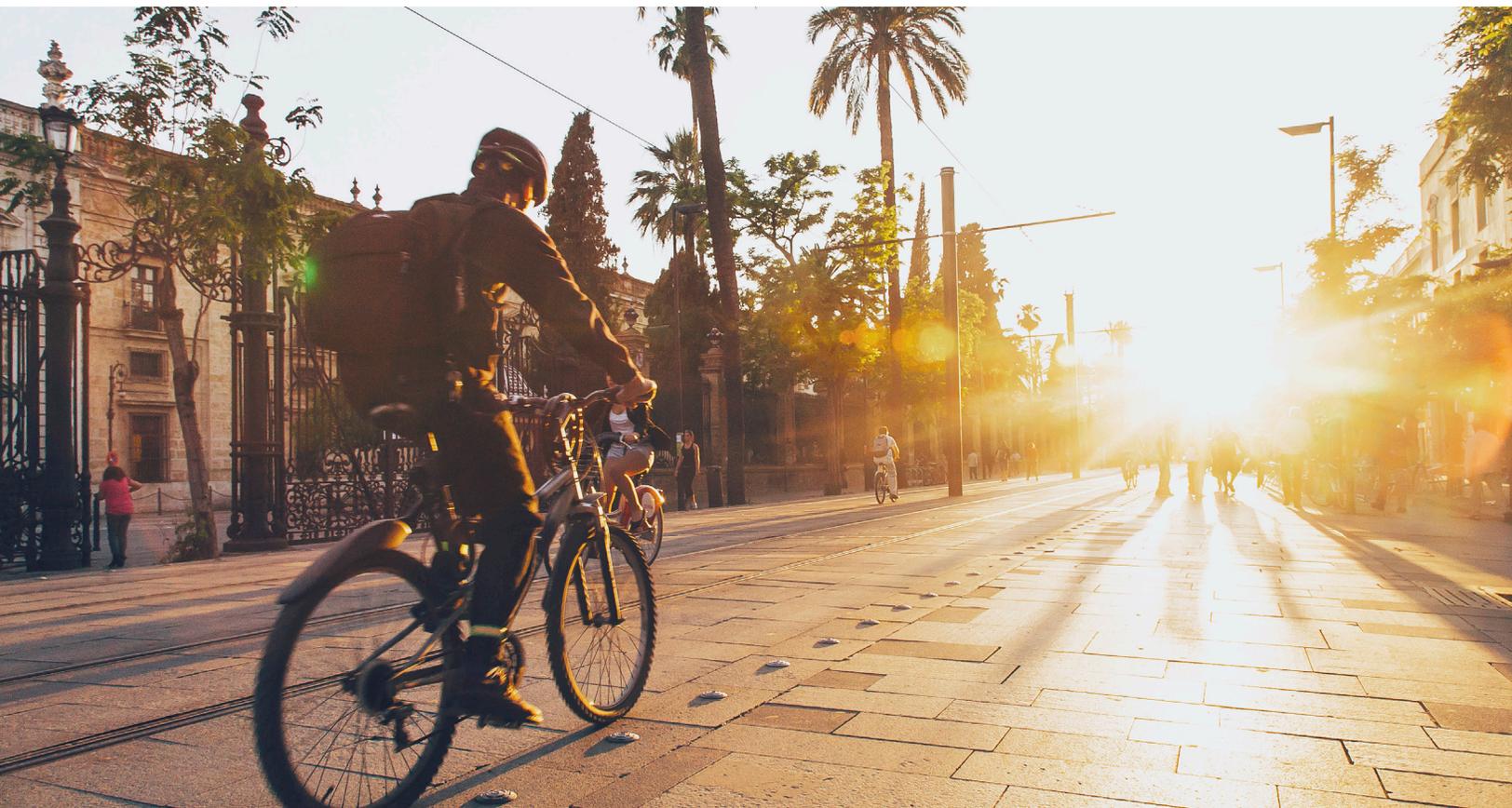


Risk Practice

Spain after COVID-19: From resilience to reimagination

COVID-19 will have a deep impact on Spain's economy and the survival rates of companies. To safeguard both lives and livelihoods, public- and private-sector leaders must act swiftly in a coordinated effort.

by María del Mar Martínez, Santiago Fernández, David Francés, and Ignacio Marcos



Countries around the world are in uncharted territory. The emergence and spread of COVID-19 has touched every facet of society, and the scale of the humanitarian crisis has been matched by widespread economic disruption. Companies that had been riding six years of reasonable economic expansion in Spain (2.6 percent annual real GDP growth from 2013 to 2019¹) had to throw out existing strategies, rapidly adapt their business models, and take all necessary measures to survive the downturn. The impact on workers and consumers has been similarly dramatic.

