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Navigating the New Reality

Macro overview and recommendations for European business leaders to build resilience in a post-pandemic world

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Strategy& perspective on situation, winning strategies for businesses and key trends

Contacts

Strategy&

Düsseldorf
Dr. Peter Gassmann
Managing Director Strategy& Europe and Global ESG Leader of PwC,
PwC Strategy& Germany
+49-170-3890-470
peter.gassmann@strategyand.de.pwc.com

Munich
Dr. Philipp Wackerbeck
Partner,
PwC Strategy& Germany
+49-170-3890-659
philipp.wackerbeck@strategyand.de.pwc.com

Frankfurt
Thorben Wegner
Senior Manager,
PwC Strategy& Germany
+49-170-2238-411
thorben.wegner@strategyand.de.pwc.com

PwC

Frankfurt
Dr. Joachim Englert
Partner and Head of Advisory,
PwC Germany
+49-151-1427-571
joachim.englert@pwc.com

Munich
Dr. Klaus-Peter Gushurst
Partner and Leader Industries & Innovation,
PwC Germany
+49-175-8340-490
klaus-peter.gushurst@pwc.com

Stuttgart
Mark Smith
Partner and German Markets Leader | EMEA Clients & Markets Leader at PwC Germany
+49-160-5327-120
mark.smith@pwc.com

About the authors

Dr. Peter Gassmann is the Managing Director Strategy& Europe and Global ESG Leader of PwC. He leads the European Financial Services Practice and has many years of practical experience in the financial sector with management positions at several national and international banks.

Dr. Philipp Wackerbeck is a partner at Strategy& in Munich and is responsible for the financial services business in EMEA. He advises leading financial institutions in Germany and Europe on the development of market strategies, sustainable profitability increases, efficient risk and capital management and major transformation programs.

Thorben Wegner advises clients in the financial services industry for Strategy&. He works with international banks on strategies at the intersection of risk, regulation, operations, and IT. Based in Frankfurt, he is a senior manager with PwC Strategy& Germany.

Dr. Joachim Englert is a partner and member of the Management Board of PwC Germany as well as the Head of Advisory. His areas of expertise include digitization, restructuring and advising companies and lenders in crisis situations.

Dr. Klaus-Peter Gushurst is the Leader of Industries & Innovation at PwC Germany. His consulting work focuses on corporate management, leadership as well as strategic transformation.

Mark Smith is PwC's EMEA Clients & Markets Leader and the Markets Leader of PwC Germany. His focus lies on supporting clients in matching their strategy to transformational challenges and opportunities in their markets.

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> "Covid-19 has challenged the resilience of the European economy on an unprecedented scale. It seems that European industries are more vulnerable to the pandemic than those in other regions. We need to build on the openness to innovation and digital transformation we have witnessed this year, and reimagine existing business models to make them more resilient."

Peter Gassmann
Managing Director Strategy& Europe and Global ESG Leader of PwC

Executive Summary

Since the World Health Organization declared the novel coronavirus (Covid-19) a global pandemic in March 2020, nearly everything has changed – affecting both the way people live and how they work. With the rapid spread of disease, there have been more than a million deaths from the virus worldwide, and many more cases of illness. As a result, the pandemic has caused many countries to establish restrictions on citizens, ranging from curfews to quarantines. Back in January, the IMF expected the global economy to grow by 3.3 percent[1] in 2020, but more recent estimates have suggested it will contract by close to 5 percent[22] this year. And now, efforts to control the second wave of infection in Europe are likely to further worsen economic outlooks.

Against this backdrop, most analyses suggest a U-shaped recovery across the European Union (EU), with growth returning in 2021 but GDP still ranging below 2019 levels at the end of 2022. However, in light of the current reacceleration of Covid-19 infections across most of Europe, more and more economists and corporate leaders expect to see a somewhat slower recovery for 2021 and 2022, or even longer-lasting recessions in some European countries.

Overall, the global economic crisis is likely to be one of the most severe in history, but its impact varies by sector. Consider, for example, how food retailers have fared versus airlines. The future looks bright for companies that have been able to adapt to an increasingly virtual world, particularly compared with companies in sectors that have still not fully reopened, or whose pre-existing weaknesses prevented them from successfully pivoting during the past several months.

In addition to sector differences, the pace of recovery will continue to diverge geographically, with, for example, developing economies in Asia recovering faster than Europe and the United States. This is, in large part, driven by the different exposure of economies to international trade and their capacity to mitigate the effects of Covid-19 or stimulate demand through government spending.

