How EMEA start-ups are dealing with COVID-19

What young as well as mature companies can learn

Massimo Mazza, Karel Dörner , Max Flötotto, Tobias Henz, Michael Müller-Peltzer

May 2020

Executive summary

1. The COVID-19 crisis has hit the European, Middle Eastern, and African start-up ecosystem on two fronts: businesswise, creating a shock due to decreased consumer demand and paused operations of corporate partners, and moneywise, causing a shortage of cash thanks to less operating revenue and scarcer availability of funding.
2. The extremely disparate impact of the crisis on individual start-ups – depending both on their industry and size – is why there is no definitive playbook on the actions that they should take to navigate the current environment. On the contrary, as the situation for each start-up is highly unique, a tailored action plan is needed depending on where the company stands on two axes: the effect of the crisis (i.e., whether the start-up has won or lost due to shifts in the market caused by the crisis) and cash reserves (i.e., whether the start-up has significant reserves or limited runway).
3. Proactive measures taken by many start-ups during the crisis provide lessons for all, even larger and mature companies, and might be catalysts for a burst of innovation out of this crisis, while creating new champions.

Introduction

The current COVID-19 public health crisis is unprecedented. Its direct impact on human lives has been swift, and its economic impact is following closely. At best, the crisis has been deeply troubling for businesses. At worst, the threat is existential. Just as the impact is being felt across businesses of all sizes – from multinational conglomerates to SMEs – the crisis is affecting both well-established companies as well as start-ups.[1]

Overall, this crisis fundamentally disrupts start-ups' usual operating models, which are driven by radical innovation – a form of innovation that Europe, the Middle East, and Africa (EMEA) are in great need of not only to get out of this crisis, but as a future motor. Before the current crisis, many EMEA industries faced the difficulties of global competition and were under pressure to innovate.[2] The growing start-up eco-systems in EMEA were providing hope for the region's ability to keep up with Asia and North America. With the current crisis, that motor has begun to sputter, but if the start-ups ecosystem pays attention and takes action, this hope does not have to fade.

Start-ups are particularly affected by the crisis, as their operating and business models depend on growth and funding – both of which are under pressure right now. Additionally, start-ups typically have limited access to the financial resources, such as deep savings and lines of credit, that more established businesses can lean on when times are tough. Given the unique position that many start-ups throughout EMEA find themselves in, McKinsey Fuel Ignition – McKinsey's curated global network for start-ups and, amongst other things, think tank for corporate-start-up collaboration – has been working with start-up founders and executives to understand where specific issues for start-ups arise, both as challenges and as opportunities.

To this end, McKinsey Fuel Ignition reached out to its EMEA start-ups to find out how the COVID-19 pandemic is affecting them – and how they are dealing with this crisis. A survey of more than 120 start-up founders and managers, plus around 50 individual interactions from roundtables and in-depth interviews, revealed the details of the impact of the crisis on the start-up ecosystem. (For further information on the survey and interviews, see Text Box 1.) The bottom line: the challenge to the EMEA start-up ecosystem is at once an existential threat and a powerful opportunity for growth.

Research methodology highlights

Key aspects of the survey

- Number of responses: 119 (more than 80% of the respondents are start-up founders, and about 80% of the respondents' companies are B2B).
- Regional breakdown: 57% of the start-ups are in Germany, 38% are in the rest of EMEA, and 5% are in the rest of the world.
- Industry breakdown: 18% of the start-ups are in AI/machine learning, 16% are in hardware/robotics, 12% are in health-/med-/biotech, 11% are in fintech, 6% are in CRM/enterprise, 5% are in food and nutrition, and 35% are in other industries.
- Revenue breakdown: 70% of the start-ups generate under EUR 1 mn in annual revenue, 18% generate between EUR 1 mn and 5 mn, and 12% generate over EUR 5 mn.

Key aspects of interviews and in-depth perspectives

- The in-depth perspectives are based upon 90-minute roundtable discussions with around 100 start-up founders and managers as well as investors (primarily from Germany and the UK), incorporating interactions with: early-stage start-ups (which have received under EUR 5 mn in funding), growth-stage start-ups (between EUR 5 mn and 30 mn in funding), and mature start-ups (over EUR 30 mn in funding).
- Further, 30-minute phone interviews were conducted, providing further and deeper insights into the challenges and opportunities that start-ups see.