Spain's experience has mirrored that of its European counterparts. The nationwide lockdown that began March 15 brought daily life to a halt. Public gatherings were canceled. Students were sent home. Businesses of all sizes had to grapple with growing uncertainty about their prospects. As Spain is restarting the economy, we must address a dual imperative: safeguarding both lives and livelihoods. To succeed at this task, we must, first, craft effective policies that could accelerate Spain's recovery and lessen the financial impact on individuals and business and, second, use the crisis to catalyze change and rethink the fundamental structure of companies, sectors, and the overall economy.

In this article, we examine the implications of the COVID-19 pandemic on Spain's economic well-being through five lenses: the Spanish economy's starting point immediately before the pandemic, the impact that the crisis may have on different sectors, the government's response to date, the acceleration of trends likely to shape the next normal, and the need for public- and private-sector measures to spur the recovery. By establishing a shared understanding of the contours of this challenge, we believe we can hasten the country's move to the next normal.

A more favorable pre-crisis starting point for companies and households, but difficulties loom

A country's ability to weather the pandemic depends greatly on the fiscal condition of its public sector,

businesses, and households. In the approximately ten years following Spain's previous financial crisis, businesses show significantly lower indebtedness than they did in 2007, putting them close to the European average. Spanish households also reduced their debt levels during this period. However, the government followed a different trajectory: from 2007 to 2018, the public sector increased its ratio of debt to GDP by more than 50 percentage points and now exceeds the average sovereign indebtedness in Europe by almost 20 percentage points (Exhibit 1).

Although companies had a better pre-crisis starting point, three warning signs should be noted when dealing with the current crisis:

- The Spanish economy is more dependent on tourism than other European economies (tourism makes up 14.3 percent of GDP in Spain, versus 9.5 percent in the European Union²), which may be greatly affected by the restrictions generated by COVID-19. Spain is less dependent on heavy industry or on professional and scientific activities (12 and 9 percent respectively, compared with 16 and 12 percent in the European Union³).
- The Spanish business structure relies heavily on small and medium-size enterprises (47 percent of the Spanish workforce is in companies with fewer than 20 employees,⁴ versus 37.5 percent in the European Union). Smaller companies are more vulnerable to a weakened economy—during the period from 2007 to 2013, for example, the number of smaller companies decreased by four times more than companies of all sizes.
- Although almost all sectors have better capital and liquidity positions now than they did in 2007, some of them may be less resilient in the face of the crisis because of the structural levels at which they operate. In particular, accommodation and food services (HORECA), transport, logistics, automotive, and retail-groceries sectors have lower structural levels

¹ Compounded annual growth rate of real GDP for the 2013–19 period.

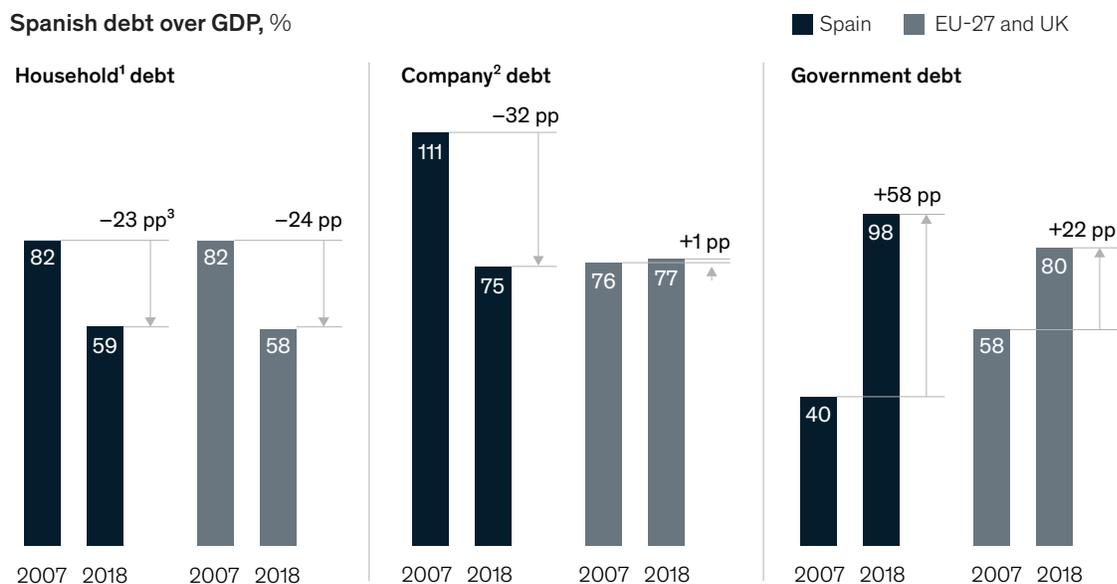
² Travel and tourism GDP contribution in 2019, according to the World Travel and Tourism Council (WTTC).

