in 1999-2000. Those environments come and go, but generally businesses thrive, or fail, because of internal issues. Culture, people, and the way you run your business is so important. It's all about your people and the capabilities that you're developing. As a learning organization, one of our values is humility. We need to admit that we don't know it all, and that everybody's making mistakes relatively frequently. The point is to understand those mistakes and how we can do things differently going forward, and transmit that learning across the organization. We emphasize having an open culture and discussions around learning. Learning from mistakes, and celebrating successes.

Agility at the organizational level is also important. I've always believed in diversity in an organization because of the way we operate across so many countries and different jurisdictions. It's almost imperative that we have language skills and different cultural backgrounds. We have a large number of female partners in our firm, both junior, mid-level and senior-level, who bring a different perspective, and make us a more effective organization.

We have also embraced working with industry experts. Coming from a consulting background myself, I think the consulting framework—defining a problem and how you're going to approach an issue, before pulling together all the data and the resources to address that—is very important.

In addition to that, there's so much value in finding people that have worked in industry who are operators in a particular kind of business, or country environment. That can really help you to manage the business.

We work with a lot of industry people pre-deal, as well as post-investment, to do the due diligence, to get a view on the business, and also to help us find the right management team. COVID-19 is going to be a defining period for a lot of firms and companies. How did you manage through it? What steps did you take? How are you coming out of it? The bottom line is people and organizational culture, and how you get the best out of people in your organization.

We found it energizing to be in crisis mode as a team, working much more closely together than we do during normal times. In a way, it pulls people together and enables you to make decisions that would have otherwise taken months or years. You're able to do it immediately, because there is a sense of urgency. Now we're trying to capture that sense of urgency and redirect it at the recovery, and the new alpha. Where do you go from here without losing that intensity? That intensity is very powerful, if you can mobilize and harness it.

McKinsey: You referred to creating alpha by being more involved in value creation, compared to minority/growth-type investments in the past. One element that people always ask is, "How do you actually build operating groups or value-creation portfolio groups?"

Jean Salata: There's no silver bullet, but you start with a framework. We have a playbook, we call it the Baring Management System, the BMS, that has six different modules. The key is to focus on one, or two, or three important levers rather than trying to do too many things at once. There's a saying that we have: "Think big, but start small." So, have big ambitions, but start with some relatively small initial steps that you can accomplish quickly. It's generally in one or two areas that there's an opportunity to show some results. Then it's about getting the right people and matching those objectives with talent. The other issue is how quickly you're able to do this. Oftentimes, it's a year before you've gotten the right people into the right positions, and the right plan in place. That's too long.

You need to develop a thesis, and have a very detailed blueprint ready, pre-investment. Post-investment, you quickly get the management team on board, modify the plan and start implementing, getting the right people in place within the first three to six months. If you hit the ground running and are at takeoff speed in the first year, then generally the investment is off to a good start, and that helps a lot.

Getting the digital and data piece right is also going to be an important part of alpha creation for most businesses. Some of this relates to how you're going to exit the company, and whether you can scale the business up dramatically through bolt-ons, or create a larger scale business with better operating leverage, margins, and valuation multiple as a result of organic growth. Maybe you will need to reposition the business.

We've invested in companies where we went into a lower growth, more commoditized-type business. We shed some of the lower-margin business lines, and focused on areas like electric vehicle supply chain, or aerospace, or medical equipment. Higher margin, high growth.

You not only change the margin structure of the business, you also change the multiple by entering higher margin, higher growth businesses. The rubber meets the road on the actual implementation of these plans. How you execute, and how long it takes you to execute, because we're all operating against the clock.

McKinsey: One thing that we observe is an increasing concentration of fundraising in a smaller set of funds. LPs are trying to narrow down the number of funds they are investing in. What's your outlook for this, and what are some of the things that GPs should be doing in order to be on the positive side of this trend?

Jean Salata: It's the evolution of the industry to some extent. It's a bit of a bubble. You're always going to have some very specialized, entrepreneurial, younger, newer firms that are on the first or second fund, or more boutique-type operations, where younger teams are growing and generating great returns, and are doing more niche strategies perhaps, or smaller deals. Then there is a lot of movement towards, and benefits from, a concentration of larger funds that are able to build scale in their own organizations, but also go after scale assets and drive change in the businesses that they invest in. The mid to large end of the market in some respects is less competitive, because there are fewer buyers for those assets. They tend to be extremely disciplined buyers. When you have billions of dollars at stake, you are not creating a very diversified portfolio where some are going to fail. You make sure every single investment is going to be fine or good. Generally, most players at that end of the market are pretty careful about the way they underwrite, which creates a self-regulating discipline in the market. As the deal size increases, you generally have fewer players. The deals are more intermediated, but you'd be surprised at the number of deals that we see that are not intermediated for a variety of reasons. It's a more bilateral-type situation. It could be a take-private, it could be a company where there is a pre-existing relationship, or it could be a strategic discussion where you have an asset that you could combine with the business. There's lots of reasons why things don't always go the auction route.

You need some scale in order to do things like building internal, sector, operating, or technology capability. For example, we have a very large debt capital markets team, internally. It does a lot of the debt capital raising for our portfolio companies, as well as the exit strategy planning.

We have a weekly meeting where we discuss signals we are receiving from our teams around the region, which enable us to decide whether to lean in to certain situations, or to avoid things that don't feel right. Then there is the move the needle point: If you are an LP and you have a large program, you need to have relatively large commitments in order to move the needle on your own program. You also want to avoid being overly exposed to any one fund, so you generally need to be in larger funds, larger programs in order to accommodate the size of commitment that you want to make. Most LPs are resource constrained, so from a productivity standpoint, they want to have larger relationships with your GPs. Increasing productivity works in everyone's benefit, including ours. There are benefits to scale, and I think this trend will continue.

A counter-argument is that if you get too large, you start to see diminishing returns as investors get too big. You can't manage so much money, it's hard to deploy, or you get too conservative, and take less risk. I have not seen that personally. There are certainly some smaller funds that generate really huge outperformance related to one or two home runs, or that sort of thing. But if you look at the expected return and the absolute return dollars generated in our industry, it's going to come from larger firms across the board. That ability to generate consistent returns on large amounts of capital, and to let that compound over time, will have the largest absolute dollar-weighted impact on investors' PE allocations, as opposed to a smaller outsized return, which doesn't have as big of an absolute impact on your program. That will continue.

The other thing we've seen is institutionalization of our asset class. It's not as much of a cottage industry anymore. We are still in the first generation of many firms. Even in the US, most founders are still running their businesses. But you will see in the next 20 years a generational change happening pretty much across the board in the developed markets, and starting to happen in Asia as well. That is exciting – the idea that you can create an institution that outlives a founder generation and create a really lasting business, like McKinsey.

That means you have to think about how you institutionalize your management team, the depth you have, and the systematic approach that you take; how you systematically approach your business and build the lasting agility and ability to innovate while bringing in great, talented, young people into your organization. What sort of recruiting and training programs do you have? What sort of HR team do you have? How do you motivate, and share the economics with a younger generation? All of these things are critical. The bigger firms are in a better position to do that over time, and to grow and institutionalize.

McKinsey: How do you see the variety of deals being done and the amount of companies becoming available for PE investment changing in future?

Jean Salata: Deal flow developed from being a minority/growth capital industry where companies needed equity capital to expand their business to include everything from generational change to corporate divestitures. In the COVID-19 period, we've seen big market dislocations creating opportunities with take-private situations. That's an area we see cyclically in emerging markets such as Asia, which tend to go through periods of big. Liquidity comes in and then goes out in waves. When liquidity dries up, markets fall, and companies become distressed. For example, the banking sector in India at the moment is quite distressed.

There are a lot of public companies where evaluations have halved, or more, as a result of stress on the system. You also have people that own companies in their own portfolios that have become public companies, or were originally public, that have been marked down dramatically in price, and where there's an opportunity to do a take-private with one of your own portfolio companies. We've seen that as well. As people do more buyouts, then one PE firm buying from another PE firm will become increasingly common. That sounds like a low-return strategy, or a hard to understand market, but it's not. Like in the stock market, people buy and sell stocks all day long from one another.

There are IPOs, which are primary issues. But most of the market trading is secondary in nature. The same thing happens in private markets. The assets get bought and sold for a variety of reasons. It's not always because one fund feels like the returns have been maximized so it's time to sell. It's generally to do with the lifecycle of an investment. You have a thesis, you go in and you build it and you have a fund life of say, 10 years. You have an investment horizon of five or six years. There comes a point when it's time to sell, you've made your money and you move on. Generally, those assets perform quite well through the second wave of ownership and even beyond. Related to that, there will be an increasing amount of transactions that involve companies where corporates decide that they have had a change in strategy and they want to divest.

In the current environment, there may be more carve-out opportunities because people may have liquidity or short-term dislocations on their balance sheet. That's quite interesting from a PE standpoint. Also, the geopolitical realities of the world today are a major issue for all of us. It creates opportunities in that people may want to decouple. People may want to refocus on one geography versus another, and maybe exit one geography as a result of geopolitical issues. You're certainly seeing deal flow from continuing generational change happening at the large buyout end of the spectrum. You're seeing more cross-border-type deals where a company is starting to globalize, and needs to grow their footprint beyond Asia, and either become part of a global business, or themselves acquire something that's more global in nature.

PE is also better understood now than it used to be. Generally, there is increasing acceptance of the role that PE can play in rejuvenating and revitalizing industry; in helping conglomerates that have probably too many subsidiaries shed some of the non-core businesses, and allow those businesses to thrive under more concentrated ownership. Management teams are very motivated by that. They see that they're going to get more attention, more capital support, and will become more efficient and competitive with an owner that's focusing on one asset, as opposed to being part of, say, 200 subsidiaries. There's a variety of areas around the region where we're seeing more and more deal flow, and I expect that to continue as our industry grows.

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Why healthy institutional investors outperform

A strong mission and excellent talent management make for healthy institutions—and better investment performance.

by Bryce Klempner, Bill Schaninger, and Elizabeth Skovira

In a time of extraordinary turbulence, institutional investors are searching for sources of stability. Our research has long indicated that, for organizations in every industry, the key to unlocking stable and sustainable performance is not to focus simply on results. Instead, the breakthrough comes when management applies equal rigor and resources both to how they make money *and* how they run the place—what we call organizational performance and health. We measure it through the Organizational Health Index (OHI). Across industries, those organizations that emphasize health deliver a total return to shareholders that is three times greater than their peers.

How does organizational health translate to the financial performance of the world's most sophisticated public investment funds? To understand more about health and performance at institutional investors (public pension funds, sovereign wealth funds, endowments, and the like), we surveyed nearly 5,000 employees at 23 global institutions that collectively manage nearly $4 trillion in assets, using OHI. We sought to understand employees' perceptions of their organizations' health and its drivers. We then considered the findings relative to investment returns.

The key finding is not shocking, but to our knowledge has not been empirically demonstrated before: the better the organizational health, the higher the investment returns. Our research showed that the degree to which employees believe in their fund's organizational mission and the quality of its talent-management practices were even stronger statistical determinants of investment performance than financial incentives. Whereas investment leaders are, at times, prone to writing off the "soft" elements of running an investment fund, indeed they matter. We recognize that 23 funds represent only a slice of the full institutional-investor landscape, that net returns tell only part of the performance story, and of course, that we cannot demonstrate causality between organizational health and performance. But our experience in the field suggests that the link is strong, and it is likely that strong organizational health helps support outperformance.

The survey results show that what matters most to achieving net investment returns is creating the right talent environment—one in which employees feel connected to the organizational mission, supported by leadership, guided in career development, and entrusted with autonomy. Hiring exceptional people is of course a big part of success—but helping them develop and thrive is also vital. It suggests that when an institution's leaders involve and empower employees through communication, consultation, and delegation, great things happen. Those qualities have never been more important than now, when COVID-19 has not only affected the investment environment but also challenged how investors operate—and underscored why their work is so meaningful.

In this article, we will review the research and outline the ways institutional investors can focus on the practices most closely linked to success.

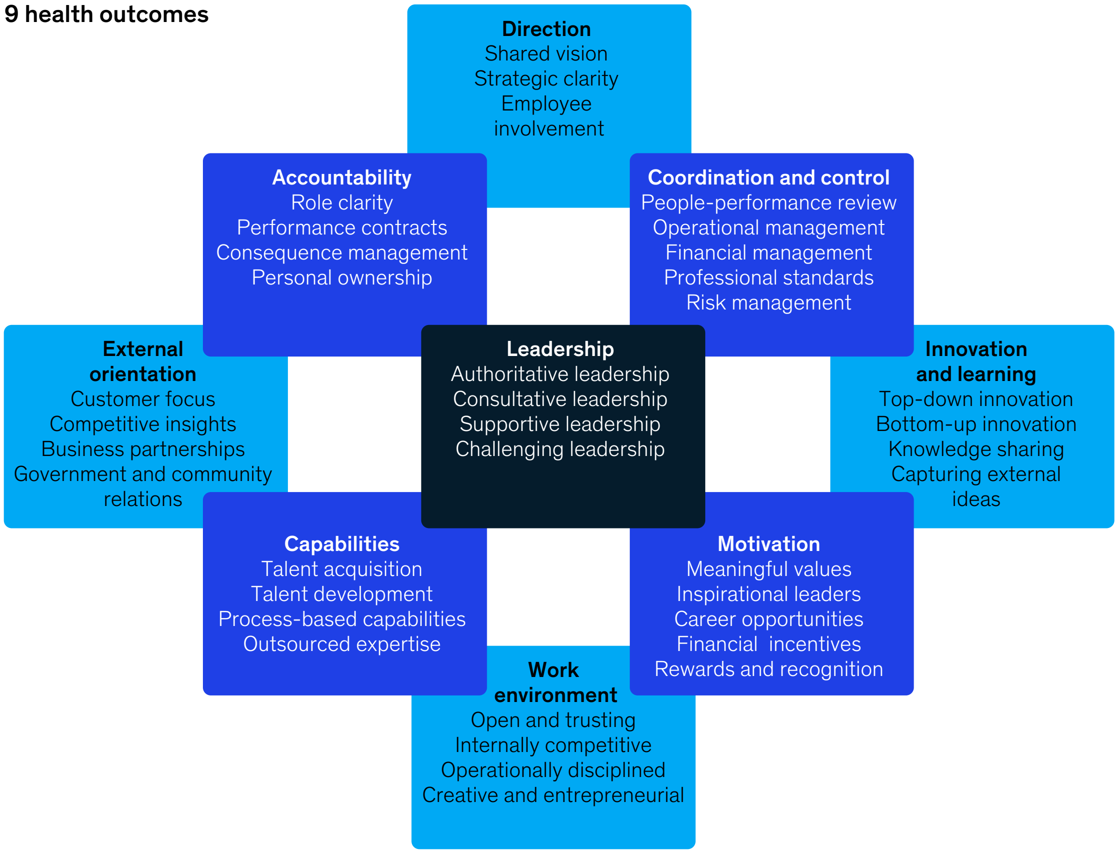
Why health is important

The search for returns has become much more complicated as investment returns have become increasingly challenged and investors have been tested by market volatility. Many pensions and other institutional investors set performance expectations decades ago, when low-risk asset classes offered high single-digit returns. Riskless returns at those levels are long gone, but the assumption that they will persist is built into the actuarial models of many, if not most, institutional investors. As such, investors must take greater risks to meet their expectations. Institutions have moved into diverse asset classes, in which success demands an ever-expanding array of skill sets and experiences. All of this has stretched the organization and increased its complexity, even as resource constraints and growing public scrutiny have tested it in other ways.

To understand how the organizational health of institutional investors is evolving in this environment, we turned to McKinsey's OHI survey. We surveyed all employees of the institution, then calculated scores for its overall health, its nine health

Exhibit

Thirty-seven practices are 'what you do'—the behavior that drives each outcome.



"outcomes" (that is, the ways a company's health is expressed), and the 37 specific management "practices" that tend to produce those outcomes (exhibit). In addition to the standard OHI survey questions, we also included several questions specific to institutional investors.[1] We conducted extensive statistical analysis to compare the OHI results with net investment returns.[2]

The ingredients that matter

At the highest level, we found a statistically significant positive correlation between organizational health scores and average five-year net investment returns. The OHI survey and benchmarking data explain nearly 60 percent of investment performance variations among institutional investors. Again, the data set used in our research was relatively small; if we were to measure the entire industry, the relationship might not be so definitive. But if we assume that the data are directionally correct—even, say, to the extent of 10 or 20 basis points—that level of impact would make a meaningful difference in portfolios worth tens of billions of dollars or more.

Looking more closely, several ingredients of organizational health showed stronger correlations than others.

High-returning funds tended to most effectively set and align the organization and its employees around its organizational mission. This bears strong

[1] We surveyed 4,859 employees at 23 institutions in Asia, Europe, the Middle East, and North America. All but one are public institutions; the one is a private university endowment.

[2] We also considered returns relative to benchmark but found that net returns are more directly correlated to OHI scores. Variation in net-return methodologies between institutions may exist.

A focus on talent management may be at least as important as compensation, if not more so.

implications for public institutions whose purpose is often to support the livelihoods of their beneficiaries. Placing emphasis on the mission-driven nature of, say, a pension managing the future livelihood of retired public servants, or a sovereign wealth fund protecting the wealth of its nation, may translate to higher returns.

High-returning funds also demonstrated particularly strong *talent-management capabilities*. It is no secret that talent matters in investing. Across all 23 institutions, we saw statistically significant positive correlations between investment returns and *talent acquisition*, *talent development*, and *use of outsourced expertise*. Interestingly, talent development proved to be a more significant contributor to organizational health than financial incentives. Institutional leaders often ask about the connection between investment returns and financial incentives to employees. This research suggests that a focus on talent management may be at least as important as compensation, if not more so. And employees of the best-performing funds strongly agree with the statement "The fund seeks to hire the most qualified external candidates, whether from public organizations or from private industry." This result is striking in its impact, but not surprising in its conclusion: talent is key to strong investment performance.