1 See McKinsey's regularly updated website "COVID-19: Implications for business" (https://www.mckinsey.com/business-functions/risk/our-insights/covid-19-implications-for-business).
2 See McKinsey article "Reviving innovation in Europe" (McKinsey Global Institute, October 2019), (https://www.mckinsey.com/featured-insights/innovation-and-growth/reviving-innovation-in-europe).

COVID-19 presents unique challenges for the start-up ecosystem in EMEA

Of all the potential areas for concern, three stand out in terms of how widely they are shared across the start-up founders and managers that McKinsey Fuel Ignition surveyed: customer retention and acquisition, funding, and cash (Exhibit 1).

Customer acquisition and retention. Of the EMEA start-up founders and executives that McKinsey Fuel Ignition contacted, 72 percent have seen a negative impact in their ability to acquire new customers. Specifically, they say that sales channels have been disrupted, in part because decision makers are not as accessible and in part because opportunities to customize products and demonstrate them face-to-face have been cut. Moreover, 84 percent worry that they will be unable to hold on to their current customers, since many corporates have frozen external project activity and consumer demand is also currently slumping. Finally, the probable reduction in consumer spending will also eventually have a ripple effect on many start-ups' top lines.[3]

Funding. Start-ups are reporting that conversations with investors reflect deep uncertainty in the market, with some investors either withdrawing from discussions or cutting the valuations of the start-ups in which they are investing. Given this activity, half of the respondents report seeing a negative impact in their current funding rounds, and nearly three-quarters expect greater challenges in closing subsequent rounds later this year.

Cash. Ultimately, this crisis puts pressure on start-ups' cash situation. And the limits of what is bearable might be reached quicker than with large corporates, as start-ups by design burn more cash than they make, have low reserves, have no access to many of the (financial) crisis relief instruments that are aimed primarily at larger companies, and are thus dependent on growth and cash infusions.

72% have seen a negative impact in their ability to acquire new customers.

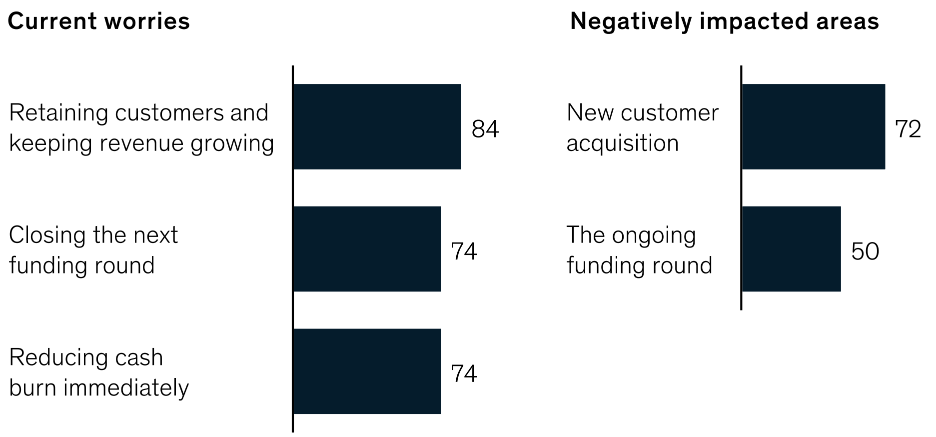
84% worry that they will be unable to hold on to their current customers.

3 See, for example, McKinsey's regularly updated website "COVID-19: Implications for business", (https://www.mckinsey.com/business-functions/risk/our-insights/covid-19-implications-for-business) and McKinsey article "Survey: Asian consumer sentiment during the COVID-19 crisis" (April 2020), (https://www.mckinsey.com/featured-insights/asia-pacific/survey-asian-consumer-sentiment-during-the-covid-19-crisis); for further information on Germany in this context, see McKinsey article "Survey: German consumer sentiment during the coronavirus crisis" (May 2020), (https://www.mckinsey.com/business-functions/marketing-and-sales/our-insights/survey-german-consumer-sentiment-during-the-coronavirus-crisis).