³ Eurostat; figures relate to gross value added (GVA), which is GDP plus subsidies minus taxes on products.

⁴ Eurostat data for 2017. Percentage of persons employed in total business economy, repair of computers, and personal and household goods—with the exception of financial and insurance activities.

Spain's public sector has increased its debt levels since 2007, while households and companies have reduced theirs.

Spanish debt over GDP, %



¹ Includes not-for-profit institutions serving households.

² Nonfinancial corporations. Includes loans and debt securities.

³ Percentage points.

Source: Eurostat

of capital and liquidity (on average, 0.8 times the liquidity ratio and 0.6 times the capital ratio, versus all sectors' average⁵).

(defined as returning to its pre-crisis GDP) by the end of 2023. Most sources agree on the severity of the 2020 GDP shock,⁷ but the recovery rate in 2021 and onward is unclear.

A potentially much higher risk of default for Spanish companies

To better understand the impact of the pandemic, Oxford Economics and McKinsey conducted analyses and developed different macroeconomic scenarios.⁶ We estimate that Spain's GDP could fall, in real terms, by 5.7 to 13.5 percent in 2020, by 5.2 to 11.1 percent in the eurozone, and by 2.7 to 6.5 percent in the world. These ranges reflect the fact that the pandemic will have a pronounced impact across countries. For this article, we have used 13.5 percent as the base scenario, which also assumes that Spain's economy will recover

We can segment Spain's sectors into three groups based on the severity of COVID-19's impact on revenues in 2020 (Exhibit 2). The three segments have similar weight in Spain's economy and labor market.

The impact of COVID-19 on revenues in Spain will vary by sector, with slower recovery times likely for sectors suffering stronger shocks.

The first segment (27 percent of gross value added, or GVA,⁸ and employment) comprises sectors that could experience a drop of more than 20 percent

⁵ Based on a sample of companies from SABI (Iberian Balance Sheet Analysis System); liquidity was measured as current assets over current liabilities, capital as equity over liabilities.

⁶ We focused on two scenarios: A1 (muted recovery) and A3 (virus contained); for more, see Sven Smit, Martin Hirt, Kevin Buehler, Susan Lund, Ezra Greenberg, and Arvind Govindarajan, "Safeguarding our lives and our livelihoods: The imperative of our time," March 23, 2020, McKinsey.com.

⁷ Our estimate is similar to that of several external sources: as of May 2020, Bank of Spain's range of scenarios 2 to 3 predicts a 9.5 to 12.4 percent drop in GDP, and Funcas's panel average predicts a 9.5 percent drop.

⁸ Excludes GVA related to imputed rents of owner-occupied dwellings.

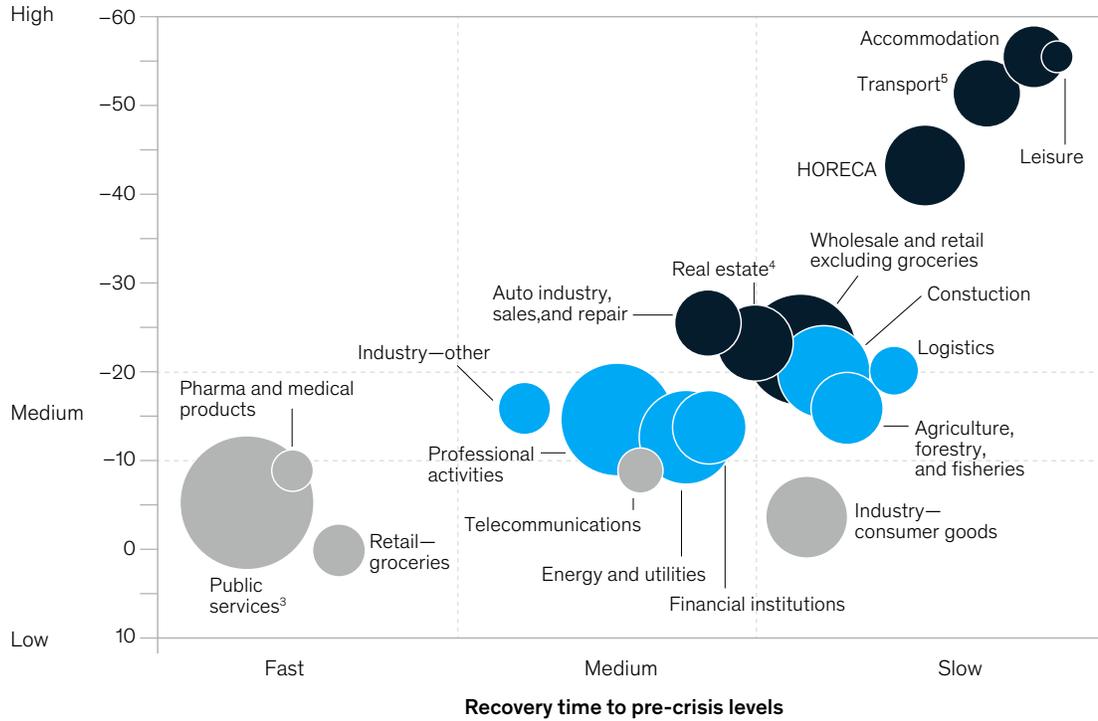
The impact of COVID-19 on revenues in Spain will vary by sector, with slower recovery times likely sectors suffering stronger shocks.