In light of these differences, we expect a K-shaped recovery, with economies and sectors split between those that return to growth fast and others that endure a more protracted downturn. As they plan ahead, it will be critical for business leaders in Europe to consider how their companies need to repair, rethink and reconfigure their operations. The ultimate goal must be to emerge stronger from this crisis, in turn becoming a more resilient organization that will be better prepared for future shocks. So how can companies do that? To start with, executives must understand and navigate four key trends, which have become even more relevant in light of Covid-19:

1. The dramatic acceleration of digitization

2. The growing importance of environmental, social and governance (ESG) goals to foster sustainability

3. The strong impetus to localize operations

4. Increasing adoption of new ways of working that enable flexibility and collaboration

1 Source: World Economic Outlook, January 2020
2 Source: World Economic Outlook Update, June 2020

SECTION 1

Europe: an overview

As the global pandemic persists and accelerates, there has been overwhelming consensus on downward revisions of economic forecasts. However, there is divergence between the specific forecasts for different regions and sectors: notably, the developing economies in Asia are expected to recover faster and adapt more quickly to a post-pandemic world compared with Europe and the United States (*see Exhibits 1 and 2, next pages*).

For leaders, this K-shaped recovery poses many dilemmas to navigate and contradictions to reconcile. In order to provide senior executives with one integrated picture summarizing the economic outlook, this report is based on analyses and insights from more than 180 research institutes and other academic organizations (*find out more in our methodology paragraph below*).