Exhibit 1

The COVID-19 crisis is causing uncertainty for start-ups

Survey insights – key concerns, percent of respondents (N=119)



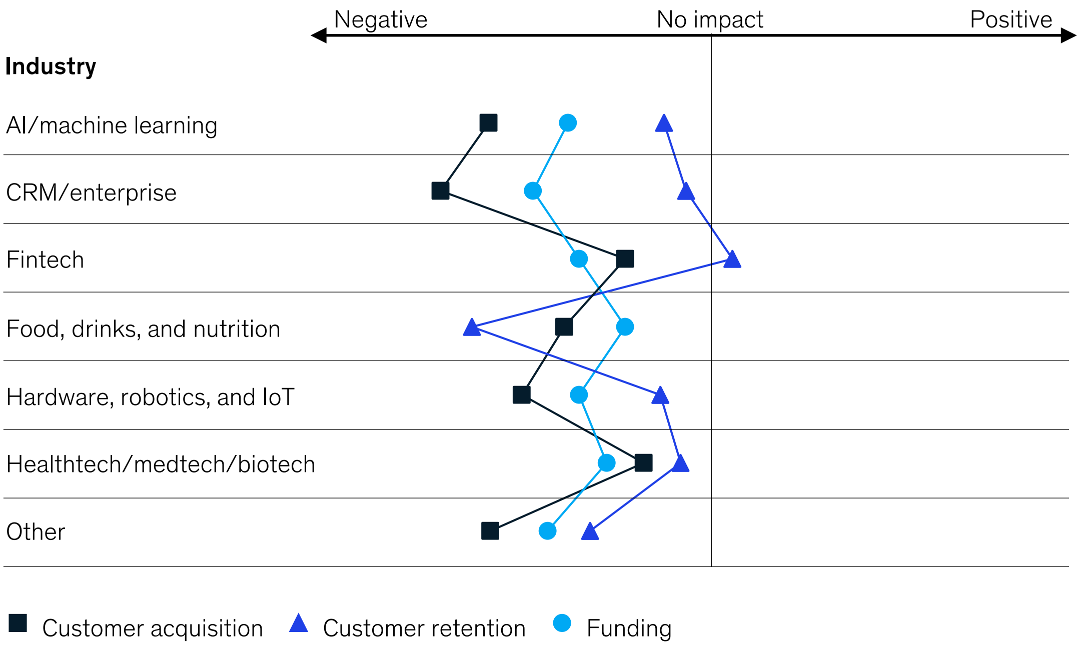
Source: McKinsey

Exhibit 2

The COVID-19 crisis is affecting start-ups differently based on industry and size

Survey insights

To what extent is COVID-19 affecting start-ups' business?



Source: McKinsey

The specific characteristics of an individual start-up determine both the impact and the strategy

The current crisis is having a wide range of effects on start-ups, with some being hit quite hard and others experiencing a much less negative impact (Exhibit 2).

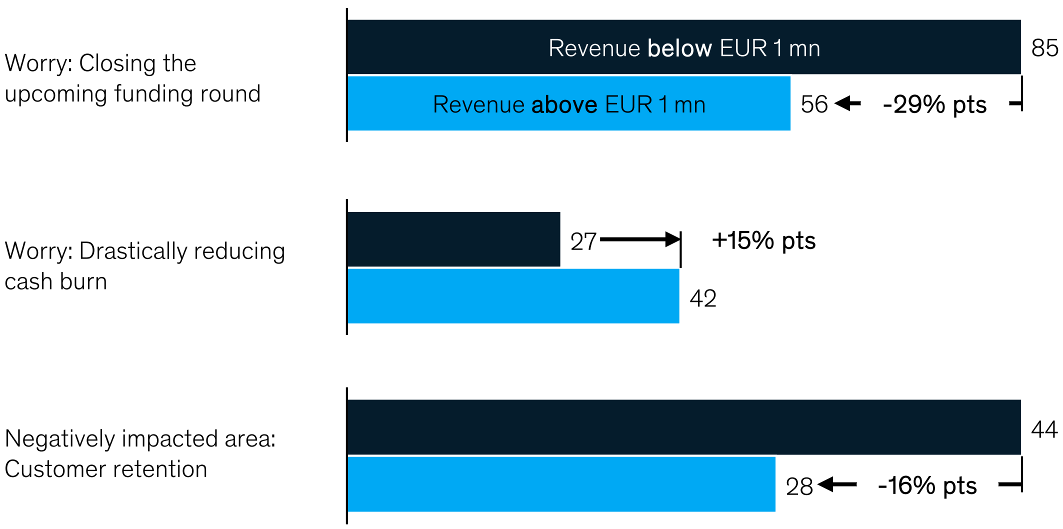
Taking a more granular look, it is evident that the impact of the crisis varies widely by industry. Some sectors are being hit particularly hard – such as food, drinks, and nutrition, which depends on people dining out or working from their offices and ordering catered lunch, or AI/enterprise software, which depends on large industry corporates. Other sectors, such as health-/med-/biotech and fintech, might experience fewer negative effects, possibly even seeing performance improvement in certain indicators. Thus, while a CRM/enterprise start-up, for example, may experience plummeting customer acquisition, its customer retention may not be impacted. Or a fintech start-up may face a more complicated funding situation but actually see a positive effect in customer retention.