Estimated revenue drop by sector in 2020 vs 2019 and recovery time, scenario A1¹

Revenue shock intensity ● High ● Medium ● Low

Circle size = % GVA² contribution

2020 revenue shock in real terms, % change from 2019 (accurate as of May 12, 2020)



Note: Does not include activities of households as employers of domestic personnel, betting and gambling, or other services and subsectors with low GVA contribution.

¹ Muted-recovery scenario laid out in "Safeguarding our lives and our livelihoods: The imperative of our time," March 23, 2020, at McKinsey.com.

² Gross value added (GDP + subsidies – product taxes).

³ Includes public administration and defense, education, healthcare, and social work. Shock related to delta in GVA.

⁴ Shock and GVA exclude imputed rents of owner-occupied dwellings.

⁵ Passenger transport only; freight transport included in logistics.

Source: Eurostat; SABI (500,000-company sample); McKinsey, in partnership with Oxford Economics

of revenues in real terms, as they rely on activities that are, for now, highly restricted or fueled by discretionary consumer spending. These include accommodation and food services (HORECA), entertainment, transport, auto, real estate, and wholesale and retail (excluding groceries).

The second segment represents 34 percent of GVA and 36 percent of the labor market; sectors in it could experience a 10 to 20 percent drop in revenue in 2020. These sectors are construction, logistics,

other industry, agriculture, forestry and fisheries, professional activities, financial institutions, and energy and utilities.⁹

Last, the sectors that may be less affected by COVID-19 represent 26 percent of GVA and 31 percent of the labor market. These sectors, with revenues potentially dropping 10 percent or less, are telecommunications, pharma and medical products, public services, the consumer-goods industry, and retail groceries.

⁹ In this article, revenue shocks are expressed in real terms and do not include the impact on prices. This is particularly relevant to the energy sector, which has experienced a severe contraction in oil prices in parallel with the COVID-19 shock.

Impact is not homogeneous across different subsectors. A more granular view, which we have built this analysis on, should be considered to fully understand sector-specific dynamics. Some subsectors will do better than their sectors as a whole, and vice versa; this may be the case, for example, in auto sales versus repair or fine-dining restaurants versus their quick-service counterparts.¹⁰

Considering these impacts, we have estimated the increase in the probability of default for different economic sectors. In aggregate, and without considering any mitigating actions by the public sector, the COVID-19 pandemic could cause more than a threefold increase in the rate of default for Spanish companies in 2020. Particularly concerning are sectors such as accommodation or HORECA, for which the default probability increase could be eightfold. Other sectors, such as entertainment, transport, logistics, and auto, might see their default probability rise by four to seven times (Exhibit 3). A heavy economic shock implies that a large number of companies may not be able to continue their operations because of not only short-term liquidity problems but also structural capital and debt positions. And every bar, restaurant, store, and other company that closes will have a broader impact on the community as a whole.

In response, companies in all sectors should plot a strategy informed by their starting points and income shock and the recovery time each sector faces. Public-sector involvement will also be crucial.

A government stimulus package in line with other developed countries despite less room to maneuver

Governments around the world have responded to the pandemic by launching sizable stimulus packages to protect lives and livelihoods. For now, the magnitude of the Spanish government's response has been in line with that of other advanced economies: its announced package of measures is equal to about 16 percent of GDP (versus 15 percent in France and Portugal, 21 percent in Germany,

and 22 percent in Italy). However, the stimulus was delivered in the context of a public sector that, given its greater debt, enjoys less room to maneuver than other European countries do.