An additional set of management practices common to outperformers is *consultative and supportive leadership*—that is, executives' embrace of trusting, engaging, collaborative styles. Institutions where employees saw leadership in this light showed a statistically significant positive correlation to investment returns. Employees in these funds who saw leadership fostering *a creative and entrepreneurial culture* felt they had the autonomy to experiment with new ways to improve investment performance, and had time away from day-to-day administration to focus on out-of-the-box thinking.

Closing the gap

How can laggard institutions catch up to their higher-performing peers? In our experience, three approaches to improve strategic direction, talent management, and leadership can help.

Direction and mission

Successful funds offer employment that is personally meaningful to employees—and help ensure that employees recognize the role they play in the fund's mission. This long-useful strategy is becoming even more important as the investing workforce becomes more millennial. Upon entering the workforce amid the 2008 global financial crisis, many millennials observed firsthand the weakening of the social contract as corporate scandals stripped workers of their pensions and companies cut jobs or closed their doors, leaving workers and their families financially vulnerable. The financial crisis understandably influenced the desire of some millennials to seek out investment jobs that help combat such challenges and bring meaning to the chaos of the world in which they have grown up. More recently, the humanitarian, social, and fiscal challenges wrought by the COVID-19 crisis may further motivate a mission-driven generation to seek out employment with a direct line to meaningful global impact.

Institutional investors are especially well positioned in this regard, and funds are taking both tactical and strategic steps to ensure that the link between the investment office and a meaningful mission is felt. For example, one institutional investor held "meet and greet" sessions among investment staff and retirees and displayed the thank-you notes they received afterward throughout the investment office. More strategically, several leading pensions are accelerating their commitment to environmental, social, and governance factors (including diversity and inclusion). More than a sentimental or symbolic impact, our research suggests that when employees feel connected to the fund's mission, investment performance follows.

Talent-management capabilities

There is no single path to great talent acquisition and development, the two critical talent-management capabilities. Our research[3] suggests that each institution must draw from a number of established practices, choosing those best suited to its particular context.

Talent acquisition at many institutions boils down to merely filling gaps when people leave or retire. A more strategic approach is to think about what will drive three kinds of value creation—business as usual, improvement initiatives, and new-growth opportunities—over the next five to ten years, while also identifying the critical roles that will be disproportionately responsible for delivering on that value. It is often 5 percent of critical roles that creates 95 percent of the value. Once these critical roles are known, the question becomes whether the most talented employees with the relevant knowledge, skills, attributes, and experience are in those roles. We rarely find that the best leaders are methodically deployed as such. Women and people of color are often among this group of underemployed talent.

Successful funds don't stop there. As we said, leading institutions tend to go beyond financial incentives. Instead, they add a second dimension to "what" was delivered by assessing "how" it was done as part of a robust performance management system. An investment track record tells only part of the story. Funds might also consider initiative and drive, risk behavior, adherence to values, and team leadership, among other qualities. And they provide managers with clear processes to minimize subjectivity and focus on development and coaching opportunities. Systematic talent management can help institutions adjust job design (for example, by removing administrative burdens), redesign career paths (through rapid advancement opportunities and special projects), and inspire better development (such as high-touch opportunities beyond formal programs). All of that can lead to more leadership exposure and influence, sooner—exactly what millennials are clamoring for.

Supportive and consultative leadership

Investment institutions tend to rely on strong talent. With exceptional people up and down the organization, it is often particularly important for senior leaders to ensure that they are listening to and empowering their teams. How can leaders of investment organizations do this? In most cases, it boils down to ensuring that formal or informal mechanisms are in place for decision makers to confer regularly with their teams, to seek their input on decisions, and to encourage employee entrepreneurship. Employees should feel like they are true thought partners and stakeholders to the organization and its leaders.

Three tactics can help. First, while most institutions have formal investment committees, not all of them are as effective as they could be. In many cases, investment committees are stymied by hierarchy and rigid processes. Consultative and supportive leaders should set the tone for the committee, making sure through their words and actions that everyone feels permission, and ideally an obligation, to offer countervailing views. This enables an organization to identify the highest-potential investment opportunities, while managing risks (relatedly, those funds in which employees perceived risk management to be sufficient had higher overall health).

Second proper delegation of authority on

[3] See, for example, Aaron De Smet, Bill Schaninger, and Matthew Smith, "The hidden value of organizational health—and how to capture it," *McKinsey Quarterly*, April 2014, McKinsey.com.

investment decisions is vital. Everyone needs to know which decisions employees can make on their own, which need discussion and debate, and which need approval from leaders. In our survey, agreement with the statement “Clear rules and guidelines exist to govern the investment decision-making process” directly correlated with organizational health. Appropriately delegating and clearly mapping roles for investment decisions provides greater autonomy and a sense of empowerment to those who are responsible and accountable, and gives those who are consulted and informed knowledge of what is happening, and the freedom to concentrate on their own work.

Finally, employees in higher-returning institutions cited an entrepreneurial culture and felt that leaders afforded them the freedom to experiment with new ways to improve investment performance. As financial markets become ever more competitive, investment leaders seeking opportunities to invest “between the lines” of traditional asset classes may find that encouraging creative thinking will serve them well.

Our research shows that, for institutional investors, good organizational health is connected to better returns. What is more, it’s also within reach even for public investment funds that are not blessed with extensive budgets. Indeed, organizational health is a kind of free lunch for investors: it costs little except time and energy, it doesn’t require legislative approval, it doesn’t entail compensation reform, and it makes the fund a better and more attractive place to work. This combination should lift organizational health to the top of the agenda for every institutional investor.

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Lessons for private equity from the last downturn

Adding value to portfolio companies and buying cheap still matter.

by Jeremiah Connolly, Bryce Klempner, Paul Maia, and Tucker Ward

One phrase heard often these days in (video) conversation with private equity professionals is, "We have been expecting a downturn for a long time—just not this one."

Of course, the havoc that COVID-19 has wrought on lives and livelihoods the world over is much more than a downturn; it is a global crisis whose human toll is yet to be understood, much less accounted. But it is also an economic downturn. This raises the question: To what extent are the lessons of previous downturns relevant?

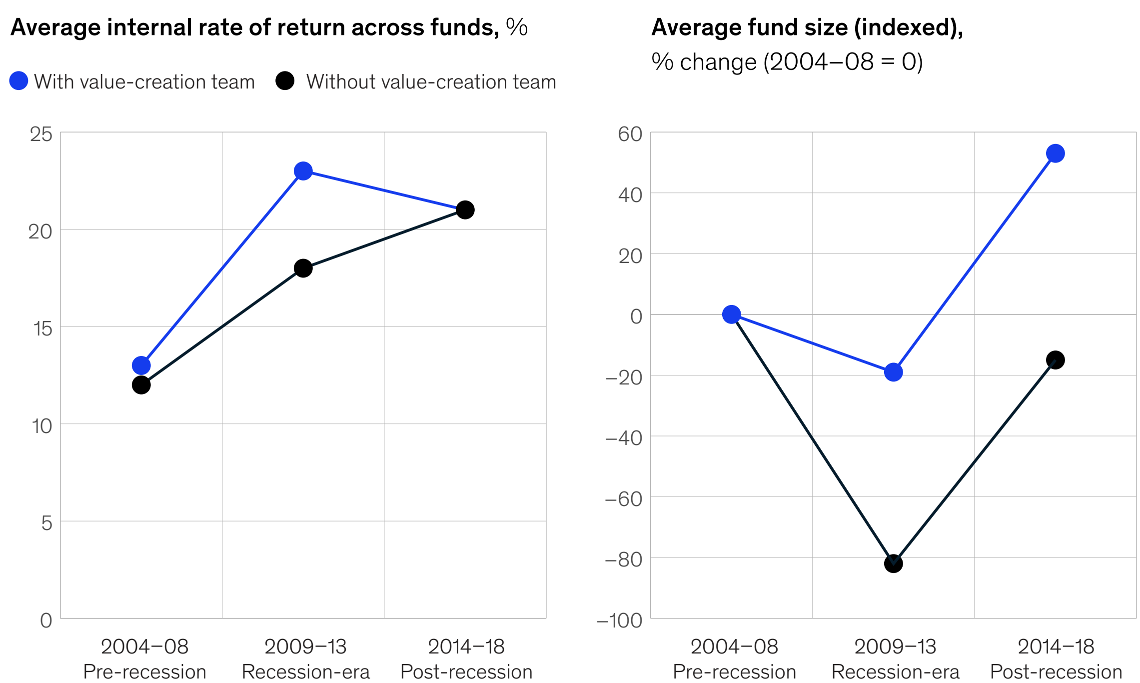
The private equity (PE) industry is still fairly young, though old enough to remember 2008. We looked briefly at two aspects of how the industry confronted the last economic downturn for hints on what may drive value in this one. In brief: operating groups appear to matter; and "buying low" is great, if you can.

PE firms with portfolio value-creation teams outperformed in the last crisis

We analyzed 120 of the largest PE firms, which included many with specialist teams focused on driving value creation in portfolio-company operations, and many without such teams. We compared their investment returns and their fundraising over 2004–18, looking at five-year periods before, including, and after the global financial crisis that started in 2008 (Exhibit 1).

Exhibit 1

General partners with value-creation teams produced higher returns during the last recession, and raised more capital afterwards.



Data source: Preqin

In brief: operating groups appear to matter; and 'buying low' is great, if you can.

Before and after the crisis, both groups of firms performed comparably (about 13 percent net internal rate of return (IRR) for vintages 2004–08 and about 21 percent for vintages 2014–18). But during the crisis years, firms with value-creation teams meaningfully outpaced the others, achieving about five full percentage points more in IRR (23 percent) than firms without portfolio-operating groups (18 percent).

Firms with value-creation teams also saw less disruption in fundraising in the crisis period, with their fund size falling 19 percent on average versus 82 percent for general partners (GPs) without an operating team. This fundraising advantage proved durable, as firms with value-creation teams saw fund size rise by 53 percent in the post-crisis years, while those without experienced 15 percent further declines in fund size.

The lesson for GPs today is self-evident—albeit hard to put into practice once already under duress. While correlation is not causation, there appears to be a strong relationship between having a portfolio value-creation team and outperforming in tough times. PE firms without such a team will likely find that assembling, let alone deploying, a high-caliber group in the midst of a global crisis may not be possible. As firms consider their options, they should note that a big team is not necessarily needed: a separate McKinsey research effort has found that the size of the operating group is not clearly correlated to fund performance or fund size. Larger firms tend to have slightly bigger teams, but there is no hard and fast rule.

Other options for GPs without these internal capabilities are to redirect dealmakers with operational bona fides toward the portfolio, or seek to bolster portfolio companies with strong operators to meet pressing needs. (Many firms also maintain strong links to trusted third-party advisers, who can play a part.)

Meanwhile, GPs that have an operating team can take some comfort in their prescience. The data suggest that firms' substantial investments in these groups have paid off. This analysis also validates the decision making of limited partners (LPs), who have voted with their feet in the same direction.

It is easier to sell high when you've bought low

There are many ways to lose out in a crisis. Common ones include deploying too much capital at the peak; selling too much in a panic at or near the bottom; and, often as bad or worse, sitting nervously on the sidelines as prices resume their climb. During the GFC, many investors made all of these mistakes, paying multiple times for what in hindsight is dubbed a "lack of discipline." Thus chastened, GPs and LPs alike have pledged over the last decade to "maintain pricing discipline" and "avoid vintage risk" and "stick to pacing plans."

This logic appears to be borne out by the data. Our analysis of 500 PE firms confirms that those which maintained their capital-deployment rate tended to outperform (Exhibit 2).

It is hard to be entirely wrong when arguing that investors should seek to buy low and sell high. Yet it is, of course, not quite that simple. Today's "low" may turn out to be tomorrow's "not yet that low." The cheap debt financing that was so plentiful a few months ago is suddenly scarce. Many sellers are less excited to exit at current prices.

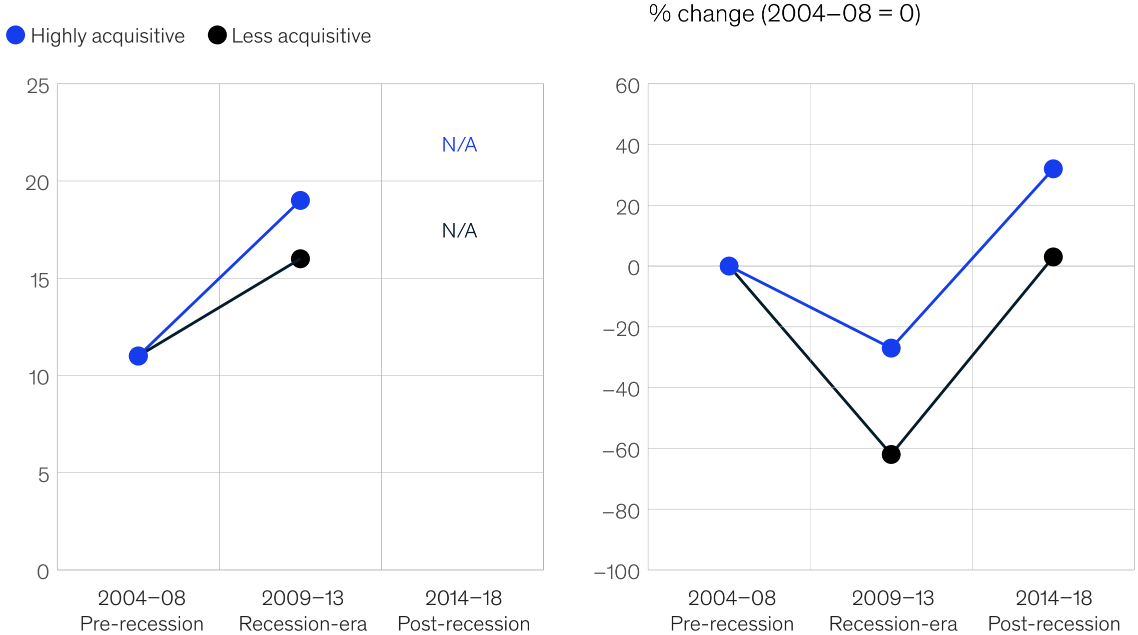
At the same time, it is a fact that public-market comparables are lower than they have been in several years. It is a fact that the PE industry has a historically large stockpile of dry powder. And it increasingly appears that for every newly unmotivated seller, there may be one or two others that find themselves with previously unexpected financing needs. So, notwithstanding the recent slowdown in deal activity, it is reasonable to imagine that many PE firms will seek to continue deploying capital despite the current tumult and uncertainty.

Exhibit 2

General partners that were more acquisitive during the recession performed better and raised more capital.

Average internal rate of return across funds, %

Average fund size (indexed), % change (2004–08 = 0)



Data source: Preqin

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Wall Street versus Main Street: Why the disconnect?

Despite turmoil in the real economy, the US stock market remains resilient because of three critical factors: the basis of valuations, the market's composition, and investors' expectations.

by Marc Goedhart, Tim Koller, and Peter Stumpner

On September 2, 2020, in the midst of the worst economic crisis since before World War II, the S&P 500 index reached a record level of 3,580, representing a year-to-date increase of about 9 percent in value. Since then, the US stock market has been resilient in the face of continuing concerns about the global pandemic and the lingering recession. Some economists and investors claim that the stock market is no longer guided by economic fundamentals but is instead leading a life of its own—one detached from reality.

We disagree.

The US stock market has remained resilient during the COVID-19 crisis because of three critical factors that reflect certain truisms about valuations, the market's composition, and investors' expectations. These factors are very much grounded in reality.

The stock market takes a long-term perspective. Today's investors realize that even if it takes two or three years to restore a normal level of GDP and profits, the pandemic's long-term effect on share prices will not be that high. The math explains why. No one knows the extent or length of this economic recession. But let's assume that for the next two years, corporate profits will be 50 percent lower than they otherwise would have been and will then return to their precrisis levels and growth rates. If we discount the impact of lower short-term profits and cash flows, the present value of the stock market declines by less than 10 percent (Exhibit 1).

The stock market does not set a value for the market as a whole. The market values individual companies from many different sectors, and these companies add up to the whole. Especially now, performance differs vastly within and across sectors.[1] Companies in oil and gas, banking,

Exhibit 1

The stock market during the COVID-19 crisis is still focused on the long term.

