McKinsey & Company

M&A Practice

India's post–COVID-19 economic recovery: The M&A imperative

The humanitarian and economic dislocations resulting from the pandemic have affected companies in India and the world. Several strategic themes can support a stronger recovery into the next normal.

by Gaurav Sharma and Toshan Tamhane

© Yuanyuan yan/Getty Images

July 2020

The COVID-19 pandemic is a humanitarian crisis that continues to damage lives and livelihoods everywhere on Earth. It has shuttered regional and national economies for weeks and months at a time. As of early July 2020, well over ten million cases had been confirmed around the world, and the virus had taken the lives of more than 500,000 people. India has struggled mightily to contain the pandemic. Indian society was mostly closed down beginning March 24. The lockdown was extended, with modified restrictions, to June 30 in the country's gradual reopening plan. At the start of July, more than 587,000 cases of coronavirus and 17,400 deaths had been confirmed in India.

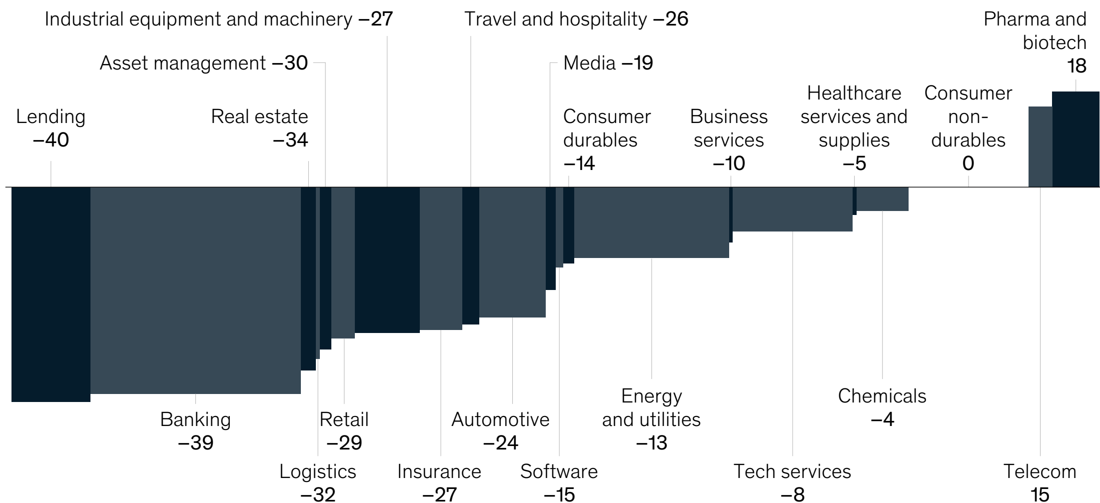
The economic fallout from the lockdown has been massive and unprecedented. Early economic indicators are sobering. Industrial production plunged by 16.7 percent in March (year on year), after only one week of lockdown. In manufacturing, the Purchasing Managers' Index (PMI), a predictor of near-term economic activity, contracted by a record amount in April and barely improved for May. The PMI for services nearly disappeared in April, with the lowest reading ever recorded anywhere in the world (5.4). Volatility and dislocations have severely disrupted the labor and capital markets. As Exhibit 1 shows, market capitalization declined significantly in India from December 2019 to May 2020, partly as a result of a net outflow of more than $5 billion in foreign investment from January to April.

India must now rise from this disaster. The 14-week suspension of operations has affected different sectors and regions differently, but most organizations face massive challenges to regain economic momentum. The importance of a well-planned inorganic-growth strategy has never been greater.

Exhibit 1

Market capitalization declined in India between December 2019 and May 2020 in most sectors.

Change in market capitalization, by sector, Dec 31, 2019–May 31, 2020,[1] %



[1]Bar width represents sector weighted by equity value as of Dec 31, 2019, adjusted for dividends and buybacks; included are all Indian publicly listed companies with revenue greater than INR 10 Cr in respective sectors.
Source: S&P Capital IQ

Most organizations face massive challenges to regain momentum. The importance of a well-planned inorganic-growth strategy has never been greater.

The M&A environment

In past downturns, companies that pursued acquisitions and divestitures in a structured way tended to outperform their peers. Our careful study of the Asian financial crisis of 1997, the dot-com bubble of 2000, and the world financial crisis of 2008–09 bears out this conclusion. In each of those crises, companies that acquired and divested in a strategic way performed significantly better than peers that were either too conservative or relied on one megadeal to recover. The differential varied by sector but reached as high as six times over.

As in past downturns, recovery from the current crisis will present companies with unusual challenges; if anything, the road back today will be steeper. To regain momentum, many organizations will have to rule out business as usual—a strategic approach to recovery will be a necessity, not an option. In this climate, well-capitalized companies could revisit their past M&A strategies. Certain financial factors might make this possible:

— *Comparatively low yields on debt.* Ten-year government securities were at 5.79 percent on June 8, 2020, compared with 7.0 percent one year ago.