In this context, the selection of the right measures becomes as important as the volume of the response itself. The current stimulus package prioritizes covering household needs, offsetting and reducing labor spending, and ensuring companies' access to liquidity through guarantees such as Instituto de Crédito Oficial (ICO) credits.

We analyzed the potential impact of two of the larger measures in Spain's rescue package: the flexibility of *expediente de regulación temporal de empleo* (ERTE), which allows companies to tag their workforces as temporarily redundant as a result of a force majeure, and the ICO credit lines. These measures have mitigated some of the economic impact of the crisis. In particular, we estimate that ERTE could reduce the aforementioned risk of default by 25 to 30 percent if applied in line with revenue shocks. In addition, liquidity injections, in the form of ICO credits and others, could help businesses with low short-term cash levels (such as HORECA, automotive, and logistics companies with an average of less than two months' worth of cash) to cope with the initial impact. Only in March, new credit to companies increased by 35 percent over the same period in 2019, according to Bank of Spain data.

Spain could also explore other initiatives and adopt additional measures. Other countries have tried additional measures to increase liquidity or transferring value such as expediting public-sector accounts payable (for example, Israel has reduced the maximum payment period to 30 days) or reducing and suspending the payment of fees, taxes, or other contributions (for example, 100 percent property business-rates discounts to leisure and hospitality sectors during the 2020–21 tax year in the United Kingdom). Some initiatives aim at accelerating demand recovery, either directly (for example, through expenditure vouchers) or indirectly (for example, by reducing value-added taxes for a year, as Germany did for

¹⁰ See Sabine Becker, Stacey Haas, Eric Kuehl, Ignacio Marcos, and Kumar Venkataraman, "Delivering when it matters: Quick-service restaurants in coronavirus times," April 14, 2020, McKinsey.com.

The pandemic's effects can triple the probability of company defaults, with hotels and HORECA most affected.

Summary of impact of COVID-19 by sector,¹ (accurate as of May 12, 2020)

	Contribution to GVA, ² %	Revenue shock, in real terms, %	Increase in probability of default ³ due to pandemic, x
Public sector	18.0	2–3	N/A
Real estate	11.5 ⁴	18–22	1.9–2.1
Professional activities	9.0	18–21	2.8–3.2
Wholesale and retail excluding groceries	8.7	11–13	2.0–2.4
Industry—other	6.1	12–14	2.0–2.3
Construction	6.0	16–19	2.3–2.7
Energy and utilities	4.8	9–11	1.4–1.6
HORECA (food services)	4.7	38–43	8.6–10.7
Financial institutions	3.8	10–12	N/A
Industry—consumer goods	3.7	1–2	~1.0
Auto industry, sales, and repair	3.2	20–24	2.9–3.3
Agriculture, forestry and fisheries	3.1	12–14	1.5–1.7
Transport	2.7	46–52	5.4–6.7
Retail—groceries	2.0	0–3	~1.0
Accommodation	1.9	50–56	6.9–8.0
Logistics	1.7	16–19	3.4–3.9
Telecommunications	1.4	7–8	1.1–1.3
Entertainment	1.2	50–56	5.8–7.2
Pharma and medical products	0.7	6–7	1.2–1.4
Total	94.4	15–17	3.0–4.0

Note: Does not include activities of households as employers of domestic personnel, betting and gambling, or other services and subsectors with low GVA contribution.

¹ Numbers based on a sample of +500k companies de SABI; impacts displayed are the result of more granular subsector analyses.

² Direct contribution based on Eurostat data at subindustry level. When subindustry not available, industry figures distributed as a function of gross margin plus nonemployee costs.

³ Change in probability of default after demand shock; assumes "regular" ERTes in line with demand drop.

⁴ Shock excludes 65% related to imputed rents of owner-occupied dwellings.

Source: Eurostat; SABI (500,000-company sample); McKinsey, in partnership with Oxford Economics

Companies' default rates could more than triple because of COVID-19.

Spanish consumers are less optimistic about the recovery than other Europeans.

restaurants, from 19 percent to 7 percent), with a special focus on the sectors in most difficulty: accommodation, HORECA, and retail.

Some changes here to stay

COVID-19 is expected to cause a permanent shift in the behavior of societies and economic agents. Since the pandemic started, we have been tracking consumer sentiment every two weeks. Spanish consumers are less optimistic about the recovery than other Europeans: 42 percent of Spaniards are pessimistic about the country's economic recovery, a ratio that has not changed in the past month, as opposed to 36 percent of French and Italians and 18 percent of Germans. In addition to 83 percent of our respondents saying they are highly concerned about the Spanish economy, 80 percent are highly concerned about health and safety issues.