Another potentially differentiating factor for how start-ups experience the current crisis is their size. Small-scale start-ups (revenue under EUR 1 million) are much more worried about funding and are more likely to struggle with customer retention. Larger start-ups (those with revenue over EUR 1 million) tend to worry less about funding; however, those with high cash burn rates feel pressure to drastically reduce spending (44 percent of larger start-ups see reducing cash burn as a priority – in comparison to 29 percent of smaller start-ups).

The extremely disparate impact described above – across both industry and size – is why there is no definitive playbook on the actions that start-ups should take to navigate the current environment. Decisive action is certainly needed; however, which actions to take needs to be decided differentially (Exhibit 3).

For example, start-ups that are currently experiencing severe negative business impact and had planned to raise money in the near term might be advised to take decisive action to reduce cash burn. This could mean looking to the rigorous cash management measures being taken by many corporate

Current worries and negatively impacted areas
Percent of respondents (N=119), grouped by revenue



Source: McKinsey

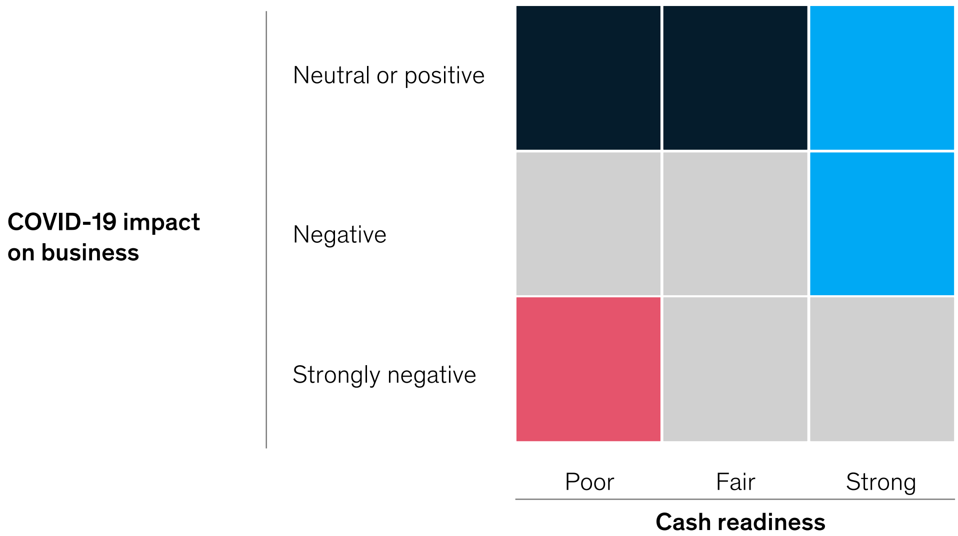
enterprises and, for example, applying for state programs such as short-time work in Germany. At the other end, food delivery start-ups, for example, which were already experiencing a strong increase in performance along certain metrics pre-crisis and have been successful in recent rounds of fund-raising, should now accelerate their efforts and capitalize on opportunities.

In any case, the majority of start-ups expect short-term support from governments (76 percent) and investors (65 percent), while fewer of them expect it from corporate partners (only 15 percent). Several instruments have been implemented in EMEA, such as deferrals of income tax payments or rent for office space. There are also additional financial instruments that are intended to help small businesses, but their accessibility for start-ups is limited and only few start-ups report that they have already received support.