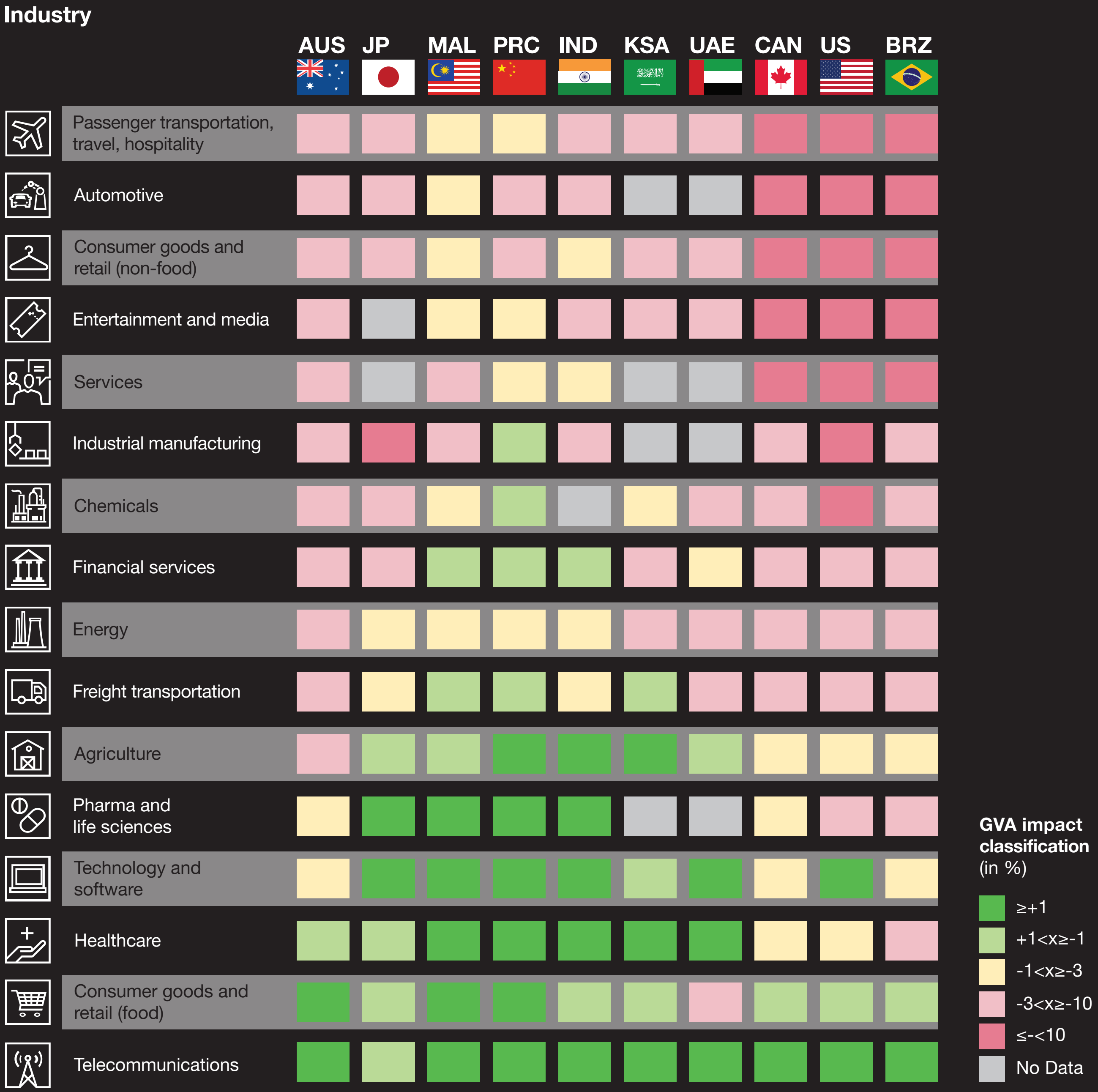
Impact by region

Based on the latest data from October 2020, we expect GDP across the EU to shrink by around 9.1 percent in 2020, but to recover in 2021 and 2022, with growth rates of 5.5 percent and 1.2 percent respectively. However, gaps are widening between countries. In Germany, we expect GDP to shrink by 7.0 percent in 2020, whereas the outlook for some other European countries continues to worsen: for instance, GDP in the UK is expected to decline by 10.1 percent, and in Spain to contract by 11.7 percent.

EXHIBIT 1
European Covid-19 impact overview for 2020

Source: Strategy& analysis, IHS Markit

EXHIBIT 2
Global Covid-19 impact overview for 2020



Source: Strategy& analysis, IHS Markit

Impact by sector

Within Europe, food retailers and telecommunications companies are emerging as clear winners in the upper half of the 'K', particularly while government-enforced restrictions such as quarantines or lockdowns are in place (*see Exhibit 3, next page*). In the longer term, technology and software companies – especially in fields