Illustrative impact of COVID-19 crisis on stock-market value, index (100 = 2020)

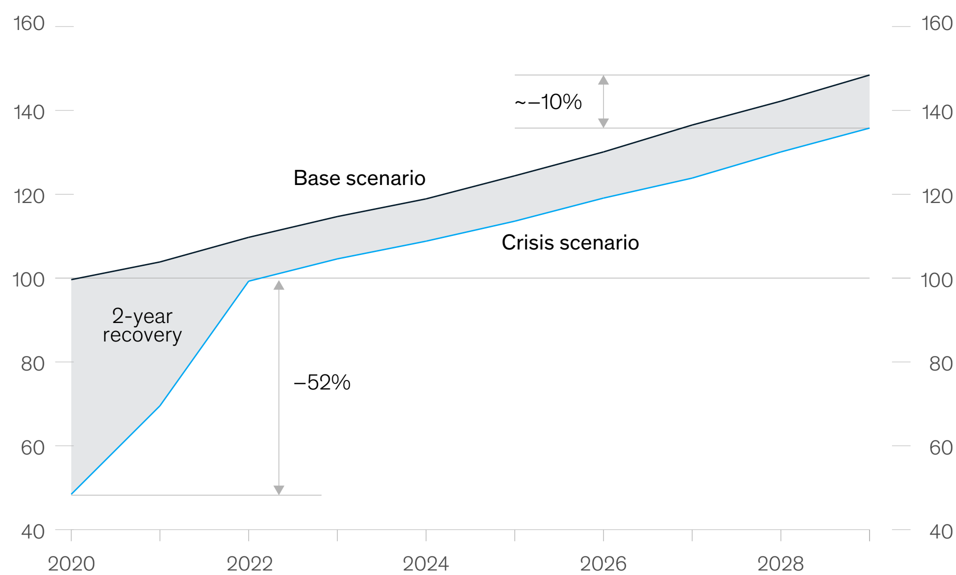
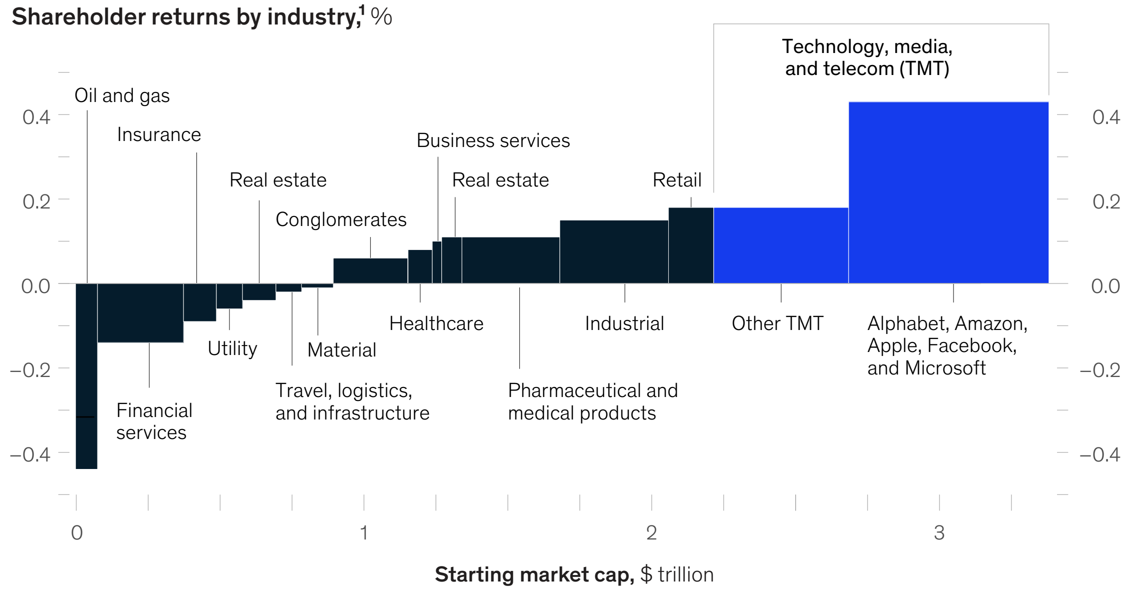


Exhibit 2

Technology companies are driving up the market's aggregate total shareholder returns.

Shareholder returns by industry,[1] %



[1]Largest 1,000 US companies. Year-to-date (September 15, 2020) weighted average; local currency.
Source: S&P Global; Corporate Performance Analytics by McKinsey; McKinsey analysis

and travel, for instance, have been significantly challenged during the pandemic, and their performance is down. Within the retail sector, grocery stores have generally fared well but department stores have not. Some companies in pharmaceuticals and in technology, media, and telecommunications (TMT) are actually doing better now than they were at the beginning of the year—in part because the introduction of new products and services affects them more than the health of the broader economy does. As a result, the stock market's aggregate value remains resilient.

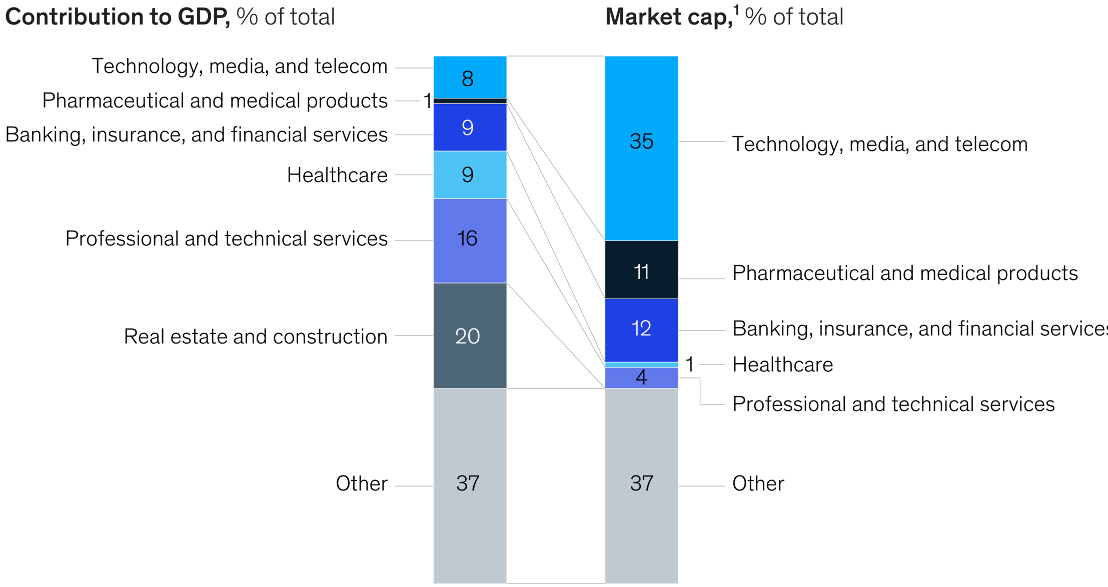
This dynamic is even more pronounced now that the TMT sector carries greater weight than ever before: its share of the top 1,000 companies has increased from about 14 percent at the end of 1995 to about 35 percent in September 2020. Alphabet, Amazon, Apple, Facebook, and Microsoft collectively account for 21 percent of the market's value—up from 2 percent in 1995 and 16 percent at the beginning of 2020 (Exhibit 2). Without these five megacap companies, the value of the 2020 market would have increased by only 3 percent (versus 9 percent). And without the TMT sector as a whole, there would have been zero growth.

The market value of listed US companies doesn't reflect employment or GDP levels in the real economy. As we have said, companies from high-growth sectors that have done relatively well during the crisis now heavily weight the US stock market. By contrast, many sectors that have done worse account for a smaller share of the market and often have few listed companies. Many apparel retailers and department stores, for example, were already under pressure even before the pandemic, and their market values were low. The current collapse of these companies' share prices does not have much impact on market aggregates. Many of the construction and professional-services firms, gyms, hairdressers, hospitals, restaurants,

[1] See "Market valuation of sectors in 2020" interactive, McKinsey COVID Response Center, McKinsey.com.

Exhibit 3

The market value of listed US companies does not reflect the dynamics of the US real economy.



[1]Largest 1,000 US companies as of September 15, 2020.
Source: S&P Global; Corporate Performance Analytics by McKinsey

and other service businesses that generate lots of jobs and contribute materially to GDP are not even listed. The overall stock market can do relatively well even when employment and GDP are severely depressed (Exhibit 3).

Similar dynamics are at play in Europe and Asia. The European market, for instance, is only 6 percent below precrisis levels. Variations in performance across sectors resemble those we find in the United States, and as in the United States, the composition of the European index does not reflect real-world GDP and employment contributions. One important difference is that there are no European megacap companies and fewer technology companies overall. In Europe, for instance, TMT companies account for only 10 percent of the market, versus 35 percent in the United States.

The disproportionate weight that the TMT sector and a handful of companies in that sector carry in the market could turn into a risk if investors decide to drop their growth expectations for even a few TMT companies. But the numbers show that the US stock market is neither irrational or erratic; the specific mix of industries in it has played a big role in making it more resilient than the economy as a whole.

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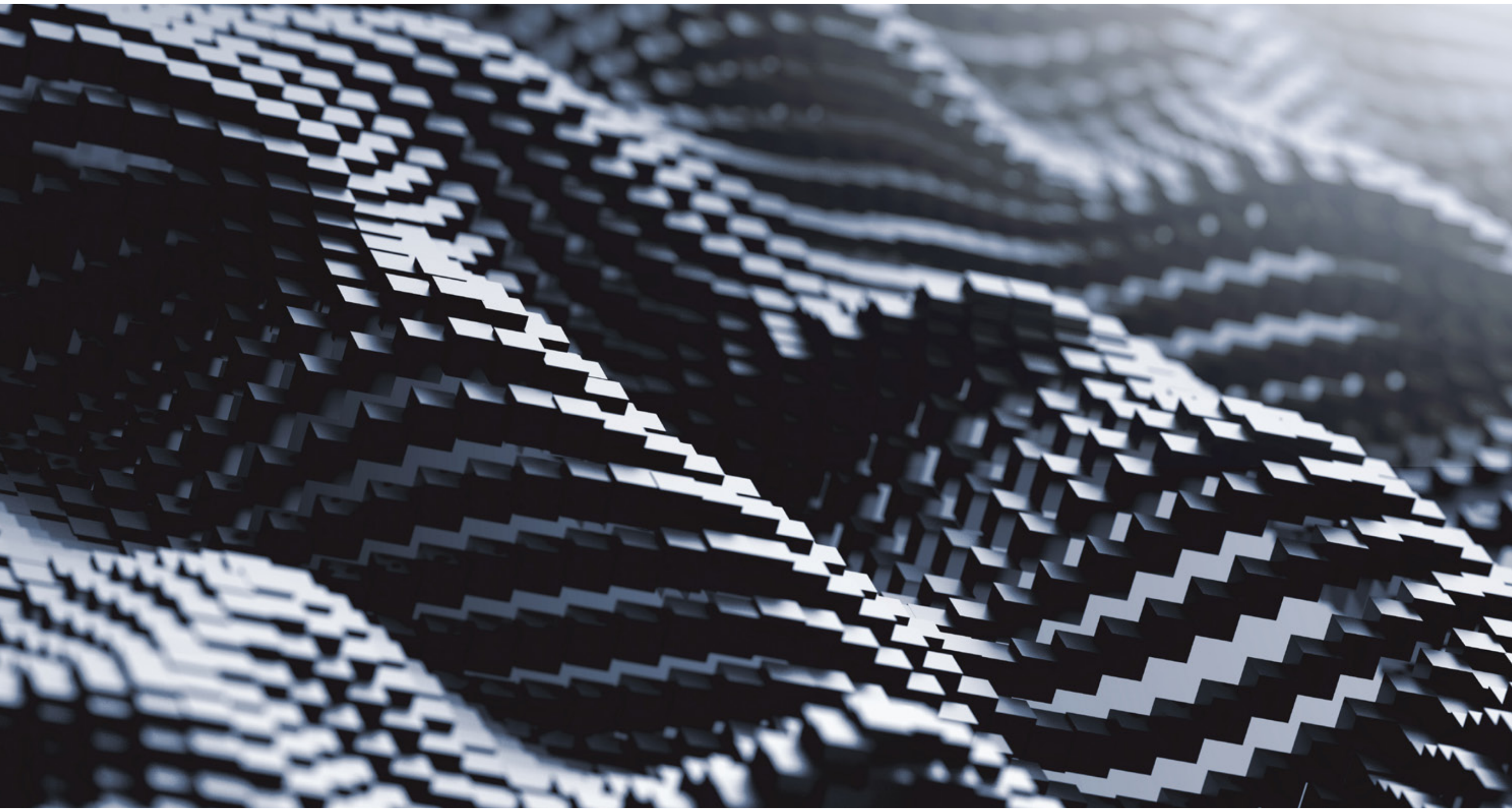
A rolling disruption: COVID-19's implications for private equity and portfolio companies

The pandemic has triggered seismic economic and societal changes. New research can help sponsors assess the strength and direction of these tremors.

by Peeyush Dalmia, Vivek Pandit, Gary Pinshaw, and Gaurav Sharma



The global COVID-19 pandemic shows few signs of relenting—in fact, in addition to its dual burden on lives and livelihoods, it is triggering civil unrest, new concerns about economic inequality, geopolitical tensions, and many other effects. The pandemic is more than an epidemiological event; it is a complex of profound disruptions.

Despite the massive and growing uncertainty, private equity (PE) firms are already adapting—looking both for ways to salvage adversely affected parts of their portfolios and for new bets that emerging trends could support. Even as wild swings in equity and debt markets have become the next normal, leading investors are pivoting their strategies away from the ephemeral and toward what they believe will sustainably succeed in postpandemic markets.

Unlike previous recessions and displacements, the pandemic will probably have many second-order and even longer-term effects on business models, consumer behavior, national and local policies, and operations. While the first-order effects are evident, the long-term shifts remain shrouded. This obscurity makes any projections about the value of displaced businesses highly speculative. Furthermore, central banks around the world have made unprecedented moves to inject as much as $9 trillion into financial assets, far outpacing the approximately $2 trillion used for that purpose during the global financial crisis of 2008–09. As a result, equity markets have enjoyed a befuddling recovery and are now only slightly lower than they were at the start of the year. But the additional liquidity serves to obscure the true health of companies and sectors; it's not yet clear which ones will thrive in the next normal and which have merely delayed the inevitable reckoning.

Amid the uncertainty, PE firms are adopting a range of stances. Managers are pivoting some portfolio companies into future growth; at others, they are riding out the storm with cost cuts. They are "hibernating" some businesses with sufficient reserves, and they are simply handing over the keys of a few companies to banks so they can focus on the future.

The stakes could not be higher for PE managers. The performance of the industry (not to mention future allocations) depends on its ability to steer a highly diverse portfolio of about 65,000 companies to safety. Our new research offers insights into the industry's current portfolio and the global pandemic's sectoral and regional effects so far, ideas about the potential shape of the economic recovery and the longer-term effects of the COVID-19 complex, and the divergent views of bond and equity investors. We conclude with some reflections on what all this might mean for PE sponsors and their companies. The only certainty is that tough choices lie ahead for managers. Picking long-term survivors may be more important than picking short-term winners.

The pandemic is more than an epidemiological event; it is a complex of profound disruptions.

PE-portfolio exposures going into the pandemic

Today, PE firms have about $5.7 trillion in assets under management (AUM). More than 95 percent of that is concentrated in 20 sectors and subsectors (Exhibit 1). Six sectors (real estate, energy and utilities, business and professional services, software, industrial equipment and machinery, and healthcare) account for more than half of total AUM. Over the past ten years, real estate and healthcare have displaced not only travel and hospitality but also media in the top six sectors.

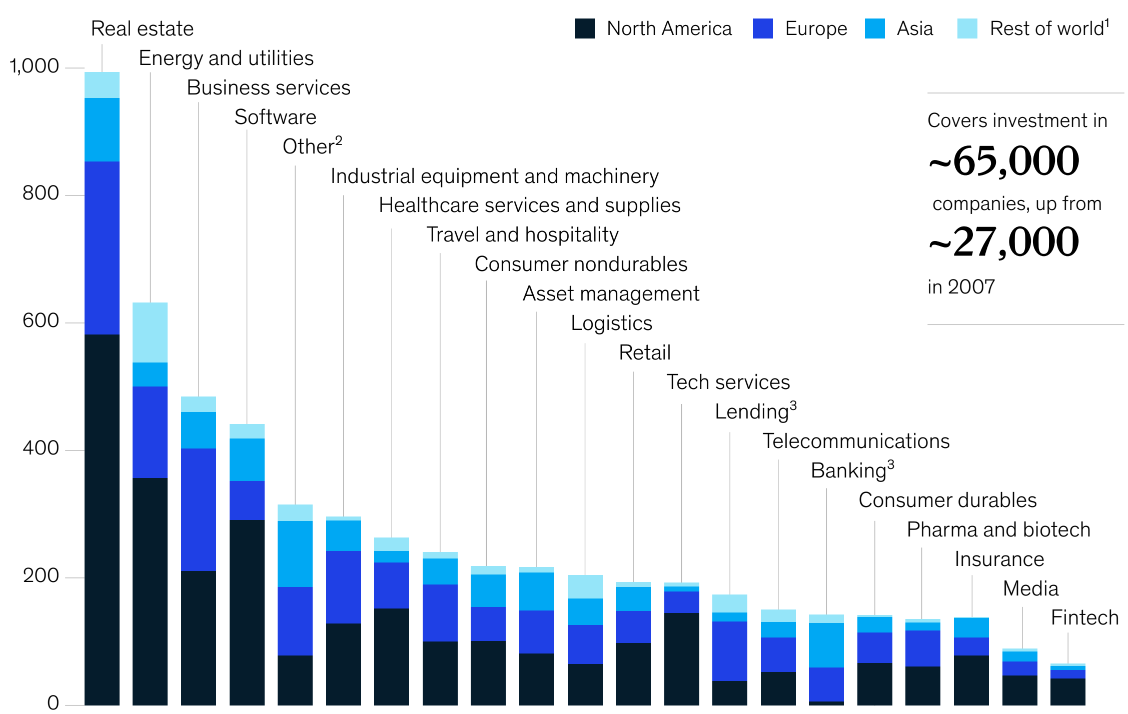
Privately owned companies often look to their public-market equivalents (PME) as a guidepost to valuations. This year through July 31, market caps have fallen by about 25 percent in travel and hospitality and by about 24 percent in banking (Exhibit 2). Sectors such as pharma/biotech, retail (including e-commerce), and software have gained.

If we apply these PME changes to the AUM of private equity firms in a crude way, the global PE portfolio declined by 4 percent as of July 31, up from a drop of about 20 percent as of March 31. Of course, the relative strength of business models, balance sheets, governance, management teams, and response measures could place many PE firms in a stronger position.

Exhibit 1

Private equity firms have about $5.7 trillion in assets under management.