Exhibit 3

Start-ups and investors must take action tailored to the degree of COVID-19's impact and their cash readiness

Implications from interviews with venture capital partners and start-up management



	Possible features	Action/advice plan
	– Plans to raise funds in Q3/Q4 2020 – Dependent on capex and long investment cycles – Demand is heavily impacted or reduced to zero (e.g., in hospitality, micromobility) – Business model relies on impacted partners	– Assess the need and possibility of pausing or ceasing operations – Consider emergency or bridge funding/financing/M&A
	– Financial exposure is in line with the market – Margin improvements are best addressed through operational measures	– Make quick decisions to focus resources and improve operating expenses
	– Recently raised funds/strong cash position – Pre-revenue, limited, or mature revenue – Flexible products and business model (e.g., digital channels, work-from-home ready)	– Reorganize resources as needed to support the evolving company strategy and capitalize on new opportunities
	– Limited cash position/runway – New markets or opportunities available in the current climate (e.g., medical equipment/testing, remote working, delivery)	– Consider cash infusions to leverage tailwinds – Assess longevity of opportunities

Source: McKinsey

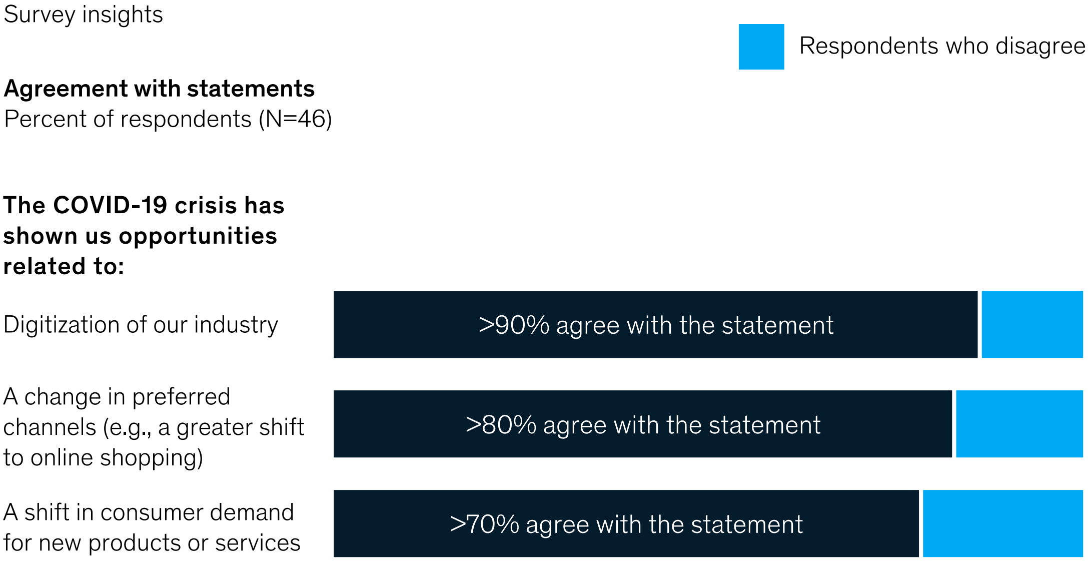
Resilient players are taking decisive action – other businesses should take note

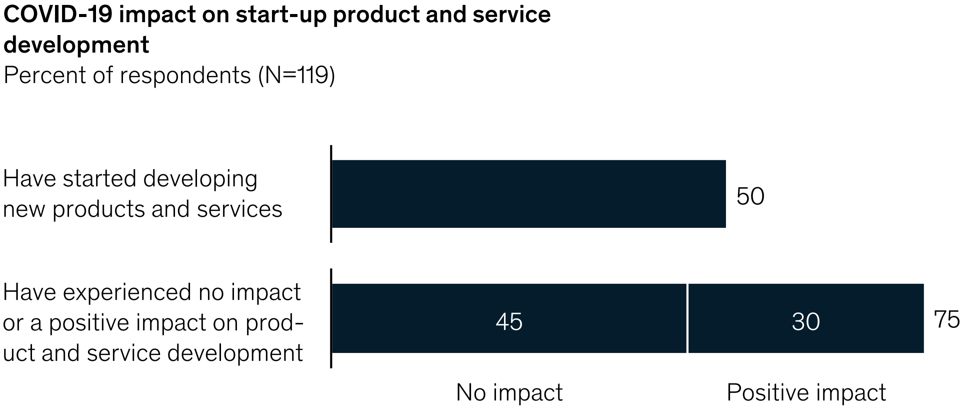
In this crisis, start-up founders and managers are demonstrating their greatest strengths: agility, creativity, and a proactive mindset. These characteristics are driving start-up activities, and are also a lesson to leaders of all types of businesses – large and small, young and mature. Most founders and managers remain optimistic when thinking about navigating the current crisis and see opportunities in key areas (Exhibit 4).