including Industry 4.0, augmented and virtual reality, and robotics – are expected to perform strongly, benefitting from the acceleration in digitizing operations.

But as Exhibit 3 shows, almost every sector has suffered. Passenger transportation, travel and hospitality, as well as the automotive industry, have been severely damaged by travel bans with no clear end in sight, as well as disruption to supply chains and production in the case of the auto industry. These sectors are likely to form the lower half of the 'K', with only a gradual recovery in developed markets.

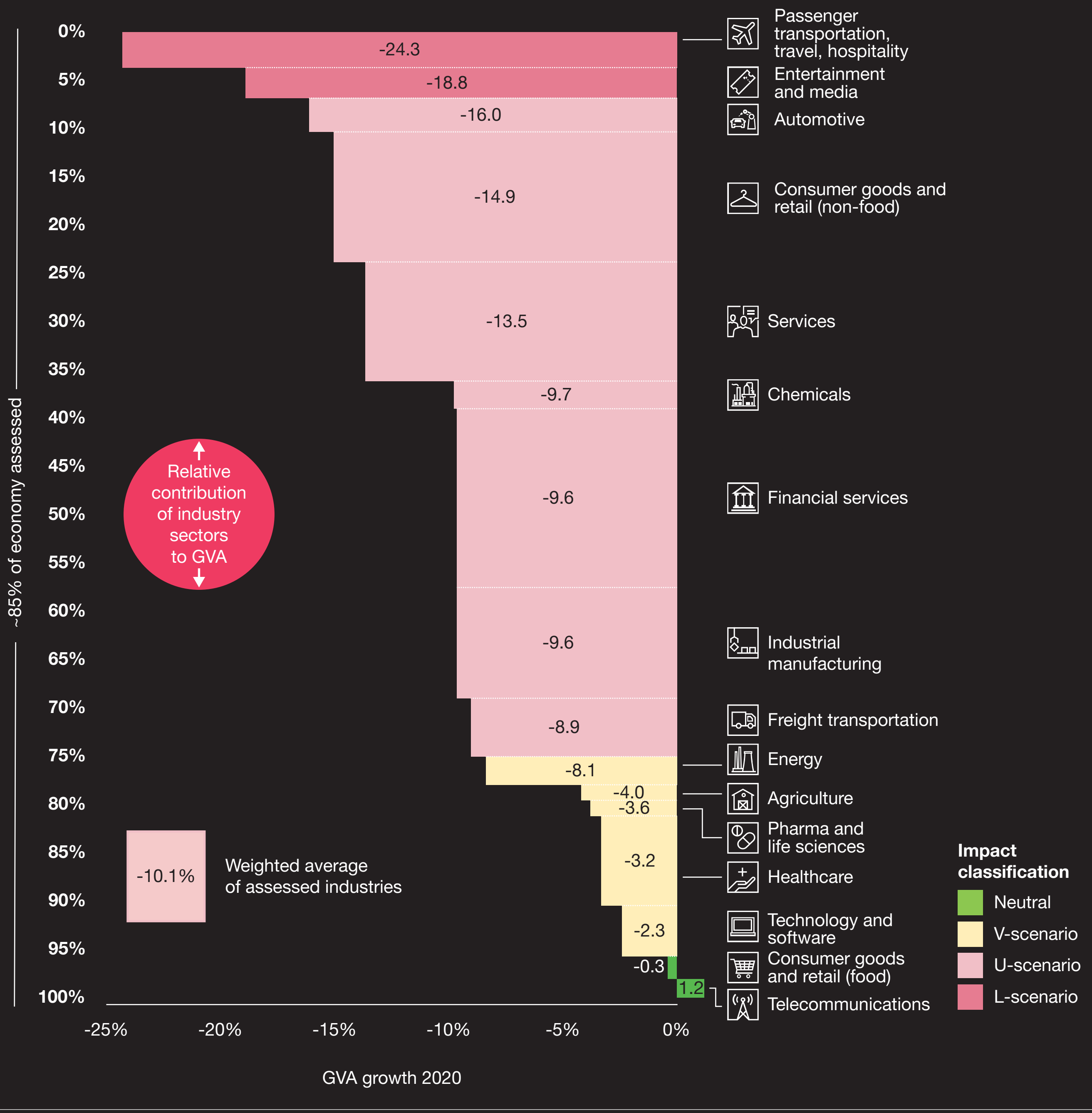
> "Almost all of Europe's industries have been hit hard by Covid-19, with a few exceptions including telecommunications. Across Europe's largest economies, the most strongly affected sectors are largely the same, including travel, automotive and non-food consumer goods. Yet, due to the interconnections across industries and the individual contribution of each sector to national economies, the overall impact varies and some economies will suffer more than others."