Global private equity assets under management (AUM), March 31, 2020, $ billion



Covers investment in

~65,000

companies, up from

~27,000

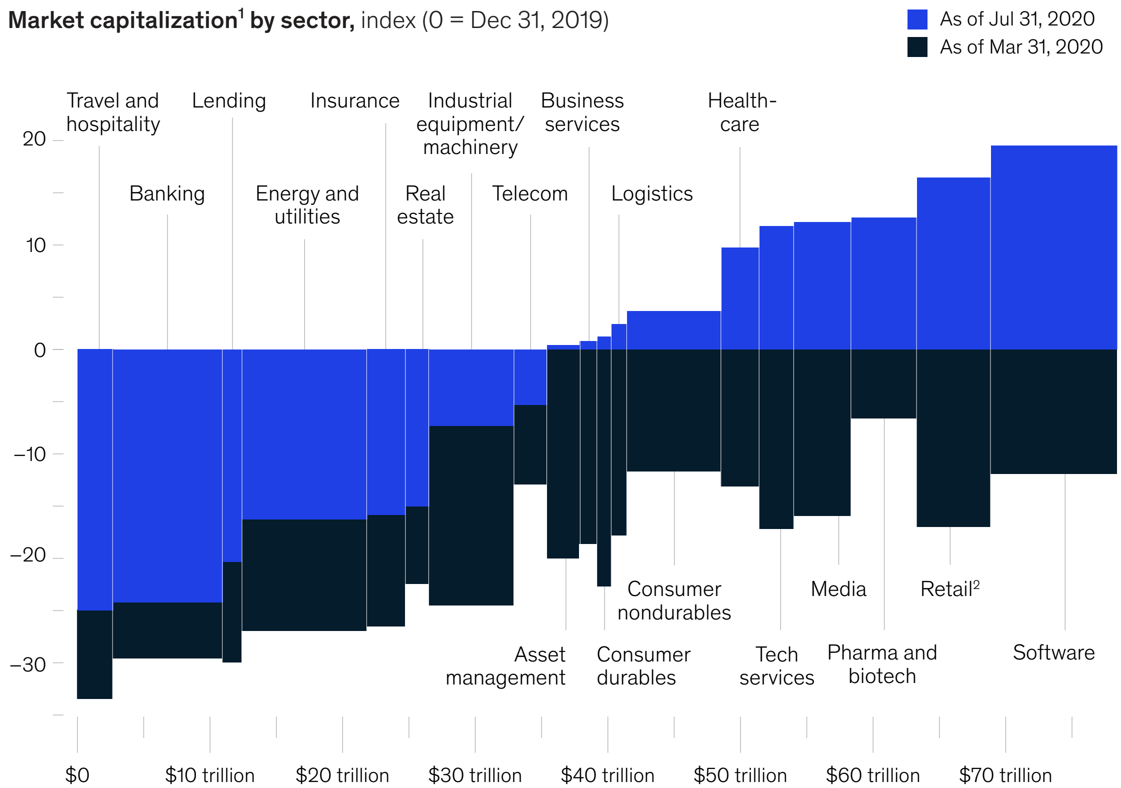
in 2007

[1]In some deals, geography is not specified.
[2]Other includes chemicals, minerals and natural resources, construction equipment, agriculture, and other business products and services.
[3]Lending includes stand-alone nonbank financial companies and lending companies; banking includes commercial banks.
Source: Pitchbook; Preqin; McKinsey analysis

Exhibit 2

Global market capitalization declined in all sectors and has since rebounded in some.

Market capitalization[1] by sector, index (0 = Dec 31, 2019)



[1]For 15,500 public companies with revenue of more than $100 million in their sectors. Adjusted for dividends and buybacks. Width of bar equals proportion of all value as of December 31, 2019.
[2]Including e-commerce.
Source: S&P Capital IQ; McKinsey analysis

Location matters as much as sector

Lockdown policies, central-bank responses, low oil prices, interest rates, and trade-flow disruptions are creating significant structural differences among national economies: for example, the banking sector's market caps have fallen by 10 to 15 percent in some countries and by more than 30 percent in others (Exhibit 3). The industrial-equipment and machinery sector has experienced similar differences, from –27 percent to +19 percent.

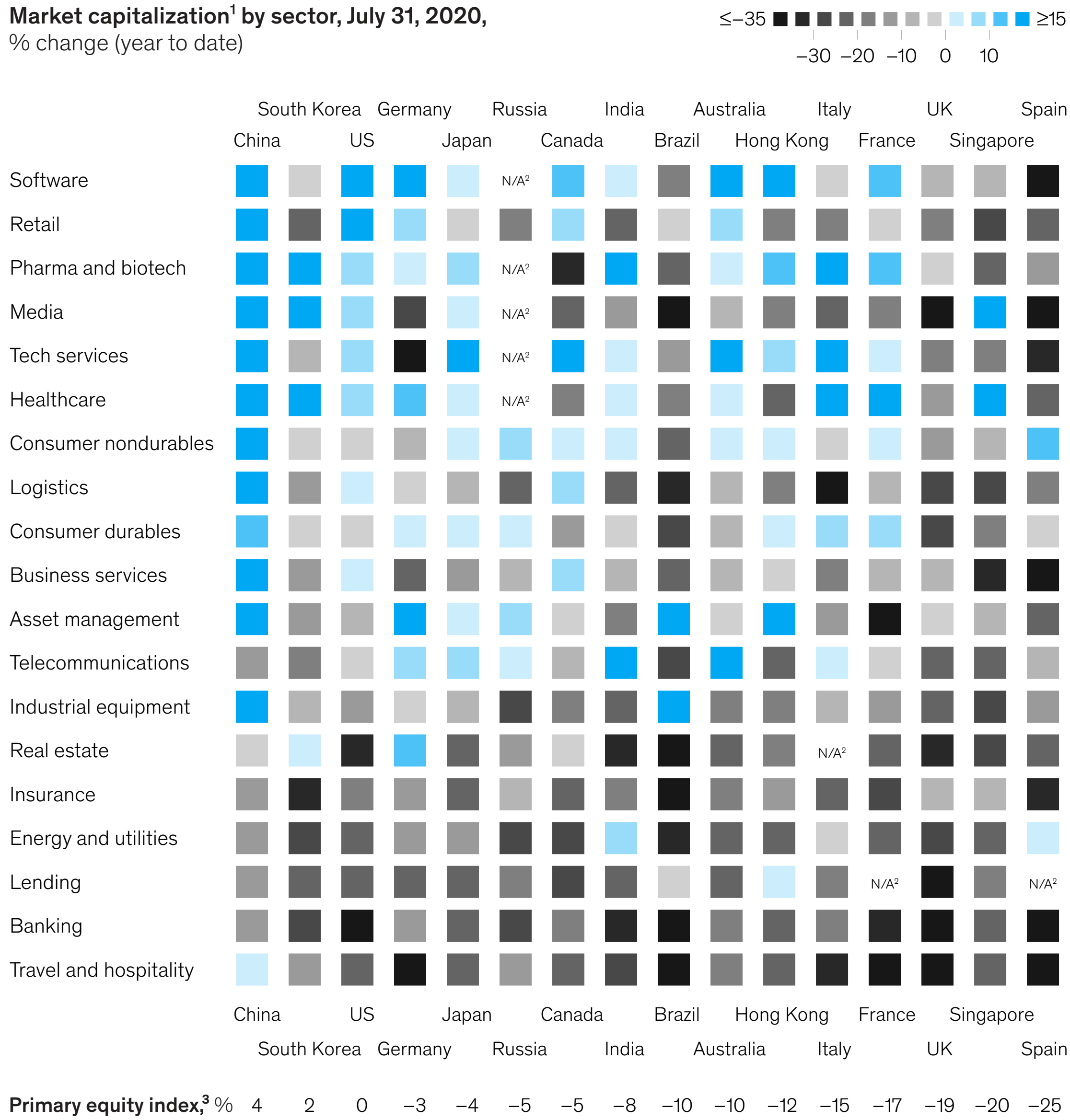
Understanding this wide variance requires more than a knowledge of near-term supply-and-demand trends. Other factors are at work, including the starting positions of businesses before COVID-19, their degree of digitization, the extent of the resilience provided by automation, and dependencies on markets locked in geopolitical disputes. Local factors, such as the size and nature of the government stimulus and the duration of the lockdown, have also affected swings in market capitalization.

Changes in these factors generate frequent revaluations and re-ratings of regions and sectors. These re-ratings are then reflected in sector valuations and country indexes, so they affect asset allocations and portfolio choices for general and limited partners (GPs and LPs, respectively).

Exhibit 3

Change in sector value varies across countries.

Market capitalization[1] by sector, July 31, 2020,
% change (year to date)



[1]For some 15,500 public companies with revenue of more than $100 million in respective sectors of respective countries.
[2]No company in this sector and country has revenue of more than $100 million.
[3]Primary equity index of country as per Bloomberg.
Source: S&P CapitalIQ; Bloomberg; McKinsey analysis

What comes next?

Six months into the crisis, people are still undecided on the shape of the recovery curve: L, U, V, W, or "swoosh." Even in our most recent survey of global executives, opinions remain mixed. As time passes, it seems that the return to predisruption cash flows and valuations could be a long haul. Major disruptions (such as the Great Depression, the two world wars, and the 2008–09 global financial crisis) reset the trajectories of most industries, and some undergo structural shifts.

Exhibit 4 shows the aftermath of the 2008–09 crisis. In some industries, P/E multiples snapped back quickly. In others, that took seven to ten years. Some have still not recovered; in other words, their

Exhibit 4

The recovery from the 2008 crisis varied by sector.

P/E-multiple disruption during and rebound from 2008 financial crisis

Sector	**Change during crisis,[1]** %	**Time to recover to December 2007 levels,[2]** months
Real estate	–62	153[3]
Travel and hospitality	–48	153[3]
Consumer nondurables	–40	120
Energy and utilities	–45	96
Tech services	–26	96
Healthcare	–47	84
Media	–51	69
Pharma and biotech	–20	63
Retail	–59	51
Telecommunications	–52	33
Business services	–36	21
Lending	–37	21
Banking	–43	21
Industrial equipment	–48	21
Software	–49	21
Asset management	–41	18
Consumer durables	–54	18
Logistics	–39	18
Insurance	–11	15

[1]Publicly listed companies around the world with revenue of more than $100 million in their sectors. Change is measured December 2007–December 2008.
[2]Defined as achieving and sustaining at least 90 percent of December 2007 levels.
[3]Not recovered as of September 2020.
Source: S&P CapitalIQ; McKinsey analysis

P/E multiples have been re-rated downward for good. Will the same dynamics unfold in the recovery from COVID-19? Possibly. But this crisis is different. Managers will need to consider the broader macro and sectorial prospects when they make decisions on investments and exits—specifically, if and when the recovery will come to the sectors of their portfolio companies and how strong it will be.

Impact of the pandemic and cascading effects

Interviews with policy makers, consumers, top executives, and industry experts helped us identify the ten specific themes most likely to affect investors. Each has first- and second-order effects and potential business implications (Exhibit 5). One truth about the pandemic is that it is accelerating existing trends, such as the *digitization of customer channels and workflows*, as well as amplifying the need for *low- to zero-touch operational models*. The pandemic is also giving rise to new trends—for instance, a need for *real-time tracking and traceability*. Other pressing needs include business models that adapt to *shifts in consumer preferences*, notably a preference for value and essentials; changes in *credit*; and changes in *government regulations and policies*, such as trade embargoes, sanctions, and other restrictions.

Exhibit 5

The pandemic has already reset the trajectory of most sectors, and more change is likely.

Disruption themes[1] and evolving implications: an illustration

	1st-order impact	2nd-order impact	Further implications
Labor availability	New operating models based on reduced or remote workforce	Need for self-help equipment, robots, autonomous vehicles	Demand for underlying tech ecosystem and engineering
Credit	Changes in credit worthiness at sector or subsector level	Shift to real-time, data-driven analysis and decision making	Demand for data exchanges and platforms
Physical distancing	Underutilization of social infrastructure; constraints in home offices	Demand for cloud kitchen, AR/VR[2] meetings, sanitization	Need for wider and faster connectivity; disinfectants
Public health and safety	Mobility constraints; push for community screening	Community immunization; management of at-risk population	Demand for sterile capacity; microgeography health infrastructure
Tracking and tracing	Source tracking (people, goods, services)	Investment in tech (IoT,[3] drones, blockchain, big data)	Need for smart supply-chain infrastructure and real-time analytics
Government regulation/support	Shift in trade policies; stimulus packages and allocations	Emergence of new services or manufacturing hubs	Reallocation of capital and rebalancing of portfolio risk
Low- or zero-touch operating models	Shift to digital channels and related automation	Remapping customer engagement; need for aggregators	Demand for reskilling, new talent to work with technology
Digital and automation	Investment in cloud, user interfaces, user experiences, IoT	Cloud-storage proliferation; focus on cybersecurity	Localized hyperscale data centers, data-center REITs[4]
Supply-chain derisking	Deglobalization, local sourcing	Product-design modifications; repurposing capacities	Application of AI and machine learning to supply-chain management
Consumption behavior	Value buying; focus on safe and trusted brands	Focus on loyalty management; e-services and unified platform	Analytics-driven hyperlocalization and personalization

[1]This analysis may not cover all factors generating local or regional variations in sector impact.
[2]Augmented reality/virtual reality.
[3]Internet of Things.
[4]Real-estate investment trusts.

Investors must interpret these themes and understand the ones that will probably have a material impact on business models, revenues, costs, future investments, working capital, and the cost of capital. To assist that investigation, we assessed the impact of the ten themes on 20 sectors and subsectors (Exhibit 6). Some sectors, such as fintech, healthcare, and pharma and biotech, appear less affected. Others, such as real estate, travel and hospitality, and some parts of logistics, may need to rethink their business models.

Measured another way, we see that indebtedness constrains some sectors in the near term (Exhibit 7). A comparison between the relative disruption of sectors during the pandemic and their debt-service coverage ratios (DCSR), suggests that about 50 percent of the PE industry's AUM is

Exhibit 6

Some sectors seem less affected by the pandemic, while others may need to rethink their business models.

Disruption impact by sector

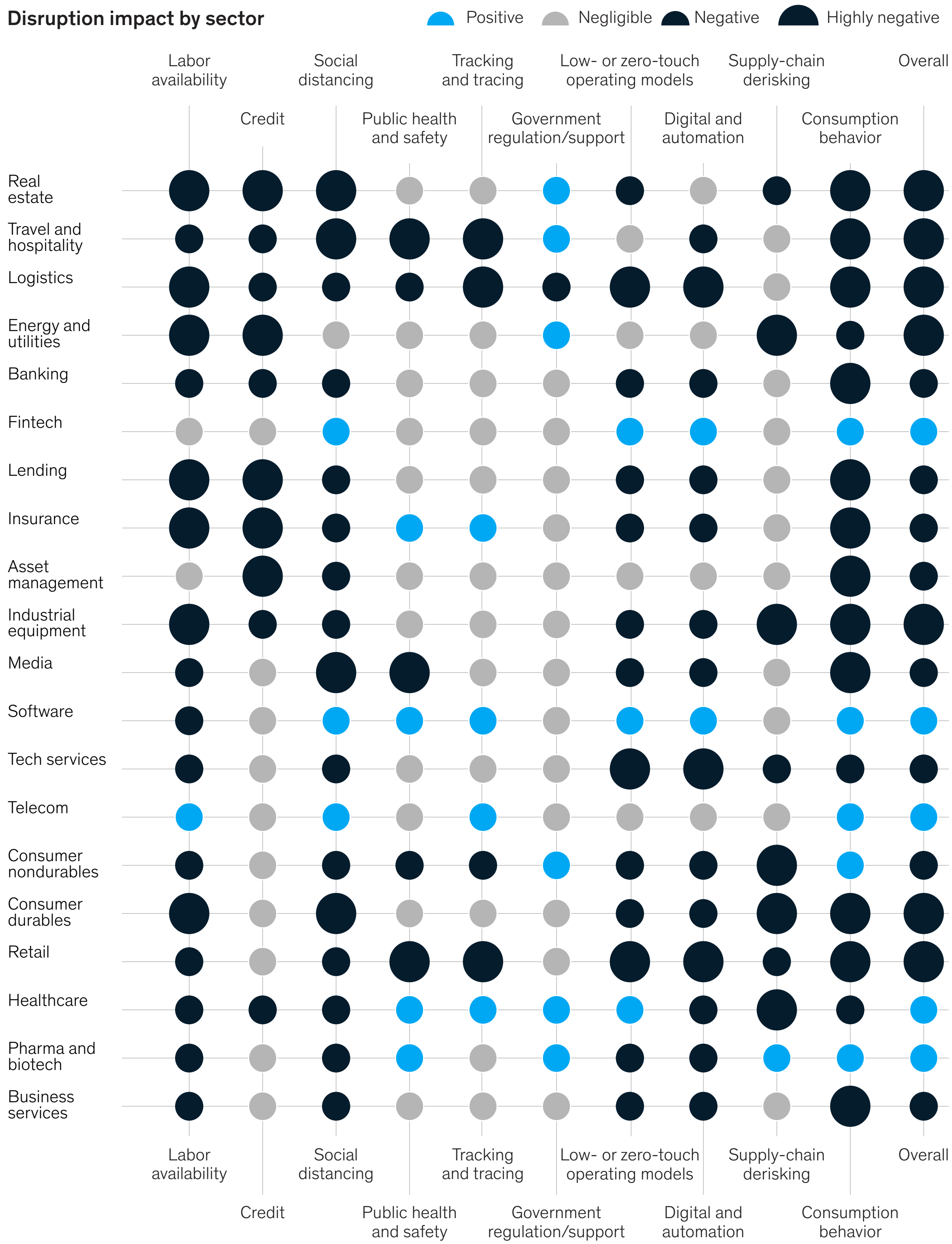
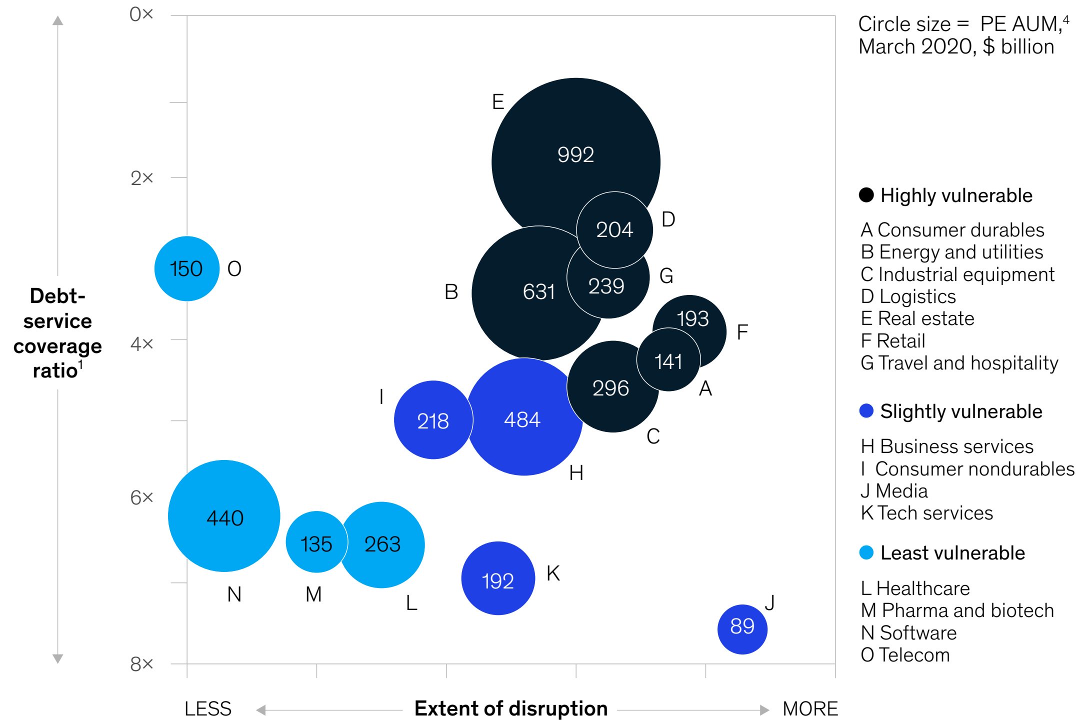


Exhibit 7

Real estate, logistics, and industrial equipment are among the most disrupted and financially vulnerable sectors.