— *Falling valuations.* Overall market cap–weighted valuations fell 20 to 25 percent from December 2019 to March 2020.

— *Increased liquidity stress.* More than 60 percent of top-500 companies had less than 90 days' cash on hand.[1]

The M&A environment will also be positively affected by the government's Make in India initiative, designed to help the country's manufacturers expand their global market share while encouraging foreign companies to consider India as an offshore destination. One of the government's policies, furthermore, protects Indian companies from takeover by certain types of foreign investment.

M&A themes

When companies approach M&A strategically, they may want to consider a few important themes. One or more of those described below would probably determine the value attainable in particular moves that companies make, as well as inform their overarching inorganic strategies.

1. 'Barbellization' and consolidation within sectors

The economic crisis set off by the pandemic is causing significant economic dislocation. Fissures are appearing in the structure of industry sectors. These could easily become the early signs of an opening gulf between companies with sufficient available funding and those without it. As the economy emerges damaged from the lockdown, the soundness of the former group will probably grow into a significant competitive advantage in available capital, customer relationships, and talent.

In our review of the healthcare and pharmaceutical sector, for example, we found that as of December 31, 2019, one group of companies had funding

[1] The top 500 companies based on market capitalization on December 31, 2019, excluding financial-services firms.

adequate for six months or more of operations, while another had funding for only 30 days or less. In the consumer-staples sector, the healthiest companies had an average debt-to-equity ratio of less than 0.1. At the lower end of the spectrum, companies averaged around 2.25—a serious imbalance (Exhibit 2).

2. Portfolio divestiture and carve-outs

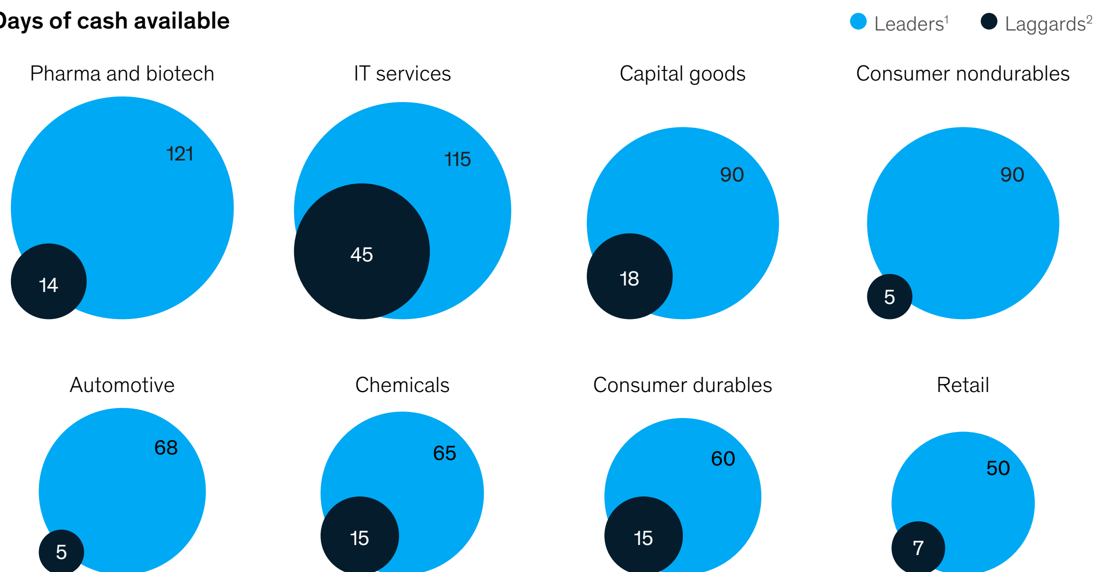
Several Indian conglomerates have a long-tail portfolio.[2] Our analysis of five of them, with combined revenues of $80 billion in 2019, revealed that the top three subsidiaries in each conglomerate accounted for at least 70 percent of the group's earnings before interest, taxes, depreciation, and amortization (EBITDA). The remaining subsidiaries—100 or more per group—contributed less than 30 percent of earnings and had most of the debt in each group.

Before the pandemic, debt-saddled long-tail subsidiaries were surviving but managed mainly with marginal attention or focus, as well as marginal levels of allocated capital and limited top talent. In the post-COVID-19 context, these businesses will find it even tougher to grow as capital becomes scarce and leverage pressures force conglomerates to act. However, many of these companies compete in high-growth, nascent areas. They could thrive under different ownership—one that regards them as a core business rather than a sideline. Our research indicates, furthermore, that some of these companies will probably fall within the primary focus areas of private-equity firms across Asia.

With increasing cash pressures on conglomerates, the need for carve-outs will probably increase, especially in noncore portfolios. Captive rebadging or "e-badging" carve-outs, for example, could create opportunities in IT services as organizations seek to reduce fixed costs and deleverage balance sheets.