Mark Smith
German Markets Leader | EMEA Clients & Markets Leader at PwC

By the end of 2022, we expect that the technology and software industries in Europe will have grown by around 5 percent compared with the end of 2019, despite Covid-19's negative impact on overall economic growth. By contrast, the entertainment and media sector will shrink by 10 percent over the same time period and passenger transportation, travel and hospitality is likely to contract by more than 20 percent.

EXHIBIT 3
Industry trajectories (2020)

GVA growth (most likely scenario) and relative industry contributions



Source: Strategy& analysis, IHS

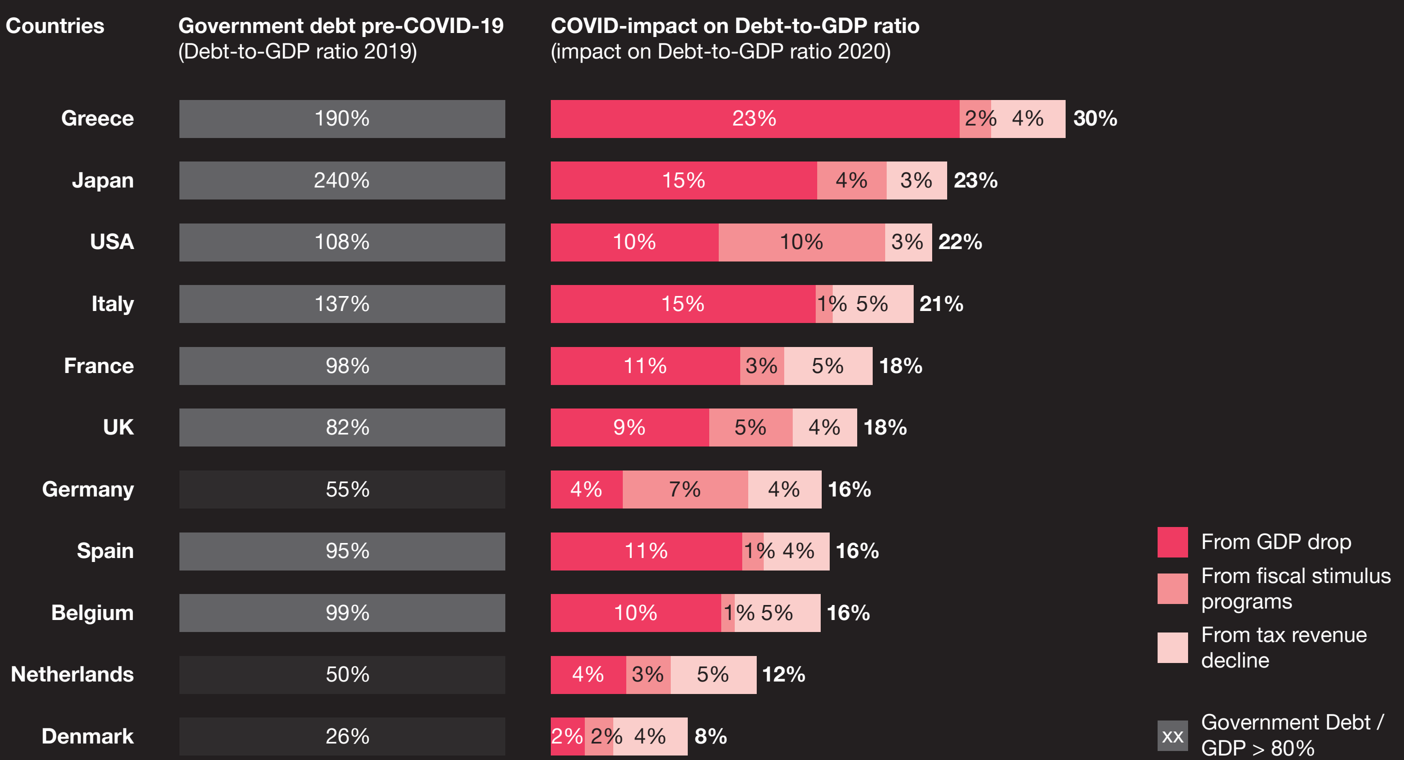
Impact of government spending

European governments have put in place short-term financial support programs to lessen the economic damage of Covid-19 and stimulate demand in struggling sectors. As a result, the far-reaching impact of virus suppression measures on unemployment will only fully emerge after these state aid programs end, when governments will find themselves squeezed by rising welfare claims, falling tax revenues, and very high post-Covid-19 debt levels.

Therefore, government debt-to-GDP ratios are likely to deteriorate significantly compared to the end of 2019 (*see Exhibit 4*). EU governments could be forced into fiscal consolidation for many years to come in order to reduce debt-to-GDP levels to an acceptable level, in line with the Eurozone's budgetary objectives. This will mean less public investment, and painful reforms of social security systems may be needed in most EU countries.

EXHIBIT 4

Covid-19 impact on dept-to-GDP ratio (%)

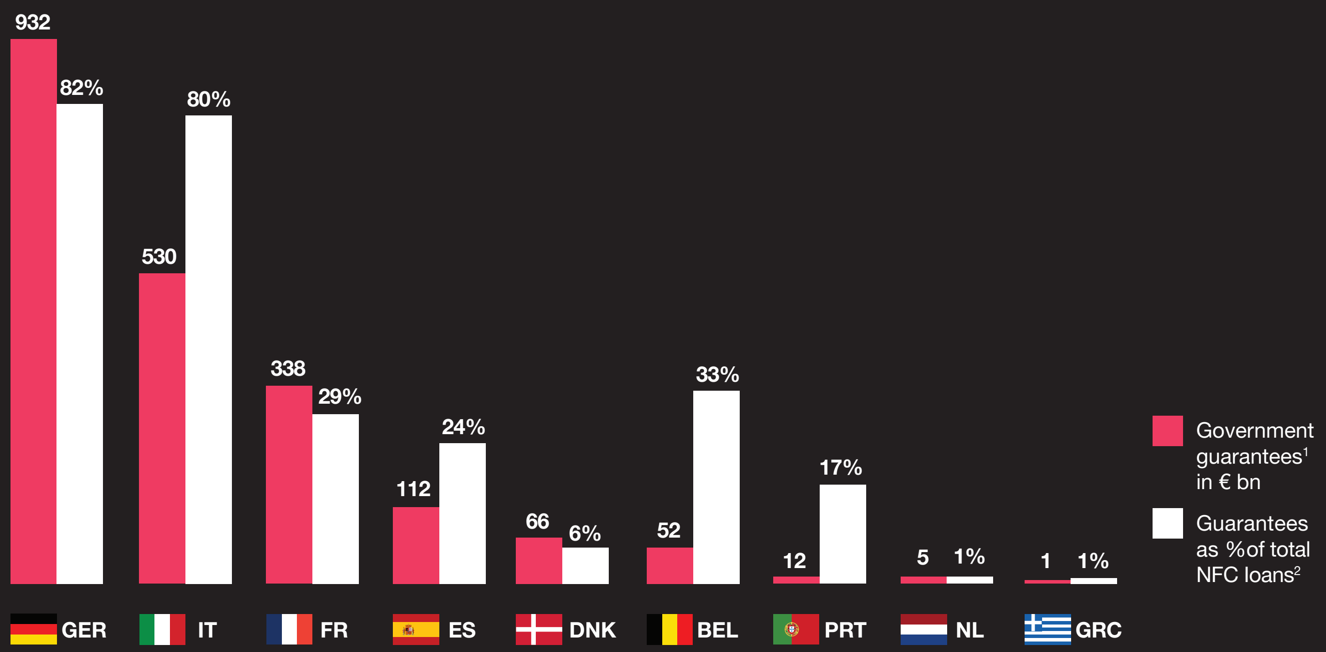


Sources: The Economist, Bruegel, OECD, Strategy& analysis

A further impact of the health and ensuing economic crises is that it may also result in a financial crisis, with companies unable to repay debt. This problem is yet to unfold. However, the guarantees on government-backed loans to help companies survive are temporary, and defaults are expected to begin as these guarantees expire. At that point, a large share of the loans will need to be refinanced, which will put pressure on the banking sector (*see Exhibit 5*).