Debt-service coverage ratio[1] and disruption,[2] by sector[3]



[1]As of March 31, 2020. Calculated as (EBITDA April 2019–March 2020) / (current debt April 2019 + interest expense April 201 9–March 2020); sector average.
[2]Qualitative assessment of disruption from COVID-19, geopolitical tensions, economic inequality, and other factors.
[3]Excludes banking, lending, and insurance, where capital-adequacy ratios or solvency ratios are more relevant.
[4]Private equity assets under management.
Source: Pitchbook; Preqin; McKinsey analysis

in highly vulnerable sectors. Significantly, some of them may be "too critical to fail" in certain countries given their contribution to GDP and jobs. Managers must therefore carefully consider the impact of the economic stimulus on all investments—especially stimulus programs that have injected capital directly into financial assets whose underlying real performance does not provide sufficient support. Managers should not confuse the availability of liquidity with the health of the balance sheet and a business model that can lead to sustained success.

Meanwhile, equity markets provide another perspective (Exhibit 8). In March 2020, the median P/E multiple had fallen in almost every sector. Since then, the multiples of leading companies at the start of the year have held up better than laggards in many sectors.

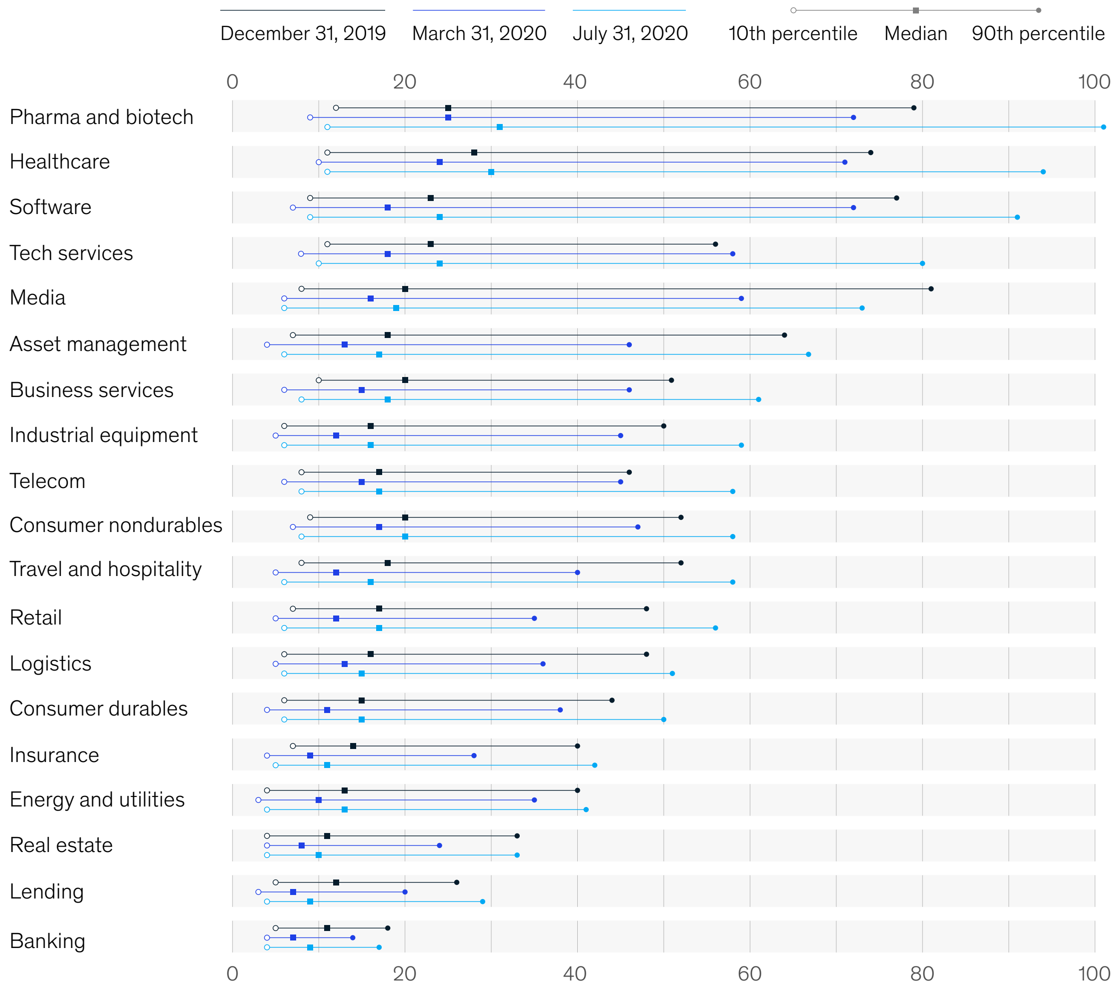
To be sure, some of the frothiness of the high P/E multiples that top companies enjoyed vanished momentarily. But equity investors seem to be engaged in a flight to safety as they continue to back top companies in each sector. More specifically, they favor companies that were well positioned (in their capitalization and leverage) going into the crisis and companies that have experienced less disruption than others because of their earlier investments in digitization and automation.

Off course, equity markets have partly recovered from their trough—a rise that is largely attributable

Exhibit 8

Each sector's P/E ratio has evolved in a different way in 2020.

A recent history of P/E ratios[1]



[1]For some 15,500 public companies around the world with revenue of more than $100 million in their sectors.
Source: Pitchbook; Preqin; McKinsey analysis

to stimulus packages and regulatory interventions, and much less to the fundamentals of the assets traded on them.

Reading the tea leaves: Implications for PE managers

What are markets telling us? How can PE firms prepare their portfolio companies for the extraordinary uncertainties of the coming months and, let us hope, the postvaccine world?

In our view, the leaders of firms need to focus on four imperatives:

Do your homework: second- and third-order effects matter. Disruptions unleashed by the pandemic are creating dark and bright spots in several industries, such as mobility, where second- and third-order effects are likely to play out. Over the short to medium term, investment in micro- and shared-mobility providers might drop. However, over the long term, autonomous vehicles, micromobility solutions, and other technologies that support physical distancing could benefit.

One second-order effect across industries has been to cast an intense spotlight on racial and gender equity. As PE companies seek to improve their record on these issues, they might consider the correlation between the financial performance of companies and the racial and gender diversity of their executive teams. In fact, companies in the top quartile for diversity are 25 to 35 percent more likely to have above-average profitability than companies in the fourth quartile.

Recognize that there could be more survivors than winners. Downturns have historically created winners and also-rans. Given the nature of this pandemic and its impact on the economy, we expect fewer “green shoot” areas where companies can grow and emerge victorious. Instead, the story is more likely to be about survival. Companies may need to rethink their business models rapidly to survive the current crisis. PE managers should aim to back medium- to long-term survivors rather than to unearth new models.

Watch bailouts and beware of zombies. Bailouts and stimulus packages are both necessary and distorting. The impact on managers is twofold. First, even as the real-world economy freezes in the short term, a flood of liquidity buoys financial markets and distorts valuations. Second, managers will need to disentangle the effects of temporary measures and assess the postcrisis prospects of companies and their customers with a cold eye. While some believe that the stimulus is a bridge to revival, others think that no amount of liquidity will prevent (or compensate for) the inevitable collapse of real-world economic activity.

At the end of the day, investors should brace for increased volatility, downgrades, and defaults. However, this also creates an opportunity for a well-calculated approach to credit investment if PE managers can choose wisely.

Understand that a lot more work lies ahead for operating teams. A recent McKinsey analysis outlines key actions for PE operating groups in the crisis. The initial priorities were to ensure the safety of employees and the continuity of basic operations and to reassess the future at a time when prepandemic worst-case scenarios had turned out to be too optimistic. Next up: PE firms are putting in place transparent systems to manage spending and savings and to build greater resilience.

Deal teams and operating teams are also reviewing their asset-management plans (such as investment theses and plans for exit), revising them for the new reality and establishing milestones for the next three, six, and 12 months. This reevaluation has significantly changed the plans for many assets. The guiding principle, in all cases, is not just to survive the crisis but also to strengthen the competitive positioning of portfolio companies by focusing on areas that can fundamentally shift operating models, customer interactions, and cost structures. In addition, PE firms can use the opportunity to reassess their interactions with (and governance models for) portfolio companies.

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Designed by McKinsey Global Publishing

Institutional investing in the time of COVID-19

Tested by the pandemic, many of the world's leading institutional investors are demonstrating resilience and agility.

by Bryce Klempner, Elizabeth Skovira, and Marcos Tarnowski

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The humanitarian, social, and fiscal challenges wrought by COVID-19—and those still to come—are historically severe. The economic harm to businesses and investors mounts daily. And it is difficult, within the eye of the storm, to ascertain the full extent of the damage.

Yet an early perspective from leading institutional investors (IIs) suggests that as destructive as the pandemic has been to their portfolios, it could have been a lot worse. After a decade-long bull run across asset classes, many investors already considered a "correction of some sort" as inevitable and had positioned their portfolios defensively. The result is that, by and large, many pension funds, sovereign-wealth funds, endowments, and other IIs have found themselves better off than they were in the 2008–09 global financial crisis. Across the industry, there is less of a sense of panic, greater investment discipline, and more continuity than there was in 2008.

We spoke with CEOs, CIOs, and other senior executives at 21 of the world's leading investment institutions, including some of the most influential pension funds, sovereign-wealth funds, and endowments. These institutions, which manage $3.7 trillion in assets across Asia, Europe, the Middle East, and North America, include some of the world's more sophisticated public investment funds. We asked them for their reflections on the pandemic, how their crisis playbooks are holding up, and what this discontinuity may mean for long-term strategy.

Hard work after the last crisis is paying off

No institutional investor will emerge unscathed from the COVID-19 pandemic. Still, although the crisis may have a long way to go, the pandemic came late in the market cycle, so many investors had already begun to shift asset allocations to prioritize greater liquidity in anticipation of a correction. Indeed, most investors we spoke with felt much better prepared for this crisis than for the previous downturn. Most of the institutions we interviewed have been following some version of a similar three-part playbook.

— First, *maintain stakeholder trust,* including the trust of board members, beneficiaries, employees, and others. Top priorities include the health and safety of employees; financial liquidity; business continuity, such as work-from-home models; and investment performance. In some cases, institutions had already discussed with their boards how to act in the next crisis. As one chief investment officer of a North American pension fund told us, "I was explaining to my board our rebalancing process and what we would be doing, at which thresholds. They stopped me and said, 'why are you telling us all this again? We know the plan. And we trust you. Let's get on with it.'" At the same time, some institutions have faced a liquidity crunch; two we spoke with had worked through it in about two weeks.

— Then, *defuse portfolio risks.* Beyond the initial hit in the public markets, many investors have been continuing to wait—and wait and wait—for the other shoe to drop. While they wonder when financial markets may reflect real-economy impacts, they have been looking across their portfolios for areas that need immediate action. Naturally, the sectors most affected by COVID-19 have been a key area of focus not just for near-term impact but also for the uncertain future facing some of these industries. Illiquid asset classes, whose valuations typically lag behind in public markets, have been a source of concern—in particular, real-estate portfolios. As one leader told us, "I'm worried about our commercial real-estate portfolio, especially offices, given work from home. . .. what is the 'next normal' going to look like?"

— Finally, *be alive to possibilities.* Many investors we spoke with still consider the markets overvalued. One endowment's chief investment officer said, "we feel that the markets remain 30 to 50 percent overvalued." Tellingly, only a few of these institutional investors were actively looking to take immediate advantage of dislocations. Most expressed caution and a need to be thoughtful about the path forward. Still, nearly all acknowledged that periods such

> as these typically lead to some outstanding investment possibilities for those with the liquidity and the stomach to capture them. “The best investments that I have made in my lifetime have generally come down to two words: ‘forced sellers,’” said the head of portfolio construction at a leading North American pension fund.

Though the playbook is similar across institutions, some have clearly fared better than others. That’s probably a result of operational effectiveness; the crisis has served as a litmus test of how well different functions across organizations have been working.

Emerging lessons from the crisis

While it’s early innings, some practices appear more often and more prominently at leading institutions.

Stick with it

Pivoting strategy in reaction to market cycles typically hurts performance. A decade ago, many investors were burned repeatedly, especially (but not only) in private markets: deploying capital at the peak, selling at a discount, then sitting on the sidelines during the recovery. Many investors and their boards have said they plan to act differently this time. Those we spoke with are focused on parsing the crisis to distinguish temporary shifts from structural market changes and on maintaining (or even accelerating) their strategic momentum. As always, some investors have shown more resolve than others and today have deeper pockets ready to deploy. Others have just barely avoided a full-blown liquidity crisis.

Leaders of these institutions underscore the importance of holding on to high-quality assets as markdowns occur and portfolios begin to exceed policy allocations—even if this strategy means raising debt. “De-risking at the bottom of the market would be the biggest shame we could bring upon ourselves,” claimed one investment leader. Others agree but caution that this approach is not easy to execute: “Everyone can nod their heads, but when you are in it and feeling it, convictions begin to slip.”

Some institutions entered the pandemic already wounded. Among public pension funds, for example, the gap in resources between leaders and laggards has widened considerably. Many faced huge funding deficits before the crisis; if markets continue to fall, such gaps will probably widen further as these funds are forced to liquidate investments to pay beneficiaries or as contributions falter. Especially given volatile oil prices, some sovereign-wealth funds may see their portfolios tapped by governments to support competing economic priorities. “We are already facing looming fund draws,” commented one sovereign-investment leader. Said another: “our challenge now is as much balancing political pressure to provide loans to certain companies as it is defending our investment portfolio.” The playing field for institutional investors is not even, and the crisis may highlight and widen those disparities.

Walk the walk on ESG commitments

Environmental, social, and governance (ESG) factors (including diversity and inclusion) are very much on the minds of intuitional leaders. In the weeks before the crisis, we surveyed the world’s leading institutional investors about their commitment to ESG factors. Seventy percent said they would fully integrate ESG considerations across all of their investment processes (Exhibit 1).

In the midst of the pandemic, some of these institutions have doubled down on ESG, believing that it is even more important in troubled times. Such fund leaders have indicated plans to maintain or accelerate their ESG plans through the crisis. If this trend takes root, it would be a departure from precedent. During the 2008–09 global financial crisis, many investors deprioritized ESG to focus on solvency. The recovery that followed proved highly carbon intensive. The coronavirus pandemic represents a visceral reminder to investors and their boards of ESG’s role in portfolio management.

Evolve stress tests

There is wide variability in how surprised our interviewees have been by the pandemic’s impact.

Some described it as a true “black swan” event, far beyond any scenarios they had modeled or considered: “This was beyond our 99 percent value-at-risk (VaR) scenario by a large margin. We had two strategies, in particular, that did not perform the way we thought they would.” Yet others say a global pandemic was in many ways entirely predictable and had already stress-tested their portfolios for this type of eventuality, forecasting a possible market downturn as severe as what we have so far experienced. “This actually didn’t even hit our 95 percent VaR threshold,” one said. As the crisis hit, these investors understood how much cash and liquidity their portfolios needed, and reacted quickly.

Test risk-factor allocations

Before this crisis, there had been a trend among leading investors to dedicate more resources to portfolio construction and asset allocation (Exhibit 2).

Risk-factor approaches to portfolio construction have received a lot of attention recently, and many say that these have done well in the crisis. One leader said, “our risk-factor approach has really softened the blow, particularly in our leveraged-loan portfolio.” Yet only a handful of leading institutions are truly embracing risk-factor approaches and following through on their implications for asset allocations and leverage. Those who implement these approaches do so largely because they believe that the promise of diversification failed in the last crisis, and that diversification across macro risk factors (equity risk, inflation, and rates, for example) is the right way to diversify. While it would be premature to declare victory, investors that use risk-factor-diversification approaches say that they have been paying off.