We have been tracking the changes in consumer behavior due to the pandemic across categories—for example, net purchase intent for snacks has fallen by 15 percent, by 51 percent for apparel, and by 75 percent for hotels and resorts—with all categories showing negative net intents except for groceries, household supplies, personal care products, and entertainment at home.¹¹ This level of negative intentions has, however, drastically improved since the first survey in mid-March, with a special focus on footwear, apparel, personal care services, or vehicle purchases, among others, partly driven by the lifting of Spain's lockdown measures. In the coming months, regaining consumers'

confidence may be the key to accelerating consumption and speed up the recovery.¹²

In addition, COVID-19 has already spawned or accelerated the following trends worldwide, including in Spain—trends that may continue to exist, even grow, after the lockdowns have been lifted¹³:

- Rise of a contact-free economy and digitization in three areas in particular: e-commerce, telemedicine, and the overall automation of work
- Effective remote working for occupations that can be done off-site, which will require additional training, collaboration, flexibility, and accountability of the workforce
- Increasing focus on resilience as well as efficiency and speed of operations, which will require comprehensive reviews of supply chains
- Closer scrutiny of businesses, which will have to work more on the “triple bottom line” (of profit, people, and planet) and keep embedding sustainability and purpose as sources of competitive advantage
- More government intervention in the economy, which began with big stimulus plans across the globe (in April alone, the total amount of stimulus plans worldwide was equivalent to eight Marshall plans)
- A stronger push to redefine global and local public health and safety policies and investments

¹¹ McKinsey & Company COVID-19 Spain Consumer Pulse surveys conducted April 30 to May 3, 2020; n = 1,004. Net intent is the difference between the percentage of people expecting to spend more and those expecting to spend less than usual in the category during the upcoming two weeks. We analyzed 32 categories. See “Consumers’ economic sentiments during the coronavirus pandemic,” McKinsey.com.

¹² See Tera Allas, Pal Erik Sjatil, Sebastian Stern, and Eckart Windhagen, “How European businesses can position themselves for recovery,” April 29, 2020, McKinsey.com.

¹³ See Kevin Sneader and Shubham Singhal, “The future is not what it used to be: Thoughts on the shape of the next normal,” April 14, 2020, and Sneader and Singhal, “From thinking about the next normal to making it work: What to stop, start, and accelerate,” May 15, 2020, McKinsey.com.

- An opportunity to embrace the level of innovation and speed that the crisis catalyzed across industries

The true impact of these trends will be known only in the future, but they will help to shape the next normal, and business leaders will need to be ready.

In Spain, the impact of the contact-free economy and accelerated digitization has been significant, and likely will continue to be. As the number of first-time adopters of products and services indicates, digitization has been growing during the crisis. For instance, 21 percent of the respondents to our Spanish consumer sentiment survey began receiving, or receiving more, grocery deliveries.

In the short term, however, the widespread contraction of consumption due to lockdown measures may be overshadowing digital dynamics that may require additional time to emerge. The net intent for some categories, such as groceries and personal care, is higher offline than online, according to our latest consumer pulse survey (for groceries, up 10 percent net intent offline and down 12 percent online)—in some cases due to the inability of companies to adapt to rising digital demand. In the medium and longer terms, though, shopping, learning, and habits of interaction may take new shapes as Spain adapts to the next normal.

An unprecedented effort by both the public and private sectors to move beyond the pandemic

An unprecedented effort by the country's public and private sectors will be necessary to hasten recovery and facilitate the establishment of a next normal in Spain. Stakeholders can view this effort looking through three horizons: survival in the immediate term (resilience), the return to some form of normality and recovery of value pools and

employment (return), and the design and adaptation to a new economic reality (reimagination). In each stage, actions by individual companies and the private and public sectors will help facilitate the economic recovery.¹⁴ (See Exhibit 4 for a look at priority actions companies need to deploy).

Resilience

During the resilience horizon, the focus is on taking the necessary measures to shore up a company's financial situation in the near term. Resilience is paramount for those sectors most hurt during the crisis—in Spain, accommodation and HORECA, entertainment, transport, auto, real estate, and retail.

Companies should concentrate on stimulating revenue streams, stabilizing supply chains, and optimizing operating models. The pandemic has accelerated the adoption of digital channels, and capturing a share of the growing digital demand will be an important element in sustaining business in the short term.