EXHIBIT 5

Recapitalization needs of the real economy



1. Measures include export guarantees, liquidity assistance, credit lines through national development banks, which are finally channeled though banks' balance sheets
2. Total guarantees of a country as percent of total loans to non-financial corporations (NFC) by banks of this country as of March 2020
Sources: Bruegel, ECB

SECTION 2

How to build resilience: repair, rethink, reconfigure

The macroeconomic picture presented above shows the extent of the hardship and uncertainty European countries and businesses will face in the near future. With no comprehensive treatment or vaccine for Covid-19 available yet, rising numbers of infections and further government restrictions will remain a threat. As a result, all organizations will need to continue to strictly manage costs and protect cash flow.

In the face of such disruption, companies may well feel they have to focus exclusively on keeping their operations going in the here and now. Undoubtedly, some will be irreparably damaged, both by the pandemic and because their business model was already losing relevance. However, most have a critical opportunity to start rethinking and reconfiguring future plans in order to build their resilience and adaptability, and emerge stronger from the current crisis. Business leaders must focus on these three strategic goals:

1. Repair: ensure viability and rebuild strength

2. Rethink: envision the future to manage today

3. Reconfigure: dramatically redesign future operations

EXHIBIT 6
Three strategic goals

Economic conditions worsen, shared global experience

1. **Repair**
Ensure viability/strength
Shut down

2. **Rethink**
Envision the future in order to manage today

3. **Reconfigure**
Dramatically redesign

Source: Strategy& analysis

1. Repair

Some organizations, particularly in certain sectors, are still in triage mode, trying to stem the loss of revenue brought about by pandemic suppression measures and changed spending habits, in order to restart operations and ensure their survival. For companies in the repair phase, leaders need to focus on these three actions:

- Address balance sheet weakness
- Stem revenue declines and identify new routes to growth
- Strengthen weakened supply chains and depleted employee bases

2. Rethink

Companies that have been able to repair their business and restart operations must decide on the changes they will need to make to remain relevant in the future. To do that, it's critical to focus on these two steps:

- Close any gaps in scenario planning and strengthen crisis preparedness, understanding that the next emergency may look very different from this one
- Define new ways of measuring success, with a focus on financial, social and environmental progress metrics that go beyond GDP and earnings-per-share

3. Reconfigure

The global pandemic illuminated how many companies were unprepared for the 21st century. Leaders at these organizations must not waste the opportunities arising from this current crisis to reconfigure their strategy and operations. Here are three important things to do now:

- Embrace trends that have been going well during the pandemic, such as remote working and distance learning, in a strategic and systematic way
- Prepare for an ecosystem-based economy – one in which value is created by ecosystems and facilitated by platform providers
- Rethink technology strategies, geographic footprints and business models to make them more robust

SECTION 3

Key trends affecting European companies

As business leaders work to repair, rethink and reconfigure their companies as outlined above, they must keep in mind the following four trends, which will be the differentiators in terms of building resilience:

1. The dramatic acceleration of digitization

Covid-19 has been both a stress test and a catalyst to companies' digital readiness. In all areas of society, from education and healthcare to grocery shopping and entertainment, digitization has been fast-tracked by the need to communicate and carry out transactions remotely. Organizations that had already invested in digitizing their operations have shown greater resilience than those that hadn't when lockdowns hit.

Digital transformation has become the most important item on CEOs' agendas, according to a recent PwC survey of about 700 chief executive officers[3]. That includes both digitizing core processes and products, and becoming more virtual by adding new digital products and services. In Italy, for example, only 40 percent of people shopped online before the pandemic, preferring to go to stores in person. A lack of broadband internet access and the poor condition of roads in parts of the country also meant that online giants such as Amazon had failed to gain traction. However, with stores closed and very strict rules on leaving the house during the lockdown period, 75 percent of Italians reportedly shopped online[4], with more than 2 million of them doing it for the first time between January and May. Even when stores reopened and people were free to return to them, they kept buying online.

For many companies, radical transformation is required – and it will need to happen quickly. CEOs need to lead with the enabling power of technology at the front of their minds and add to their top team leaders who deeply understand what technology can do for their company across the entire value chain. Many companies will need to look at cross-sector partnerships to boost the capabilities that are required in today's world.