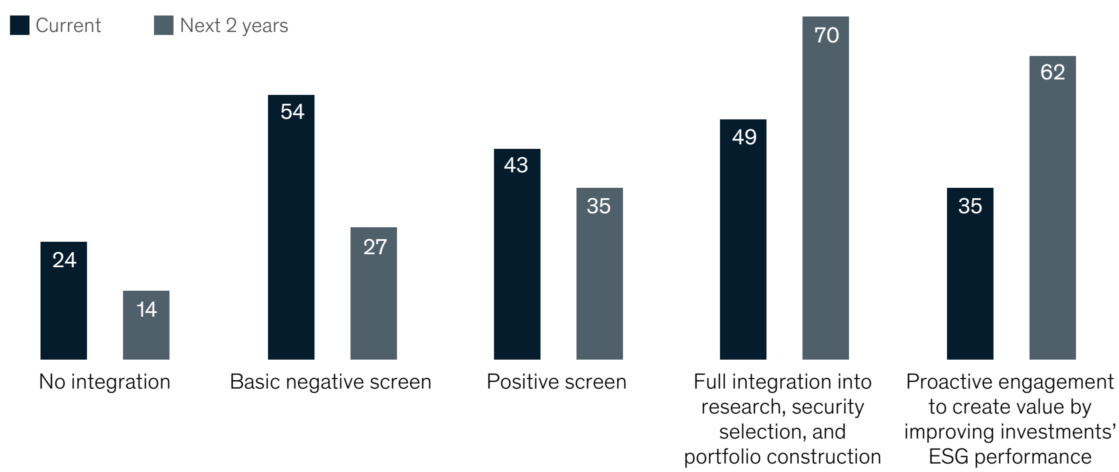
Act as true partners

There is no doubt that the current crisis is a moment of truth for institutional relationships. Some of our interviewees highlighted the importance of being good partners to external managers and peers, fairly balancing liquidity demands, and honoring deal commitments. “It is challenging to stomach because their liquidity is our illiquidity, but they

Exhibit 1

ESG will be more integrated into investment processes.

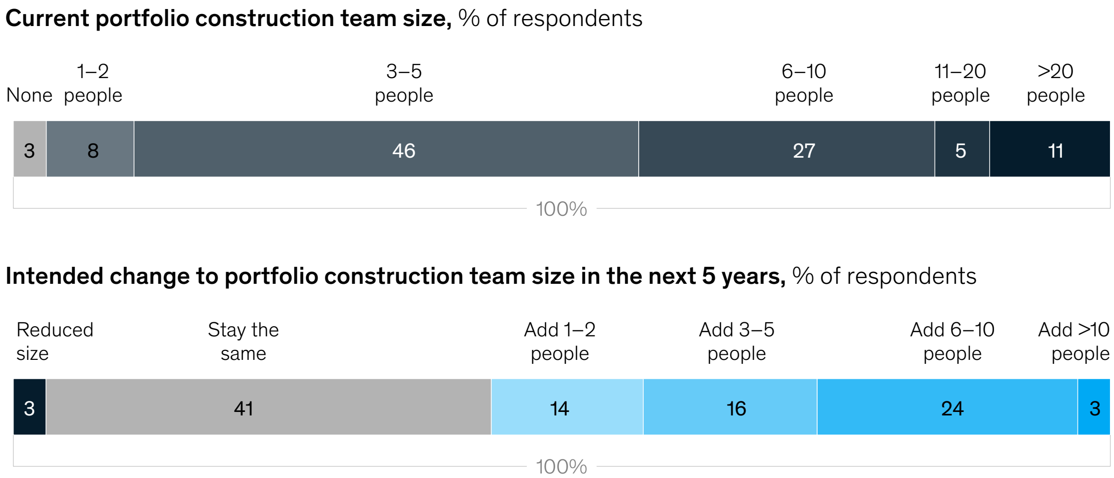
Methods of integrating assessments of environmental, social, and governance (ESG) performance into regular investment-analysis process,[1] % of respondents[2]



[1]Question: How do you integrate assessments of ESG performance into your regular investment-analysis process?
[2]Respondents could select more than one option; n = 37.
Source: McKinsey Institutional Investor Survey 2019

Exhibit 2

Most investors plan to expand portfolio-construction teams.



Note: Figures may not sum to 100%, because of rounding.
Source: McKinsey Institutional Investor Surveys 2016 and 2019

are our partners and we want them to put capital to work," said the chief investment officer of one North American endowment. The need for true partnerships also applies to funds with institutional investment-platform relationships. Some of these partners, particularly in areas such as commercial real estate, are suffering deeply. The current situation is putting the concept of long-term partnerships to the test.

Exercise people leadership

A handful of leaders also said that they want to double down on their longer-term strategic agendas, especially on the talent front. Many private-sector employers worry about layoffs, for example, but one leader articulated a plan to accelerate recruitment efforts. "We've always believed that getting the best talent was what would make or break our success, and our organizational mission speaks to people, now more than ever." Indeed, many see the current disruption as a moment of truth in their relationship with their people—an opportunity to build trust and loyalty with current employees and to differentiate themselves from other market participants in recruiting new talent.

The magnitude and ramifications of the pandemic's impact on these large pools of capital—and on the public servants, pensioners, citizens, students, and others who depend upon them—will not be well understood for years. But these early signals appear to offer a directional sense: as in rosier times, the most thoughtful investors carefully separate temporary shifts from longer-term secular changes, trying to stay a step or two ahead of a deeply uncertain and rapidly evolving situation.

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Preparing for private-equity exits in the COVID-19 era

Exits have all but stopped, for the moment. Leading firms are taking advantage of the extra time.

by Alastair Green, Ari Oxman, and Laurens Seghers

The global coronavirus pandemic, a humanitarian crisis with few precedents, is exacting a toll on lives and livelihoods alike. Private equity (PE) firms, like all other companies, have been working diligently on both fronts: ensuring the safety of employees and customers, and shoring up portfolio companies so they can ride out the crisis. Now that these first few months have passed, firms are turning to other challenges. For the hundreds of founders and sponsors contemplating a sale in 2020, that means contending with four enormous uncertainties the COVID-19 crisis has produced seemingly overnight:

— *Substantial barriers to deal execution have emerged.* For example, it is now difficult to conduct due diligence face-to-face or to visit production facilities (assuming that they are open), and financing to support deals costs more.

— *Valuations have suddenly shifted.* For the most part they are lower because the performance of businesses, at a time when demand has been collapsing, is uncertain and public equity multiples are volatile.

— *Humanitarian, health, and business disruptions have proved overwhelming.* These concerns are occupying all available management time and attention; firms have rightly deprioritized exits.

— *New weaknesses have been revealed in many companies.* This includes companies that appeared attractive in good times but are now less so to buyers. Many companies have suffered an economic hit from the COVID-19–led recession. Some, such as service providers that once described themselves as "mission critical," have discovered that many customers view their offerings as discretionary.

The results of the pandemic have been startling. With a couple of exceptions—such as structured transactions and deals signed before the crisis—traditional PE exits have slowed significantly since mid-March of this year. Announced PE exits dropped almost 70 percent globally in May 2020 versus May 2019.

Hundreds of sponsor-backed companies preparing for imminent exit now find themselves in a waiting state: unable to exit but with additional time to prepare. To find out when exits might return, and how CEOs and sponsors can use the additional time, from March to May we interviewed more than 40 sponsors, investment bankers, and CEOs, mostly based in Europe and the United States. The range of estimates was wide; most said exits might come back in six to 12 months; few respondents said more than 18 months. Exits for PE investors through traditional leveraged buyouts will remain difficult for at least an additional four to six months, and many sponsors are spending far more time than normal on preparing exits. The last point came as a surprise. Our 2019 survey of 30 US-based private equity firms found that, on average, mid- and senior-level deal professionals spend only 3 to 5 percent of their time actively preparing for exit.

Many sponsors told us that they are taking unusual steps to prepare for exits. In this article, we will spell out these emerging best practices to help companies make the most of their exit preparations during the COVID-19 era. In our conversations, we observed four major tactics CEOs and sponsors are now pursuing. Of course, each company is different and each may pursue a different combination of these tactics.

Investing in growth areas

Many companies have seen significant growth in certain categories (such as personal protective equipment and other healthcare-related goods and services); many have also seen growth in online sales. Others have been less fortunate: COVID-19 has spurred many companies to open new business models to stay relevant in the next normal.

For instance, we spoke with one service company that had a small-scale delivery business. The head of the delivery unit was surprised to see an uptick in orders of all kinds beginning in mid-March. In addition, a growing number of smaller merchants wanted the company to distribute for them and were willing to share profits. Instead of viewing the distribution revenues as a one-off event, the company is investing in its distribution model and creating a delivery-loyalty program. It now expects the new revenue stream to account for more than 20 percent of gross profits by the end of 2020.

As another example, the chief revenue officer (CRO) of a specialty janitorial company described how employers are pushing to disinfect work environments more frequently than they did before COVID-19. The increased rate of cleaning has helped the company to grow, but that growth has come with requests from customers for a dashboard to track and monitor the cleanliness of their facilities in real time. The CRO recognizes that investing in the appropriate customer-facing technology will soon become a critical enabler to continue servicing the growing janitorial market.

Capturing value—or signaling its potential

Creating more value is an integral part of the holding-period playbook, but the crisis is giving companies a chance to pursue such efforts more deeply than they did before. We spoke with the CFO of one technology company nearing the end of the holding period. It is now bringing forward a program it planned for the next holding period, should it have been necessary. The company is renegotiating its third-party spending and proactively cross-selling in its major accounts. As a result, it appears to be on track to lift its earnings before interest, taxes, depreciation, and amortization (EBITDA) by more than 15 percent. While the current crisis did not precipitate the value-creation effort, it did provide the time to change the back-office model—and helped its customers understand the need for change now.

Other companies focus on demonstrating their value-creation potential to buyers rather than capturing it themselves. One business-service company with double-digit growth broke down its growth prospects in every product category and for each of its top 250 customers. By studying three historical trends—the growth rate in new-product cross-sells, the pace of new-client introductions, and the typical "ramp" of customer spending over five years—it has developed a far more detailed revenue forecast, which it will use to reallocate its resources. The analysis took a few weeks—time it did not have earlier but now does.

Another portfolio company, active in manufacturing, introduced natural-language processing to extract key terms rapidly and accurately from its thousands of contracts and to help monitor expiration dates. This information helped the company to realize cost savings in both long- and short-duration procurement contracts. The digitization of terms makes it possible to manage vendors in real time, without the need to reference original contracts—again saving time and resources.

A third company—a healthcare payer—is contemplating a multiyear transition to a fixed price per patient, after years of charging variable costs. While the company cannot migrate all its customers to the new model, it is carrying out experiments at a handful of them to demonstrate better medical outcomes for patients, as well as more attractive margins for future buyers. The crisis has created a window for experimentation.

Hard pivots

As we mentioned, the recession has revealed material weaknesses in some business models, such as those of specialty retailers that mistakenly saw themselves as essential to consumers and of retailers that lack bargaining power with suppliers. After solving their immediate liquidity issues, forward-thinking sponsors are making the hard choices now to pivot to a stronger and more resilient business model.

One technology company preparing for exit sold predominantly into the real-estate and hospitality sectors. It had generally priced on a pay-per-use model, which was attractive to many customers. It had previously resisted attempts to move to a fixed-fee software-as-a-service (SaaS) model, as many similar companies have done. Although it has sufficient cash on hand to withstand a protracted downturn, it is now taking the plunge, moving many of its customers to fixed-price or take-or-pay contracts that will provide an even greater cushion in the next downturn (and will probably support better financing).

Some portfolio companies are also diversifying revenues to reduce cyclicality and improve resilience. For an infrastructure-services company focused on logistics and installation of capital equipment, this means a shift toward recurring revenues tied to services in operations and maintenance. Similarly, an industrial-equipment company shifted its mix to include more digitally enabled services.

Strategic planning for a changed future

A handful of companies we spoke with said that in the years ahead, their customers and competition will look very different. They also acknowledge that they do not yet have all the answers about how to prepare. Rather than adjust the existing model, they are fundamentally rethinking their strategies and building them around clear-eyed visions of the future.

Take the example of a real-estate-finance company that leverages its 15-year history and database of past deals to underwrite its loans. It has seen, firsthand, that the cost of capital is rising in its industry—and this is putting pressure on many smaller competitors that lack its underwriting sophistication. The company is securing additional sources of capital and investing in data scientists to serve its customers even more efficiently by more accurately underwriting the risk in their projects. Demonstrating greater efficiency and the ability to scale is now a core part of the company's road map for the future.

Another example comes from a media-service business with a large international exposure. It was gearing up for exit in the near term, but the deal team and management quickly realized that timeline was unsustainable. Instead, they opted to recommit to the future of the company and to review its end markets strategically. This drastically increased the ambition of the business: the deal team and managers identified many M&A targets at attractive valuations. Pursuing these should help turbocharge growth in the years ahead and may also allow entry into adjacent market segments that were out of the picture only two months ago.

The impact of COVID-19 on companies will differ greatly, both in direction (a positive or negative impact on performance) and the degree of change (small or drastic) required to adapt to the next normal. Smart companies and their sponsors—probably in touch with their investment bankers—should invest the time to understand which strategies can help create value and then begin planning accordingly.

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Reimagining the office and work life after COVID-19

The pandemic has forced the adoption of new ways of working. Organizations must reimagine their work and the role of offices in creating safe, productive, and enjoyable jobs and lives for employees.

by Brodie Boland, Aaron De Smet, Rob Palter, and Aditya Sanghvi

COVID-19 has brought unprecedented human and humanitarian challenges. Many companies around the world have risen to the occasion, acting swiftly to safeguard employees and migrate to a new way of working that even the most extreme business-continuity plans hadn't envisioned. Across industries, leaders will use the lessons from this large-scale work-from-home experiment to reimagine how work is done—and what role offices should play—in creative and bold ways.

Changing attitudes on the role of the office

Before the pandemic, the conventional wisdom had been that offices were critical to productivity, culture, and winning the war for talent. Companies competed intensely for prime office space in major urban centers around the world, and many focused on solutions that were seen to promote collaboration. Densification, open-office designs, hoteling, and co-working were the battle cries.

But estimates suggest that early this April, 62 percent of employed Americans worked at home during the crisis,[1] compared with about 25 percent a couple of years ago. During the pandemic, many people have been surprised by how quickly and effectively technologies for videoconferencing and other forms of digital collaboration were adopted. For many, the results have been better than imagined.

According to McKinsey research, 80 percent of people questioned report that they enjoy working from home. Forty-one percent say that they are more productive than they had been before and 28 percent that they are as productive. Many employees liberated from long commutes and travel have found more productive ways to spend that time, enjoyed greater flexibility in balancing their personal and professional lives, and decided that they prefer to work from home rather than the office. Many organizations think they can access new pools of talent with fewer locational constraints, adopt innovative processes to boost productivity, create an even stronger culture, and significantly reduce real-estate costs.

These same organizations are looking ahead to the reopening and its challenges. Before a vaccine is available, the office experience probably won't remain as it was before the pandemic. Many companies will require employees to wear masks at all times, redesign spaces to ensure physical distancing, and restrict movement in congested areas (for instance, elevator banks and pantries). As a result, even after the reopening, attitudes toward offices will probably continue to evolve.

But is it possible that the satisfaction and productivity people experience working from homes is the product of the social capital built up through countless hours of water-cooler conversations, meetings, and social engagements before the onset of the crisis? Will corporate cultures and communities erode over time without physical interaction? Will planned and unplanned moments of collaboration become impaired? Will there be less mentorship and talent development? Has working from home succeeded only because it is viewed as temporary, not permanent?

The reality is that both sides of the argument are probably right. Every organization and culture is different, and so are the circumstances of every individual employee. Many have enjoyed this new experience; others are fatigued by it. Sometimes, the same people have experienced different emotions and levels of happiness or unhappiness at different times. The productivity of the employees who do many kinds of jobs has increased; for others it has declined. Many forms of virtual collaboration are working well; others are not. Some people are getting mentorship and participating in casual, unplanned, and important conversations with colleagues; others are (For this edition of *McKinsey on Investing*, we've added a current perspective on these trends. See sidebar "The workplace will never be the same" on page 58.)

Four steps to reimagine work and workplaces

Leading organizations will boldly question long-held assumptions about how work should be

1 Megan Brenan, "US Workers Discovering Affinity for Remote Work," *Gallup*, April 3, 2020, gallup.com.

done and the role of the office. There is no one-size-fits-all solution. The answer, different for every organization, will be based on what talent is needed, which roles are most important, how much collaboration is necessary for excellence, and where offices are located today, among other factors. Even within an organization, the answer could look different across geographies, businesses, and functions, so the exercise of determining what will be needed in the future must be a team sport across real estate, human resources, technology, and the business. Tough choices will come up and a leader must be empowered to drive the effort across individual functions and businesses. Permanent change will also require exceptional change-management skills and constant pivots based on how well the effort is working over time.

We recommend that organizations take the following steps to reimagine how work is done and what the future role of the office will be.

1. Reconstruct how work is done
During the lockdowns, organizations have necessarily adapted to go on collaborating and to ensure that the most important processes could be carried on remotely. Most have simply transplanted existing processes to remote work contexts, imitating what had been done before the pandemic. This has worked well for some organizations and processes, but not for others.

The workplace will never be the same

For investors in and owners of office properties, 2020 has been a roller coaster of a year. The great experiment with remote work in 2020 left an unprecedented amount of office space empty for many months. While challenging for many knowledge workers, 72 percent said they "love working from home" in a recent survey.[1] Many workers wonder if the typical office might become a thing of the past. At the same time, rents came in at about 95 percent of normal during the year, and delinquencies of more than 30 days were consistently below 3 percent.[2] All of this added up to office real-estate investment trusts losing 20 percent of the prepandemic peak of their unlevered value.[3]

Many had doubts about working from home. The experiment of 2020 defied expectations because of mass adoption of collaboration technologies. And it reset expectations for the future, because it created a newly imagined possibility of how much flexibility one can have in where and how one works. Still, the vast majority of organization leaders we speak with believe that some frequency of physical presence is critical. Even some of the companies that have announced permanent work-from-home options are simultaneously signing major leases or building new headquarters.