Exhibit 2

A clear distinction is visible in the cash positions of 'haves' and 'have-nots' in industry sectors.



[1]Mean of top 10 percentile (based on market capitalization as of Dec 31, 2019) of all Indian publicly listed companies with revenue >INR 100 Cr.
[2]Mean of bottom 10 percentile (based on market capitalization as of Dec 31, 2019) of all Indian publicly listed companies with revenue >INR 100 Cr.
Source: S&P Capital IQ

[2] A long-tail portfolio is the strategic approach of profiting from an aggregation of small-volume sales of diverse products that competitors may have ignored.

Given the crisis-induced turbulence and liquidity pressure, start-ups may now be more receptive to acquisitions, sales of strategic stakes, and joint ventures.

3. Acquisitions of regional companies
In consumer goods, pharma, and retail, success requires a strong brand, as well as a deep distribution and supply-chain footprint. For such industries, established companies may want to acquire local brands that are very strong in a particular region, state, or other niche market. The crisis has put liquidity pressure on these smaller companies. In consumer goods, for example, sales of some of them are falling because retailers are rationalizing their assortments and consumers are shifting to online channels. Leaders that acquire these smaller brands could energize them by using existing privileged trade relationships and big production footprints. The parent company could thus improve the acquired brand's value while gaining access to new customers in attractive segments.

4. Enhancing technological and digital capabilities
In the pre-COVID-19 world, some "old economy" companies committed themselves to enhancing their digital and analytics capabilities by using automation, customer-personalization strategies, greater process efficiency, and new digital business models. The progress of these in-house efforts was usually slow as a result of inadequate talent, company culture, and not enough investment. Digital-native start-ups with adequate funding and valuations were reluctant to discuss M&A.

The COVID-19 crisis may have changed this. Funding for start-ups is now scarcer, as indicated by the 38 percent reduction in the number of series A start-ups in April 2020 compared with a year ago and the 65 percent reduction in the number of series B start-ups during the same period.[3] The scarcity of funding is more severe in certain large subsectors that enjoyed average monthly levels of $50 million or more in 2019. In fintech, for example, funding for start-ups has fallen by 75 percent compared with last year. For vehicle- and ridesharing start-ups, no fresh funding is available.

Given the crisis-induced turbulence and liquidity pressure, start-ups may now be more receptive to conversations on topics such as acquisitions ("acquihiring"), sales of strategic stakes, and joint ventures. Acquihiring transactions could not only provide financial lifelines to start-ups with shorter funding runways or less balance-sheet strength but also help traditional companies realize their data and analytics aspirations—a win–win.

5. The need for alliances and partnerships
In the post-COVID-19 environment, industry borders are likely to become less defined as more companies shift, ever more profoundly, toward digital channels. The use of mobile phones rose by more than three hours per user in the week ending March 27, for example, as compared with the previous (prelockdown) week. The increased time included a 40 percent jump in the use of apps for online courses, a similar jump for social media and chat services, and increases of 26 percent in gaming, 20 percent in fitness and health apps, and 11 percent in video streaming.[4]

Digital and digitally nimble companies will probably seek to extend their presence across such domains by using cross-cutting platforms. This trend could pose fundamental questions for "mono-industry" companies, such as banks and nonbank financial

[3] Pitchbook database on funding of start-ups in India as of April 30, 2020.
[4] "COVID 19: From a consumer lens—a by Performics India," April 13, 2020, performics.com.

institutions, retailers, pharmacies, movie chains, and logistics firms. Partnerships and alliances for sharing customers, gaining access to data, cross-selling, or integrating value propositions will become critical lifelines to help these companies stay relevant—even within their own industries.

The reconfiguration of sectors and markets will continue for some time. Organizations should now rethink their corporate strategies and evaluate how a new or revised one for M&A can help realize their new ambitions. As for specific M&A activities, discussions will probably start soon, but actual handshakes and formal closures may still be six to 12 months away.

In this period, the shape of the next normal will become more apparent and accepted. Due diligence, for example, could happen remotely, in accordance with local lockdown and opening rules. Regulatory approvals may take longer, and more lead time will be needed to close funding. We nevertheless firmly believe that the time to revisit M&A strategy has come. It is far better for companies to prioritize potential themes and actions and to initiate conversations proactively than to wait and react—or, worse, to lose their former positions to innovative digital competitors.

Gaurav Sharma is an associate partner in McKinsey's Delhi office, and **Toshan Tamhane** is a senior partner in the Mumbai office.

The authors wish to thank Abhishi Bhatia, Amala Gupta, Avineet Sadani, Dushyant Singh, Saharsh Sood, Piyush Vijay, and Natasha Wig for their contributions to this article.

Designed by Global Editorial Services
Copyright © 2020 McKinsey & Company. All rights reserved.