Upskilling the leadership team and the entire workforce will be key to increasing the level of digital readiness in the organization. Not everyone will need to know how to code, but people up and down the organization will need to know how to use technology to deliver on their company's purpose.

3. Source: PwC CEO Panel Survey, 2020
4. Source: The New York Times, September 26, 2020

2. The growing importance of ESG goals to foster sustainability

At the start of 2020, sustainability was at the top of the political agenda in Europe, as the European Parliament voted to support the European Green Deal in January.

While many companies had to pause their sustainability initiatives to act on the immediate impact of the Covid-19 crisis, such as ensuring liquidity, this is likely to be a temporary pause. Bolstered by new regulations and growing consumer support, the trend for more sustainable business practices is expected to recover quickly and accelerate in the coming years.

Some big corporations have already made significant financing commitments as part of their net zero emissions commitments. Notable examples include Amazon's $2 billion Climate Pledge Fund, Microsoft's $1 billion Climate Innovation Fund, and Unilever's €1 billion Climate & Nature Fund. Governments are promoting green investment as part of economic recovery plans, and investors are also getting on board. Funds that invest according to ESG factors attracted net inflows[5] of $71.1 billion between April and June 2020, taking assets under management to a new high of just over $1 trillion.

As a result, ESG strategies should go beyond meeting minimum regulatory requirements and seek to differentiate the company and build resilience through ambitious, focused sustainability goals.

5. Source: Financial Times, August 10, 2020

"This crisis has shown that an ESG focus is not a vague long-term goal but a fundamental cornerstone for making our societies and companies more resilient. Integrating sustainability into a company's strategy, operating model and day-to-day processes will be fundamental to unleash the full potential for value creation in the new reality."

Peter Gassmann
Managing Director Strategy& Europe and
Global ESG Leader of PwC

3. The strong impetus to localize operations

For a number of years, there has been a trend toward nationalism in Europe – and it has only been accelerated by the pandemic. Global institutions are losing power. Trade wars are becoming increasingly common and difficult to resolve. And governments have increasingly prioritized national self-interest over solving global problems. Over the past several months, many governments felt they could better handle the public health crisis by temporarily closing borders, and relief programs were primarily designed to protect domestic economies.

Global supply routes were also interrupted, forcing companies to localize their supply chains. This highlighted the need to increase resilience and reduce dependence on a single country or supplier. Some companies had to stop production altogether during lockdowns in supplier countries, and many US and European manufacturers are now looking into moving production closer to their customer base.

According to PwC analysis[6], companies have been reassessing make-versus-buy decisions, and increasing their capacity by up to 20 percent. Digital technology allows companies to develop supply chain ecosystems that are both autonomous and integrated, building their resilience to respond with speed and agility to future challenges. Digitization also enhances transparency, giving organizations increased visibility over inventory and capacity, making it easier to identify and manage risks and respond to events.