Sectors should also work collaboratively to boost demand by ensuring client confidence through hygiene and health protocols and implementing campaigns to promote local demand. This is particularly important in the tourism sector: international tourists represent 55 percent of total revenue in Spain, compared with 29 percent globally, according to the World Travel and Tourism Council.

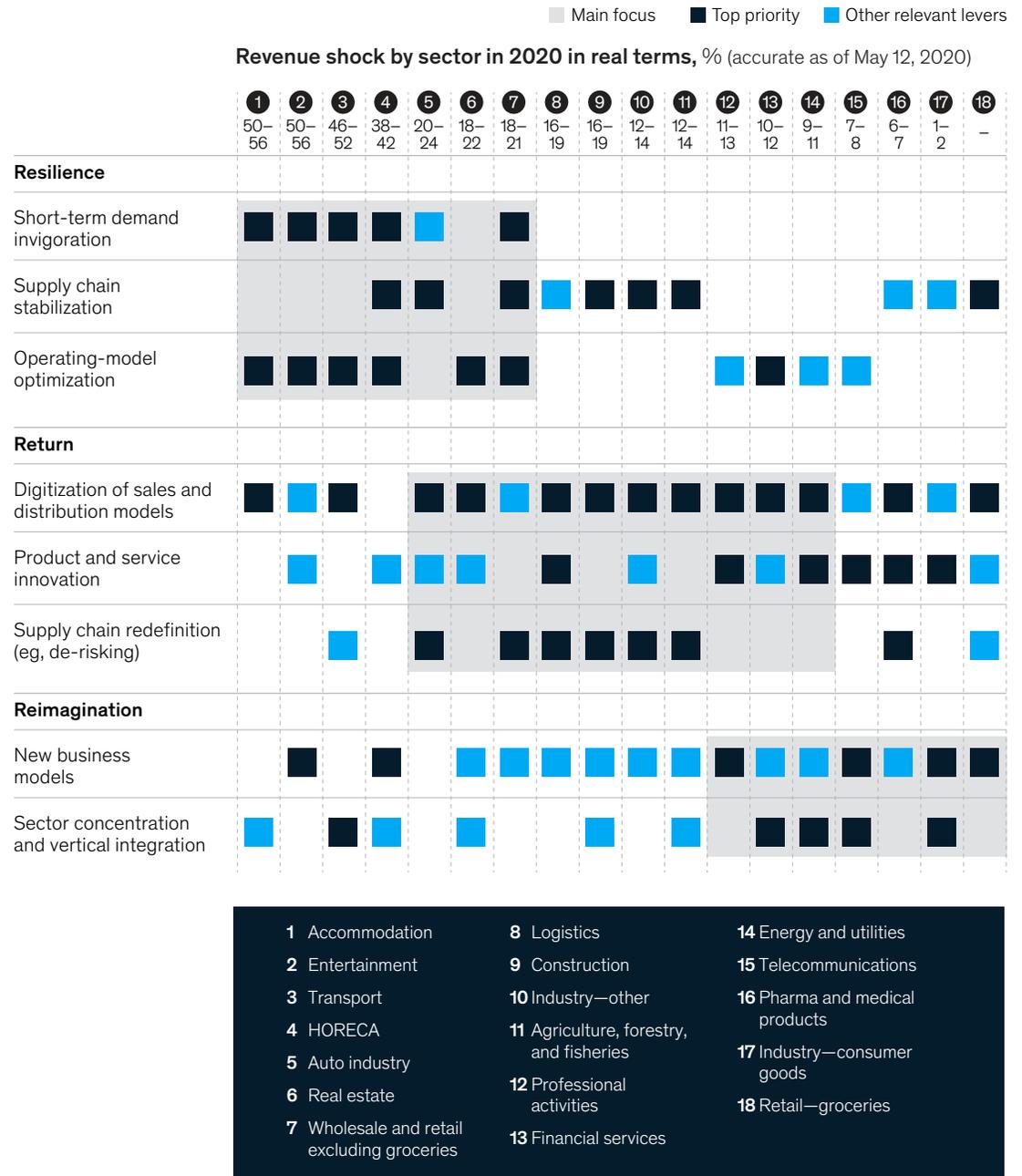
To support companies and sectors, the public sector could facilitate access to liquidity and capital and incentivize demand in struggling sectors.

This resilience phase initiatives can be illustrated with the example of HORECA, one of the most affected sectors, in which all stakeholders should work in order to accelerate demand. Restaurants, a large portion of which do not offer delivery service today,

¹⁴ The aim of this article is not to provide a detailed view on each sector but rather the overview for the full economy of Spain. Detailed impact of COVID-19 across sectors and functions can be explored in "Coronavirus: Leading through the crisis," a collection of insights on McKinsey.com.