The future of work will be a hybrid, but the proportions of working-from-home time and in-office time are far from settled. As they feel their way into the next normal, organizations seek to combine the best of how they operated before the pandemic with what they learned from the crisis. Their reflections are already leading many to focus on the in-person, face-to-face "moments that matter" for employee collaboration, alignment, and community. Investors in offices are eager to see how frequent these moments are—daily, weekly, or monthly—which will help determine the amount of space that office tenants need as well as the designs and configurations that will promote the interactions that tenants seek.

Right now, the amount of office space that meets those needs seems small. Many markets could experience both an oversupply of space, and a scarcity of offices that are purpose-built for hybrid work. Spaces, designs, experiences, amenities, leases, food and beverage access, and the like will have to be reimagined for hybrid work. The premium that such space might command remains to be seen.

In our view, landlords need to adapt in the following five significant ways:

Become a solution partner rather than a negotiating foe. Most tenants do not yet know how to navigate hybrid work. Tenants need owners to come forward with solutions rather than be foes across the negotiation

Organizations should identify the most important processes for each major business, geography, and function, and reenvision them completely, often with involvement by employees. This effort should examine their professional-development journeys (for instance, being physically present in the office at the start and working remotely later) and the different stages of projects (such as being physically co-located for initial planning and working remotely for execution).

Previously, for example, organizations may have generated ideas by convening a meeting, brainstorming on a physical or digital whiteboard, and assigning someone to refine the resulting ideas. A new process may include a period of asynchronous brainstorming on a digital channel and incorporating ideas from across the organization, followed by a multihour period of debate and refinement on an open videoconference.

Organizations should also reflect on their values and culture and on the interactions, practices, and rituals that promote that culture. A company that focuses on developing talent, for example, should ask whether the small moments of mentorship that happen in an office can continue spontaneously in a digital world. Other practices could be reconstructed and strengthened so that the organization creates and sustains the community and culture it seeks.

table. Owners will need to evolve their leasing approach into so-called consultative sales. For example, landlords can partner with tenants to figure how much space is needed.

Make the workplace magical. Occupiers will increasingly focus on making the workplace an exciting place to be, given that the next-best alternative (home) has proved better than imagined. Cube farms have to go. Space has to be purpose-built for hybrid work. An ecosystem of restaurants, lounges, food and beverage stations, and the like must emerge. Services such as food ordering, concierge services, and room and workspace booking must become digital and convenient and be safe and healthy.

Expand flexibility. New leasing models were just the start. The notion of flexibility will expand to include lease structures and the space itself. Owners could begin to experiment with innovative lease structures, similar to those in retail. In addition, as lessees help a hybrid workforce adapt to new ways of working, they will want greater variability in the amount and type of space they rent and in the timing of their requirements in a given week or month.

Emphasize tenant selection. All tenants are not created equal. Winning landlords will need to think about their tenant mix and the importance of physical space to tenants' business models and ways of working. Landlords able to lease space thoughtfully, with these considerations in mind, are likely to have a "stickier" set of leases that will support their business in coming years.

Reimagine operations. During the lockdown, owners and operators of space had to develop new ways of working to service their buildings. From leasing to property management to tenant experience, the way companies operate day to day can become hybrid itself with the right digitization. Landlords need to both adapt to and embrace these new models of operations to improve the tenant experience and gain cost advantages.

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1 McKinsey survey of 556 US consumers, December 2020.
2 Weighted by REIT market capitalization. "REIT Industry September 2020 Rent Collections," Nareit, September 23, 2020, reit.com.
3 Green Street.

For both processes and cultural practices, it is all too tempting to revert to what was in place before the pandemic. To resist this temptation, organizations could start by assuming that processes will be reconstructed digitally and put the burden of proof on those who argue for a return to purely physical pre–COVID-19 legacy processes. Reimagining and reconstructing processes and practices will serve as a foundation of an improved operating model that leverages the best of both in-person and remote work.

2. Decide 'people to work' or 'work to people'

In the past couple of years, the competition for talent has been fiercer than ever. At the same time, some groups of talent are less willing to relocate to their employers' locations than they had been in the past. As organizations reconstruct how they work and identify what can be done remotely, they can make decisions about which roles must be carried out in person, and to what degree. Roles can be reclassified into employee segments by considering the value that remote working could deliver:

— fully remote (net positive value-creating outcome)

— hybrid remote (net neutral outcome)

— hybrid remote by exception (net negative outcome but can be done remotely if needed)

— on site (not eligible for remote work)

For the roles in the first two categories, upskilling is critical but talent sourcing may become easier, since the pool of available talent could have fewer geographical constraints. In fact, talented people could live in the cities of their choice, which may have a lower cost of living and proximity to people and places they love, while they still work for leading organizations. A monthly trip to headquarters or a meeting with colleagues at a shared destination may suffice. This approach could be a winning proposition for both employers and employees, with profound effects on the quality of talent an organization can access and the cost of that talent.

3. Redesign the workplace to support organizational priorities

We all have ideas about what a typical office looks and feels like: a mixture of private offices and cubicles, with meeting rooms, pantries, and shared amenities. Few offices have been intentionally designed to support specific organizational priorities. Although offices have changed in some ways during the past decade, they may need to be entirely rethought and transformed for a post–COVID-19 world.

Organizations could create workspaces specifically designed to support the kinds of interactions that cannot happen remotely. If the primary purpose of an organization's space is to accommodate specific moments of collaboration rather than individual work, for example, should 80 percent of the office be devoted to collaboration rooms? Should organizations ask all employees who work in cubicles, and rarely have to attend group meetings, to work from homes? If office space is needed only for those who cannot do so, are working spaces close to where employees live a better solution?

In the office of the future, technology will play a central role in enabling employees to return to office buildings and to work safely before a vaccine becomes widely available. Organizations will need to manage which employees can come to the office, when they can enter and take their places, how often the office is cleaned, whether the airflow is sufficient, and if they are remaining sufficiently far apart as they move through the space.

To maintain productivity, collaboration, and learning and to preserve the corporate culture, the boundaries between being physically in the office and out of the office must collapse. In-office videoconferencing can no longer involve a group of people staring at one another around a table while others watch from a screen on the side, without being able to participate effectively. Always-on videoconferencing, seamless in-person and remote collaboration spaces (such as virtual whiteboards), and asynchronous collaboration and working models will quickly shift from futuristic ideas to standard practice.

4. Resize the footprint creatively

A transformational approach to reinventing offices will be necessary. Instead of adjusting the existing footprint incrementally, companies should take a fresh look at how much and where space is required and how it fosters desired outcomes for collaboration, productivity, culture, and the work experience. That kind of approach will also involve questioning where offices should be located. Some companies will continue to have them in big cities, which many regard as essential to attract young talent and create a sense of connection and energy. Others may abandon big-city headquarters for suburban campuses.

In any case, the coming transformation will use a portfolio of space solutions: owned space, standard leases, flexible leases, flex space, co-working space, and remote work. Before the crisis, flexible space solutions held about 3 percent of the US office market. Their share had been growing at 25 percent annually for the past five years, so flexibility was already in the works. McKinsey research indicates that office-space decision makers expect the percentage of time worked in main and satellite offices to decline by 12 and 9 percent, respectively, while flex office space will hold approximately constant and work from home will increase to 27 percent of work time, from 20 percent.[2]

These changes may not only improve how work is done but also lead to savings. Rent, capital costs, facilities operations, maintenance, and management make real estate the largest cost category outside of compensation for many organizations. In our experience, it often amounts to 10 to 20 percent of total personnel-driven expenditures. While some organizations have reduced these costs by thinking through footprints—taking advantage of alternative workplace strategies and reviewing approaches to managing space—many corporate leaders have treated them largely as a given. In a post–COVID-19 world, the potential to reduce real-estate costs could be significant. Simply getting market-comparable lease rates and negotiating competitive facilities-management contracts will not be enough. Real-estate groups should collaborate with the business and HR to redo the footprint entirely and develop fit-for-purpose space designs quickly—in some cases, by creating win–win approaches with landlords.

The value at stake is significant. Over time, some organizations could reduce their real-estate costs by 30 percent. Those that shift to a fully virtual model could almost eliminate them. Both could also increase their organizational resilience and reduce their level of risk by having employees work in many different locations.

Now is the time

As employers around the world experiment with bringing their employees back to offices, the leadership must act now to ensure that when they return, workplaces are both productive and safe.

Organizations must also use this moment to break from the inertia of the past by dispensing with suboptimal old habits and systems. A well-planned return to offices can use this moment to reinvent their role and create a better experience for talent, improve collaboration and productivity, and reduce costs. That kind of change will require transformational thinking grounded in facts. Ultimately, the aim of this reinvention will be what good companies have always wanted: a safe environment where people can enjoy their work, collaborate with their colleagues, and achieve the objectives of their organizations.

[2] McKinsey's May 2020 Survey of Office Space Decisions Makers. n = 319. Companies surveyed have at least 2,000 full-time employees.

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The PE company CFO: Essentials for success

Private equity portfolio companies are crucibles for CFOs. Here are four essential priorities to get started on the right foot.

by Ankur Agrawal, Jeremiah Connolly, and Matthew Maloney

The idea of leading a private equity (PE) firm's portfolio company can seem attractive to many experienced CFOs. In some cases, the work may involve reviving ailing companies. In many instances, however, the finance leader will be participating in the development of a yearslong growth plan for the company, tasked with identifying opportunities to both control costs and improve operations.

Few opportunities offer CFOs the same prospects for putting their skills to the test, transforming a business, and opening doors for achieving even more impact in the future. Conversely, few opportunities offer the same perils. The skills and knowledge that make a CFO successful in more typical operating environments become table stakes in the PE world, in which borrowed capital means the risks are larger, the time to show results is shorter, and the scrutiny from investors is more intense.

The nature of reporting relationships can also be challenging. Some PE firms may trust the management teams they have in place but may still want to be involved in the financial end of things, requiring frequent updates from the CFO. Others may be relatively hands off when it comes to communications and guidance. Moreover, a PE-portfolio company's CFO is typically new to the company—and often to the industry—so there are no existing relationships to fall back on within the C-suite team, and no legacy within the company to draw upon.

The CFO will need every hand on deck to implement new processes and transform performance. Yet this individual will likely be leading smaller finance teams than would be standard—and will have just as many fires to put out.

The challenges will be new and daunting—but very addressable for CFOs who explicitly acknowledge the differences in managing people, processes, and performance in PE-owned companies. Based on our research, interviews, and experience with CFO transitions, we believe that focusing on four priorities can help ensure CFOs' success in portfolio companies, or at least set them on the right path. Specifically, they will need to get up to speed quickly on the economics at play, identify the talent gaps on their teams, establish a reliable fact base for making critical decisions, and actively lead the transformation charge.

Get clear about the economics

The new CFO's primary responsibility, of course, will be to understand the company's balance sheet and cash flow, as well as its debt covenants. The economics are likely to be more complex in this context, however. With debt fueling their investments, some PE firms emphasize cash flow in a far more demanding way than is typical in most operating-company environments: weekly or even daily reporting on cash is not unusual.

The CFO will need insight into the gritty details of what creates value and costs at the portfolio company, probing fixed and variable costs that reveal what matters most in the business's operating leverage. One CFO we interviewed estimated that developing this insight occupied as much as half of his time in his first six to 12 months. He faced IT issues (disparate systems) and cultural issues (isolated and protective business units), both of which limited his access to critical data.

The finance leader should not expect that this information will be obvious or that preexisting reports will help them understand the business—or even tell a consistent story. Inertia is the main reason that there are boundaries among business units, so the fact that unit A is more profitable than unit B reveals nothing about which activities are the ones creating (or draining) profits. Yet a comprehensive fix will likely require a lot more time than the CFO has. Instead, the CFO will have to build a minimally viable level of clarity while running the current operation and launching improvement initiatives.

The CFO of a PE-retail company recognized that trying to pull all cost data for the company's product portfolio would be impossible because the IT

Even CFOs who pride themselves on their people and talent-management skills often face challenges in PE-owned companies, in which the management infrastructure can be in flux.

systems were too antiquated and there wasn't time to do manual cleanup. Instead, his team created a standard-cost model that it could apply, with minor adjustments, to the majority of the company's products. While not precise enough for close questions on profitability, the model revealed that whole categories of products were significant money losers—largely because their prices failed to account for all logistics costs. Eliminating the bottom-decile products entirely and raising delivery charges for products in the next few tiers allowed the company to stop much of the hemorrhaging in its cash position. That bought the team time to refine the model further in reviewing the rest of the company's product line.

Find the right people

Even CFOs who pride themselves on their people and talent-management skills often face challenges in PE-owned companies, in which the existing management infrastructure can sometimes be in flux, even as investors are demanding results. The CFO, who, again, is typically an outsider, must figure out which people can lead under which circumstances and empower them. As one CFO told us, while he's updating existing treasury systems and control processes, he's also using the process to assess talent, searching for diamonds in the rough—those people who might be able to drive special projects and help transform the company. It's a perfect moment to remember that skills matter much more than job titles. For instance, the financial-planning analyst who's eager to change the way things are done may be a natural to join the transformation team. And for the treasury manager who excels at that role but also covers other parts of the function, this might be the time to redesign the role.

Indeed, the CFO must encourage talented, engaged employees to lead initiatives that deliver on the portfolio company's investment thesis, thus democratizing value creation beyond the finance function. As the CFO at a midsize PE-owned company told us, "My team members have started creating automated dashboards, but they don't have the skills to tell me anything new. It's just one more thing to look at." His task is now to coach his team members so they can extract meaning from the dashboards and act on what they find.

Such efforts at empowerment and delegation will need to include teaching people from other fields to "speak finance"—at least enough to help them work more productively with the CFO and finance team. Those with a good understanding of the company's financial position can help shift the culture away from doing things the way they have always been done and toward active efforts to improve the bottom line—for example, by tweaking performance-management systems so that employees feel encouraged to find and eliminate waste.

Own the data

A third priority centers on the use of data. The CFO's outsider status, at least initially, makes it critical for the business leader to have an expandable, reliable fact base for uncovering new and powerful opportunities for value creation—ones that the company can capture quickly.

Few PE-owned companies have good data readily available; if they did, they probably wouldn't have become portfolio companies to begin with (exhibit). Moreover, they often lack the data-analysis and -tracking capabilities required to capitalize on value-creation opportunities. Yet the PE time horizon means that a multiyear rollout of a new enterprise-resource-planning system will not be feasible, even if it were desirable. Portfolio-company CFOs thus need to understand where and how to use lower-cost digital technologies to maximize the benefits in months or even weeks rather than years.

Even in a relatively short period of time, a PE-owned company's CFO can make targeted investments in productivity-enhancing tools, such as off-the-shelf, cloud-based invoice-management software that reduces time and hassle while increasing transparency and policy enforcement. A useful approach is to identify those data initiatives that will deliver high-value, quick wins in the near term while also getting other middle- and longer-term projects in flight.

That's the approach an international retailer is taking. Before it was acquired by a PE firm, it had more than 100 separate IT systems, each siloed from the rest. With revenue falling, there was no budget or time for a major IT upgrade. But a targeted, million-dollar investment in a cloud-based data lake provided much of the same benefit—supporting business intelligence and data visualization, for instance, which are both essential for future investments in performance improvement—but with only weeks of design and implementation.

Lead the transformation charge

The final priority for the new CFO in a PE-owned company is to keep the overall transformation on track. That includes defining key performance indicators and monitoring metrics in ways that are robust but not overwhelming.

Almost invariably, the private equity sponsor will have identified an investment thesis and will assume momentum. In daily operations, however, the CFO must understand how value is created on both the cost and revenue sides of that thesis and then

Exhibit

Data fragmentation is a top challenge for many CFOs.

Top challenge for CFOs, % of respondents (n = 50)

Source: Findings from the private-equity CFO roundtable sponsored by McKinsey and the *Financial Times* in September 2019, with 50 respondents to a series of "pulse check" questions herd all resources toward the desired outcome. Ideally, the CFO will own or co-own a few key transformation initiatives, thereby giving the CFO a showcase to model the change that leaders want to see.

With a good handle on the finance function and a clear understanding of primary levers for value creation, the CFO can be a challenger and influencer within the portfolio company—holding overly optimistic CEOs and inwardly focused business-unit leaders to account. The CFO should lead monthly business reviews with leaders in all functions, examining the factual foundation of their activities and proposals (free from bias and emotions) and ensuring that their investment decisions are in line with the company's overall priorities. In so doing, the CFO becomes the strong right arm of the CEO (and the PE fund) on strategic questions as well as on financial results and decisions.

Within PE-owned companies, CFOs are constantly measured against an ever-rising bar. The finance leaders who can master the four critical priorities described here can improve the odds of success, not just in their existing roles but in other C-suite positions in future portfolio companies.

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Seeing the savings: Toward transparent management of portfolio companies

Early in the COVID-19 crisis, sponsors and portfolio companies collaborated to find ways to conserve cash. The next step, delivering the savings, requires heightened diligence and discipline.

by Barr Blanton, Matthew Maloney, Ben Mathews, and Jason Phillips

In April 2020, we wrote that private equity (PE) firms were consistently partnering with the leaders of their portfolio companies to identify potential actions to preserve cash and ensure liquidity. At the time, the decisiveness of those initial actions was reassuring. Yet today, many PE firms are questioning whether their portfolio companies will deliver the promised savings.

One concern is that, in most markets, the COVID-19 pandemic is the first major economic crisis in a decade. A steep learning curve is to be expected as portfolio companies navigate it. Further, PE-firm leaders have often had the experience in which "big savings programs" do not translate into real results in P&L.

A number of PE firms are taking a more forward-leaning approach. They are recommending process and behavioral changes to help their portfolio companies better measure and manage the work of saving cash and managing liquidity—work that can be critical to survival. Two approaches can support that goal.

A "spend control tower" (SCT) offers a pragmatic way for companies to ensure that they are spending the right amount, no more and no less. And an approach to track the "delta and absolute" makes sure that savings (the delta in performance that a company expects) are real and are fully realized when P&L absolute values are calculated. The combination is the "unlock" that many companies are missing to ensure that the savings proposed in meetings find their way to the bottom line. Not only does the approach help deliver the savings, it also promotes the culture of ownership, agile ways of working, and fact-based discussions that will continue to help management teams deliver greater impact over time.