6. Source: PwC “Advanced capabilities can boost supply chain resilience”, 2020

4. Increasing adoption of new ways of working

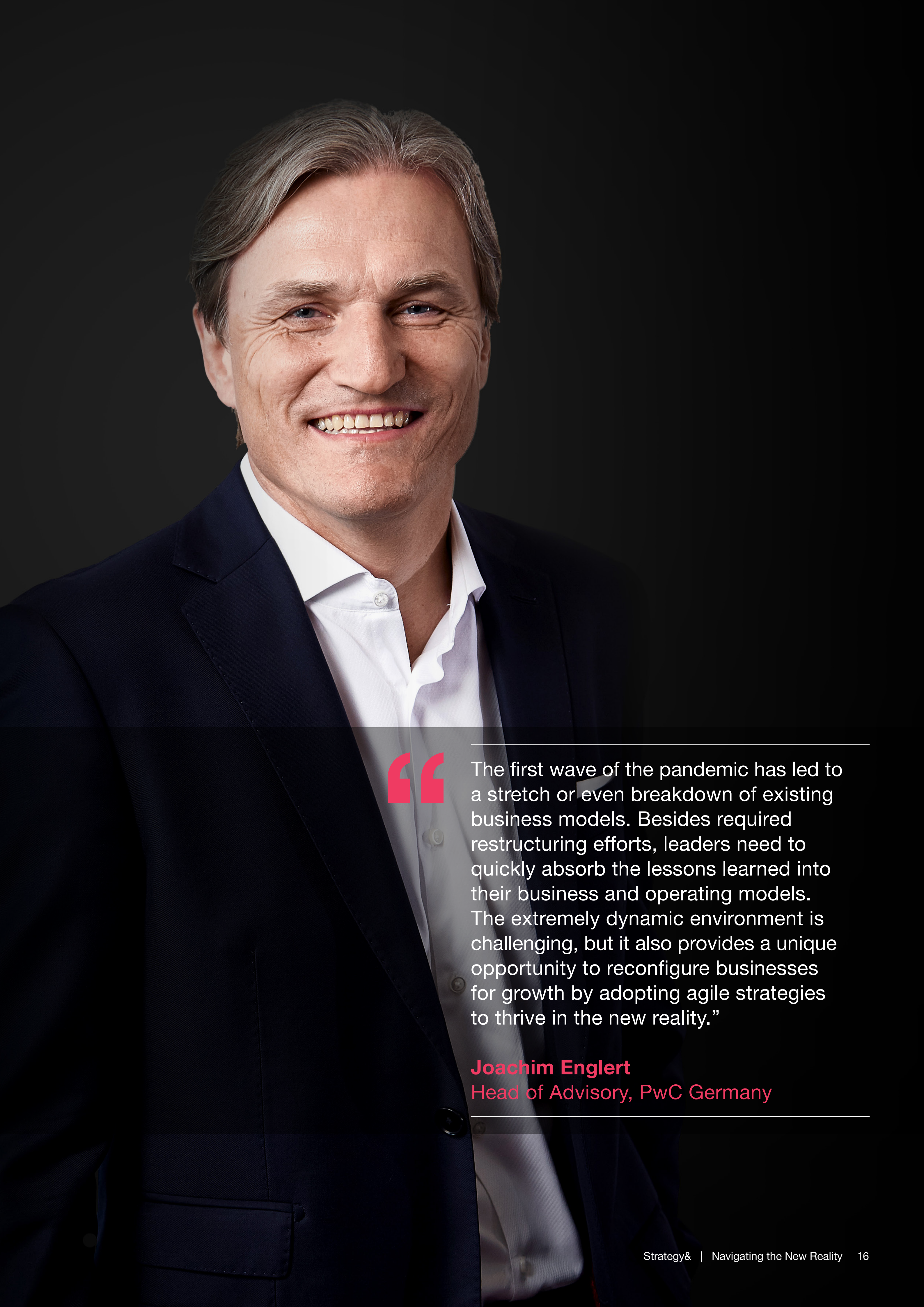
Almost overnight, Covid-19 transformed the working patterns of companies and governments worldwide, transplanting many employees from the office to their homes. According to Gartner Research[7], the share of employees working from home at least some of the time will increase from 30 percent to 48 percent after the pandemic. This rapid and widespread shift to remote working has two main areas of impact: first, on managing the workforce; and second, on real estate.

Companies are already making long-term plans. Deutsche Bank, for example, has made the reduction of office space in Zurich and New York, among other locations, a new part of its cost savings program, and a member of the board of Siemens announced an ambition for its employees to work from home two to three days a week, even after the Covid-19 crisis is over.

It seems likely that a hybrid model, one that combines working in an office and working from home, will be much more common in the future. Therefore, having a strategy for managing at least a partially remote workforce is essential. This means that new leadership styles and remote management skills[8] will be required, and upskilling may be needed for all levels of management[9] to keep productivity and engagement high. To build and maintain a corporate culture, it will be important to think about how organizations can enable collaboration and community among remote teams. That will require investments in both people and technology.

The overall economic impact of increased remote work remains hard to assess at this early stage, but it's clear that more people working from home affects the whole value network around big offices. Restaurants, local retailers, transportation companies and petrol stations mainly serving commuters will inevitably have fewer customers. Already, PwC in the UK estimates a £15.3 billion annual hit to GDP[10] in the country if working from home continues at the levels seen during the pandemic.

7. Source: Gartner, 2020
8. Source: strategy+business, July 31, 2020
9. Source: strategy+business, September 28, 2020
10. Source: PwC "The economic impact of returning to the office", 2020



> "The first wave of the pandemic has led to a stretch or even breakdown of existing business models. Besides required restructuring efforts, leaders need to quickly absorb the lessons learned into their business and operating models. The extremely dynamic environment is challenging, but it also provides a unique opportunity to reconfigure businesses for growth by adopting agile strategies to thrive in the new reality."

Joachim Englert
Head of Advisory, PwC Germany

Methodology

Strategy&'s Covid-19 economic scenarios are based on a consensus of analyses that incorporates more than 180 sources and predictions (including from global research institutes, universities, investment banks, national governmental and supranational bodies, and ratings agencies), as well as financial data on 40 million corporations globally from 35 countries and 16 industries. Estimates according to the V-, U- and L-shaped scenarios on a country and industry level lead to a K-shaped pattern as certain economies and sectors diverge. The scenarios have been updated monthly since March 2020.

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