Exhibit 4

Each company's particular level of income shock will determine its priorities during the three post-COVID-19 horizons.



This is a moment when winning companies can differentiate themselves from the pack.

could focus on accelerating its delivery uptake. The sector as a whole could consider sector-wide quality standards that increase customers confidence and on-site consumption. Public sector could also explore mechanisms to help accelerate demand, such as increasing terrace spaces.

Return

The next horizon involves the return to pre-crisis business levels and consumer activity. This might mean embracing trends that shifted or accelerated during lockdown and that won't completely revert to the status quo.

Migrating to digital sales models and refreshing product portfolios to adapt to new customer needs will be important for companies in this phase. In this context, redefining the physical footprint and the role of the stores will be a common theme across industries, from retail to banking. Banks, for instance, may have to rethink the role of branches as customers shift to digital interactions (for example, 20 percent of Spaniards expect to visit branches less frequently to make transactions as the pandemic eases).¹⁵ This is especially significant in Spain, where the number of branches per inhabitant is much higher than that in other European countries (in 2019, Spain had 56 branches per 100,000 inhabitants; its European peers 32).¹⁶

Companies could also consider redefining supply chains to reduce risk. The crisis has placed more pressure on just-in-time, zero-stock approaches

that many companies employ as well as increased the importance of end-to-end supply-chain visibility. Therefore, this stage could require a reassessment of the entire business system, including more contingency planning to return to production at pace and at scale.

Accelerating digitization could benefit from broader industry approaches. Company-by-company undertakings may be inefficient, given a business structure highly concentrated in smaller enterprises. Joint efforts to create more resilient business models can support the return—for example, shared-service centers and joint procurement strategies could capture efficiencies and improve margins of multiple sectors.

The public sector is expected to be vital in this phase, too, through potential policies that support the recovery of traditional growth engines and the evolution of newer growth sectors, ensuring an adequate regulatory framework and a resilient healthcare system.

Reimagination

While much of the Spanish economy will return to its pre-pandemic structure, some parts will be changed forever, a consequence of an imminent restructuring of the global economic order. For this reason, a multipronged effort will be necessary to adapt the business landscape to the next normal and reveal opportunities to improve business performance. The sectors that could suffer a lower short-term

¹⁵ McKinsey Financial Insights Pulse Survey; n = 1,021.

¹⁶ A simple average of the European Banking Federation's data on the number of branches in France, Germany, Italy, Portugal, and the United Kingdom.

demand hit—telecommunications, pharmaceuticals and medical products, retail groceries, and energy and utilities—could start focusing now on what their businesses will look like in the future.

In this third horizon, reimagination, companies first need to determine whether to pursue traditional business models or explore new ones, considering how their customers' needs and preferences have changed. These efforts could lead to a wave of mergers and acquisitions and partnerships and alliances. Organizations will also need to invest in talent management, including reskilling and upskilling, to prepare their employees for the new economic reality. This is a moment when winning companies can differentiate themselves from the pack.

Productivity will be one of the most important measures at this stage, to ensure sector competitiveness in the long term (Spain has a 26 percent lower GVA per employee than the combined European Union and United Kingdom). This gap might be partly bridged by further concentration of fragmented sectors. In addition, the COVID-19 pandemic could accelerate the sustainability trend among sectors. A cross-sector sustainability push could mitigate the potential risks of being a first mover in this field.

Finally, the public sector has, again, a role to play in supporting the reimagination of the economy. This is the case not only in terms of supporting the reinvention of companies and sectors as a whole but also through doubling down on a selected number of projects that could define the new Spain. Accelerating the country's digitization, encouraging consolidation, developing the infrastructure of the future, and making the transition to a carbon-free economy are just a few possibilities.

Spain's economic recovery will be neither instant nor easy—the pandemic's impact has been seismic. But the experience could also be an opportunity to create value in the next normal while protecting lives and livelihoods. We know that the road back will require a sweeping effort from the country's public and private sectors alike. Policy makers, both Spanish and European, could reflect on how to provide the appropriate framework for private initiatives to thrive and for business owners to navigate the turbulent times ahead. Just as Spain fought its way back from the global financial recession, the country can rise to this challenge and rebuild its economy. Better days await.

María del Mar Martínez is a senior partner in McKinsey's Madrid office, where **Santiago Fernandez** and **Ignacio Marcos** are partners and **David Francés** is an associate partner.

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