The spend control tower

Typically deployed in a time of crisis for a finite period (six to 12 months), an SCT is both a team and a process. Every day, managers propose expenses to a central decision-making body. They make a case for those expenses, saying why they are needed. The SCT hears them out, then approves or rejects the proposal that same day.

An SCT focuses primarily on general and administrative spending, as well as some indirect costs of goods sold. It reviews all spending, including point-of-sale purchases, invoices, expense reports, and recurring expenses, such as subscriptions. (It doesn't manage direct costs of goods sold.)

The SCT process temporarily supersedes all current spending-approval processes and the mechanisms many companies have installed to ease purchasing, such as blanket purchase orders and purchasing cards. An SCT tracks all its decisions. In our experience, using the SCT approach can quickly reduce non-direct-cash expenditures by 10 to 15 percent.

A 'spend control tower' offers a pragmatic way for companies to ensure that they are spending the right amount, no more and no less.

While the SCT approach can seem simplistic, disengaging, and time consuming—particularly during a crisis—a closer look reveals the power embedded in a process that's focused, deliberate, and disciplined:

— *Focused.* While the SCT approach isn't particularly complicated, it can be very effective. It begins by addressing the fundamental premise that too much spending is on autopilot and that mindsets around spending must be reset. At most companies, a delta-prior-year approach to budgeting rarely allows for that change—detail is lacking, and budget owners often don't know where to look for opportunities. A renewed focus on fundamentals can help companies prioritize critical expenditures and reset their spending bases accordingly.

— *Deliberate.* Executives often worry about whether the approach will alienate their workforces. When an SCT is supported by strong communication, with a clear case for change, we have found the opposite. As Byzantine, multilevel review processes are replaced by a streamlined approach that results in accelerated approval, line managers come to appreciate SCTs. Employees often find the speed and agility of the approach for justifiable spending to be energizing. Some team members, however, will likely find it intimidating or frustrating, so making a compelling case for change is particularly critical.

— *Disciplined.* While a daily process can seem time consuming, many leaders are surprised to find that the volume of issues isn't as significant as expected. Maintaining discipline is key: most organizations can effectively manage the SCT process in 30 minutes per day with the right procedures, roles, and preparation.

Initially, the biggest difficulty an SCT faces can be in making the tough decisions—in saying no. It's changing not only processes and behaviors but also mindsets and culture around budgets and expenditures. That's where an SCT team needs a clear mandate from the top and the initial engagement of senior leaders to model the desired changes.

Another problem is lack of time. While reviewing all invoices individually requires incremental effort at first, the workload reduces dramatically over time as employees adjust and adapt to the new culture. Once an SCT establishes expectations about what will and won't be approved, it isn't uncommon for those operating in steady state to spend fewer than 30 minutes a day on SCT work.

The delta and the absolute: How savings get seen

As managers of cost-cutting programs know, even well-designed initiatives are subject to leakage. Most commonly, managers will siphon off savings from the programs and reallocate them to other parts of their budgets.

Whether a company uses an SCT or other methods to rationalize its spending, it needs to ensure that savings stay saved and show up on its bottom line. In our experience, that requires two steps. The first is making sure that the designed savings are really there for the taking. The second, once the initiative is underway, is making sure that the savings are visible to managers as they are achieved, as part of the monthly reporting process. Cost cuts and similar performance initiatives are only successful if the delta is converted to absolute value at the year's end.

Are the savings real? Verifying the delta

In our experience, three actions can form a systematic approach to making sure that the savings are there to be had. While they are common-sense moves for many managers, they aren't common practices.

A first move is to *build the right fact base to measure improvement*. In our experience, a company must develop a clear baseline of actual results rather than using traditional budgets or forecasts, both of which often contain broader assumptions that are more difficult to unpack at the same level of granularity. A baseline should be built in a way that will illuminate the drivers of a company's performance.

To then drive specific savings initiatives, a company must *identify a single source of truth* that houses all the values of planned initiatives, and their status, across all departments and functions. Most managers have experienced the pain of combining various spreadsheets, presentations, and valuation methods to come up with a board-level view of value creation and progress. That complexity inhibits speed, transparency, and accountability and, ultimately, makes it more difficult to track savings to the bottom line. A single source of truth solves the issue.

Third, in our experience, initiatives are often assigned a general value (such as $1 million over two years). But few companies make it sufficiently clear where the value will show up in the P&L and how it will materialize over time. That makes it difficult to "find" the value later. In our view, a tracking approach for each initiative must be mapped to general-ledger accounts, and initiatives' impact (monthly, quarterly, and yearly) must be anticipated in planning. When combined with a baseline based on actual results, those actions create the foundation for a company to "squeeze out" additional productivity by *using initiative plans to reforecast the business*. That removes the possibility of unintended leakage or reinvestment.

Are the savings realized? Converting to absolute
Companies know well that many factors influence published results. Business trends, the macroeconomy, production variations—all those and more routinely push results up and down. Finance teams know that better than most because they are asked to explain variance every month.

But few companies tackle the problem comprehensively. Most are content to calculate the net figures each month, and offer a few anecdotes to explain variance from plan. That's a problem: not only does it mean that the effect of savings initiatives is obscured by other factors, it also means that management doesn't have a solid understanding of the true influences on performance. What's needed is a more detailed look at the changes in several categories of change, including business growth, acquisitions, improvement and deterioration—and savings initiatives.

Consider a category we call "headwinds and tailwinds"—macrofactors, such as changes in accounting rules and unusual weather patterns, that are outside a company's control. Companies can calculate the effect of such factors on margins and expenses; in so doing, they remove one layer of the uncertainty masking the effect of savings initiatives. Similar work on other categories can pull back the rest of the curtains.

Achieving that kind of detailed understanding of the "hydraulics" inside the net numbers is both an art

Most companies are content to offer a few anecdotes to explain variance from plan.

and a science. It can be done quickly, in an analog way, and doesn't need to be 100 percent accurate. Simply going through the exercise can be revealing, as it informs a more precise management discussion on business performance.

Digitizing the tracking approach

Some analytically advanced portfolio companies have gone a step further, embedding their tracking systems as digital overlays to the financials of their enterprise-resource-planning systems by using either custom interfaces or a third-party solutions. That approach requires some initial effort to set up: companies must map general-ledger codes to a standard taxonomy to prevent "whack a mole" spending. Without a standard taxonomy, coding is discretionary. Too often, a reduction in temporary-labor costs, for example, is offset by an increase in office-services spending for the same expenditure.

Recognizing the power and value of such an overlay, some PE firms have deployed a consistent system across their portfolio companies to enable dynamic visibility from a firm level into the operating performance of their investments. While relatively rare in the pre-COVID-19 world, that cross-portfolio monitoring system has paid off handsomely in recent months for firms that had the foresight to build one.

Such firms were able to pivot the frequency of their performance reviews—from monthly to weekly or from weekly to daily—quickly, with minimal distraction of the portfolio-company finance teams that were focused on steering the businesses through the crisis. Those firms also were able to create standardized dashboards to track company performance against specific COVID-19-related savings initiatives to target areas of risk across the portfolio quickly. While such a portfolio-management model may have seemed time intensive and interventionist a few months ago, it may well become increasingly common in more PE firm playbooks in the coming months as the global economy begins the climb out of the current economic crisis.

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Startup funding in logistics

A new report looks at the impact of new money in an old industry—and what it means for incumbents, startups, and investors.

by Ludwig Hausmann, Tobias Wölfel, Jaron Stoffels, and Oliver Fleck

© Getty Images

The transport and logistics sector has seen marked improvements in recent decades. As new technologies have entered the market, efficiency has increased and prices have decreased. Yet the industry continues to face significant challenges, including a high number of breakpoints, complex pricing rules, and a lack of data standardization.

While low profitability has made it difficult for the industry to address these issues, a new generation of logistics startups aims to solve them. In our new report, Startup funding in logistics: New money for an old industry?, we analyze more than 120 of the biggest logistics startups—representing an estimated 93 percent, or $26 billion, of total startup funding in logistics to date—and explore recent funding trends and their implications for incumbents, startups, and investors. The remainder of this article teases out lessons from one chapter of the report. For more information on more recent developments, see the sidebar "The impact of COVID-19 on logistics startups and venture-capital funding."

Venture capital discovered the logistics industry in 2015

Venture capitalists (VCs) have recently invested around $28 billion in logistics startups, nearly all of it since 2015. In our sample, the number of reported deals was stagnant from 2016 to 2018 then dropped in 2019. Over the same period, the average deal size and total funding grew threefold (Exhibit 1). These findings show that growth is no longer fueled by having multiple funding rounds; instead, it occurs as startups reach maturity and receive larger funding rounds.

As in other industries, logistics funding is highly concentrated. The ten best-funded companies have received about 46 percent of total funding, and the top 20 about 66 percent (Exhibit 2).

Most funding goes to startups working on last-mile and freight platforms

This significant rise in funding begs the question: Where does all this money go, and what are the trends getting investors excited about this industry?

Last mile: Venture capital's favorite

Most funding, around $11.1 billion, was raised by startups offering last-mile delivery services to retailers and individuals—a VC bet that we analyzed in detail in 2017.[1] Of this amount, $9.9 billion went to startups that rely on unconventional delivery modes, such as crowdsourced delivery, drones, autonomous vehicles, and shipments to parcel lockers. This trend suggests that investors see an opportunity for unconventional last-mile services to complement companies with traditional delivery fleets as they anticipate the next normal in last-mile parcel delivery.

One unconventional startup is Nuro, which designs, manufactures, and operates delivery robots. Its R1 driverless delivery vehicles are being piloted in Houston, Texas, and Scottsdale, Arizona, through a partnership with Kroger to deliver groceries for a fee. The California-based company's Series B venture round brought in $940 million in February 2019 and was led by SoftBank's Vision Fund.[2]

Another unconventional player, the Shenzhen-based Hive Box, was established in 2015 and now operates more than 150,000 parcel lockers located across China. Together, these receive more than nine million parcels per day. Five express companies, including SF Express, have a stake in Hive Box. The company raised $323 million in a Series B round in January 2018 and to date has received more than $700 million in funding.

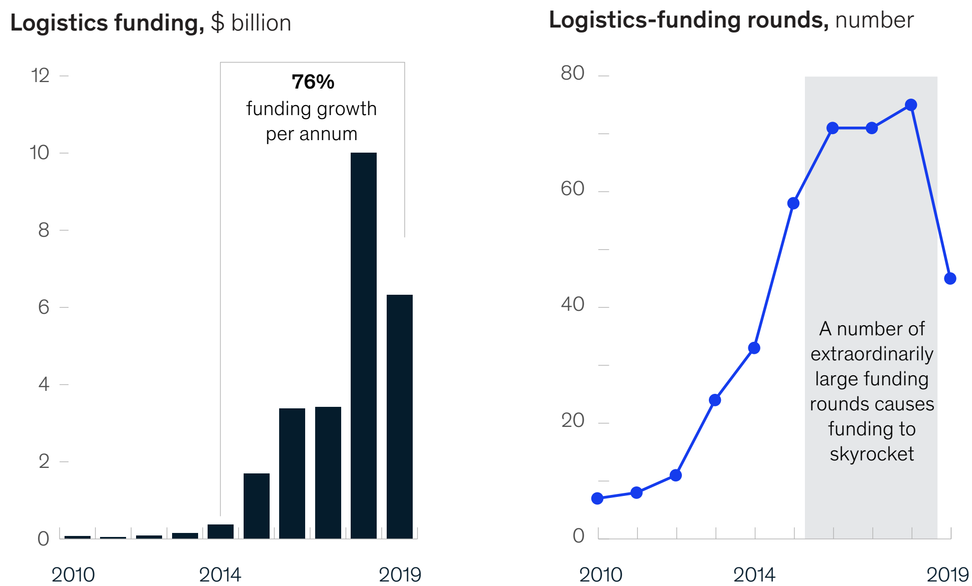
The freight platform market: Startups pushing forward, incumbents catching up

Freight platforms have also captured investor attention. This holds especially true for platforms that focus primarily on road transportation, which have received about $6 billion in funding. While the vast majority of this sum comes from investment funds, this segment has also seen the most corporate funding. For example, DB Schenker acquired a $25 million stake in the road-freight booking platform uShip.

Road-freight platforms enhance pricing transparency, professionalize, and digitize the often informally handled shipper–carrier exchange.

Exhibit 1

Total funding in logistics startups has seen a dramatic increase over the past few years, growing at a 76 percent compound annual growth rate since 2014.



Source: CB Insights; company websites; Crunchbase

They focus on leveraging existing data as a means to address vast inefficiencies that still exist in the market (for instance, those caused by empty runs). Thus, these startups significantly contribute to improving sustainability within the transport and logistics industries, a trend that is becoming increasingly relevant. They are extremely easy for truckers and others to use, which improves the customer experience.

While road-freight marketplaces and solutions have yet to capture large volumes, they have challenged asset-light brokers and freight forwarders by matching shippers, loads, and carriers directly, thus threatening to replace traditional intermediaries. Some incumbent players have already reacted to the emergence of road-freight startups. For instance, DHL Freight launched the online marketplace Saloodo in 2016, and Kuehne + Nagel launched FreightNet, a road-freight booking platform, in 2014.

Freight platforms that focus on air and ocean transport have raised far less than their road transportation peers—about $1.6 billion. Flexport, with its strong offering and prominent customer base, clearly dominates this segment and accounts for $1.3 billion of this funding. Flexport recently announced a partnership with Chinese delivery and logistics company SF Express to provide complete freight services, including full container-load ocean shipping and air cargo.

Incumbents have also reacted in this segment. For instance, Maersk launched its own digital forwarder, Twill, in April 2017. The digital shipping platform initially focused on shipments between China and the United Kingdom, but quickly expanded and managed to reach 27 countries by the end of 2018.

Asia–Pacific: Successful new entrants with traditional business models

Outside of mainland China, Asia has a high concentration of very well-funded logistics startups, especially in Hong Kong, India, and Singapore. Last-mile startups entering the market with more traditional modes (such as scooters, vans, and trucks) are most successful in the Asia–Pacific region, especially in India, where players, such as Delhivery and Xpressbees, have built a completely new parcel network and collected hundreds of millions in funding within a few years. These developments show that the traditional parcel players' offerings have not sufficiently addressed these markets.

Incumbents: Here to stay?

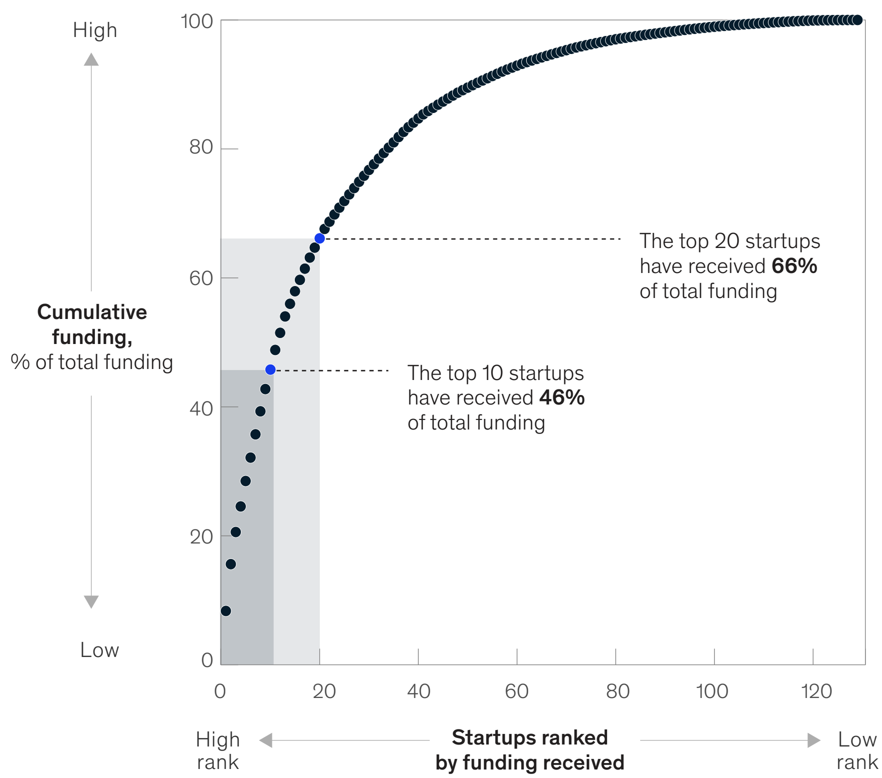
Although logistics incumbents are not going anywhere, the question remains: How disruptive will these startups turn out to be? The good news for the traditional logistics providers is that the network, assets, and relationships of incumbents are not going to be disrupted over the short term, at least not in their major markets. Currently, no new entrant has enough control over its network to ensure globally integrated, seamless transportation on behalf of a large shipper—a capability that Kuehne + Nagel or DHL Global Forwarding consider their domain.

At the same time, startups have conquered markets where incumbents had a weak offering. To prevent new entrants from capturing the second wave of growth segments and keep other customers from insourcing, incumbents must review their global presence and customer satisfaction across service segments. They should also focus on new customer requirements, such as increased sustainability, and map these within the most promising growth segments.

Exhibit 2

The ten best-funded startups account for 46 percent of total funding.

Startup ranking by cumulative funding



Source: Crunchbase

Overarching partnerships will be increasingly important to succeed in the future, especially since processes in the industry are so intertwined. Connecting startups with incumbents can unlock substantial opportunities for all stakeholders. Incumbents have the opportunity to learn from young companies and deploy digital capabilities to link their physical network with customers; startups get to improve their credibility and brand awareness, as well as gain access to customers. Incumbents can benefit by learning how to become more agile, getting new ideas, and helping their brand be perceived as dynamic and digital.

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