Exhibit 4

Start-ups are seeing fundamental changes in their industries and customer behavior – and are reacting accordingly

Survey insights





Source: McKinsey

For example, the most agreed upon opportunity is the digitization of their industries and offerings, with over 90 percent of survey respondents expecting it to happen. This is followed by an adaption to more digital channels (over 80 percent of respondents) and a shift in consumer demand for new products or services (over 70 percent).

Start-ups have a great willingness to learn from the current challenges and further improve their management skills and processes. To seize on changed circumstances, they are adapting in various ways:

New products. About 50 percent of the survey respondents have begun developing new products and services – most of them digital. Looking at only smaller start-ups, that share climbs to over 55 percent. About one-third of start-ups are even seeing a positive impact on their ability to develop new products or services. While new product development in response to COVID-19 seems to be happening across industries, there are specific cases where it has become particularly frequent. For instance, start-ups that have long fought to get public services digitized – for the purpose of more efficient interaction – might finally get to take part in an extensive movement surrounding a process that has stalled in the past. Not to mention that start-ups help start-ups. For instance, large-scale hackathons such as the #WirVsVirus (us against the virus) hackathon organized by the German government have leveraged start-ups and creative inventors, who push (mostly digital) ideas that benefit society and the ecosystem itself.

New channels. Some start-ups are already adapting some of their processes in response to the current environment. Most prominently, they are shifting sales processes into the virtual world. B2C start-ups are moving aggressively into online sales (if they are not already there), while B2B start-ups are digitizing and using the opportunity to professionalize their sales processes:

> **"As we can no longer rely on convincing our customers in personal conversations and product demonstrations, we have now laid our focus on improving the (digital) lead qualification process of our B2B business."**
>
> *Founder of a seed-stage industry 4.0 start-up helping machinery manufacturers manage their assets*

New access. Some start-ups are proactively seizing the opportunity of changed circumstances to enhance their access to markets and particular customers. With healthcare now in the spotlight, healthtech and medtech start-ups can gain high-level support (if they are able to cut through the noise):

> **"In the past seven days, we have achieved what we've been trying to achieve in the one and a half years before. It is amazing who at government level can suddenly be reached using active networking and which hospitals now want to share data with us."**
>
> *Founder of an early-stage medtech from Munich*

>90% see an opportunity for their business in a COVID-19-related digitization of industry.

50% of the start-ups have begun developing new products and services – most of them digital

However, there are also multiple examples from industries that are less prominent in a pandemic, where founders have managed to pitch themselves to the top of decision makers' agendas. These include a procurement start-up that is now helping corporates at the highest levels to source backup suppliers, and a customer service start-up that managed to access crisis management boards at corporates for quick and unbureaucratic project execution.

New value propositions. Others are radically adapting their marketing approach. From McKinsey Fuel Ignition's conversations with start-ups, the ability of start-ups to present their value to potential customers in new ways has become clear. One start-up, for example, has been able to seize the chance to digitize property management – an industry that has traditionally been offline and has thus had to almost completely shut down during the crisis. By offering free usage of its platform now, this start-up is lowering the barrier to use and securing future revenue.

□□□

Due to the severity of the current existential crisis, which poses unexpected fundamental challenges to even the best-managed start-ups, it is not yet possible to predict its outcome. Depending on the new normal that the world is heading towards, some of the uplift will be temporary, while some might be here to stay. For the types of uplift that remain, companies – start-ups and corporates alike – that have endured up to this point will need to figure out how to capture it sustainably. In any case, the start-ups that act proactively will be the fastest to profit – and others can learn from them.

Amid the dynamic changes that a crisis of this scale imposes on everyone, the upcoming months will reveal further challenges or opportunities for businesses, but also crystalize who is successfully navigating through this. The learning curve is continuous in this uncharted territory – McKinsey Fuel Ignition will report on the new lessons in subsequent articles.

Contacts

Massimo Mazza is a senior partner in McKinsey's New York office.
massimo_mazza@mckinsey.com

Karel Dörner is a senior partner in McKinsey's Munich office.
karel_doerner@mckinsey.com

Max Flötotto is a partner in McKinsey's Munich office.
max_floetotto@mckinsey.com

Tobias Henz is an engagement manager in McKinsey's Munich office.
tobias_henz@mckinsey.com

McKinsey & Company
May 2020
Copyright © McKinsey & Company
Designed by Visual Media Europe

www.mckinsey.com

@McKinsey
@McKinsey