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US small-business recovery after the COVID-19 crisis

Improving operations and adapting business models can help small businesses in many industries recover. Finding the cash to do so may be a stretch.

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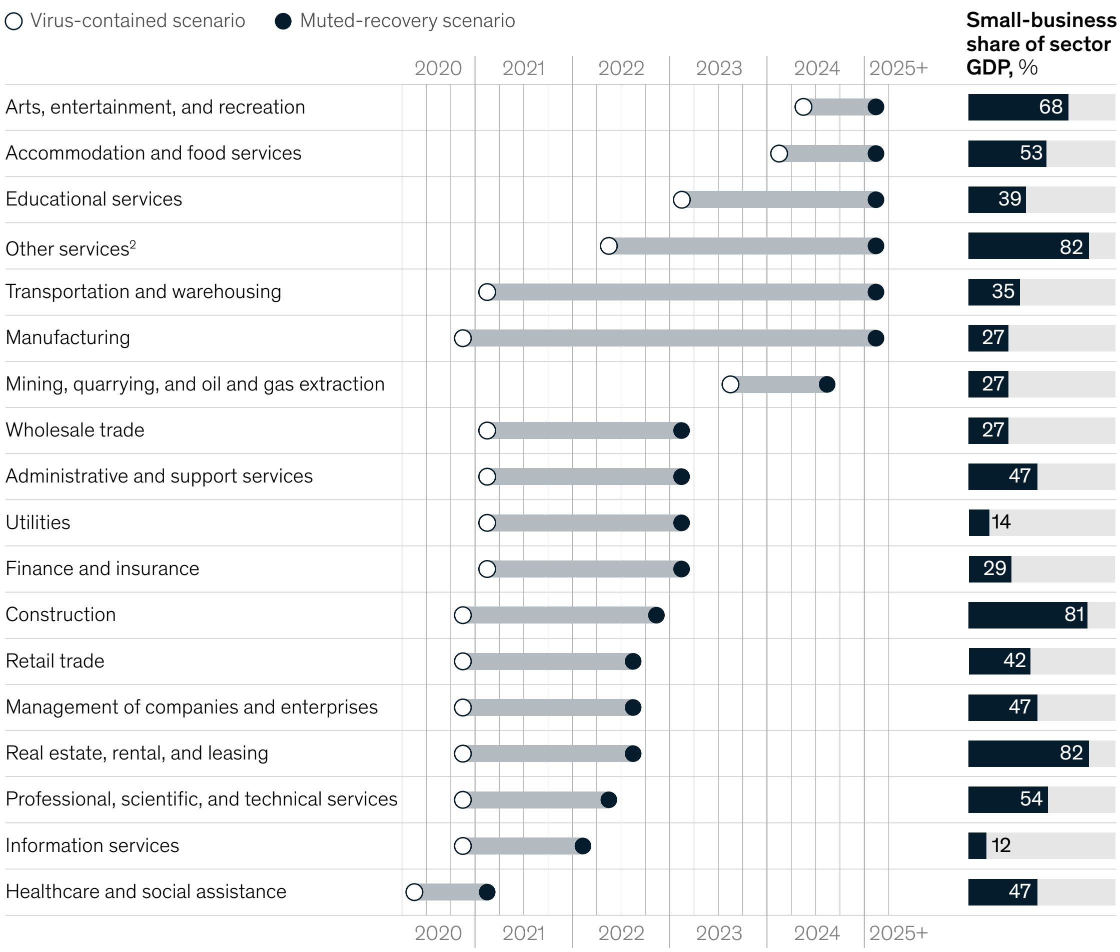
The unique nature of the COVID-19 crisis poses a new set of challenges for US small businesses as they claw their way toward recovery. Many face muted demand, new customer expectations, and operational challenges because of health and safety restrictions. Recovery will take time. After the 2008 recession, larger companies recovered to their precrisis contribution to GDP in an average of four years, while smaller ones took an average of six.[1] How long it takes in the current recession will depend on both economic vulnerability to the COVID-19 response and the prevailing macroeconomic outlook in their respective industries. Across all businesses, that could take five years or longer under two scenarios that McKinsey Global Institute and Oxford Economics have modeled and that more than half of global executives surveyed see as the most likely to unfold (Exhibit 1).[2] Among small businesses, recovery is again likely to take even longer. Many may never reopen.

Exhibit 1

In a muted recovery, it could take more than five years for the most affected sectors to get back to 2019-level contributions to GDP.

Estimated time to recover to pre-COVID-19 sector GDP[1]



[1]Data as of June 15, 2020.
[2]Excluding public administration.
Source: Oxford Economics; McKinsey analysis; McKinsey Global Institute analysis

[1] Kathryn Kobe and Richard Schwinn, *Small business GDP: 1998–2014*, US Small Business Administration Office of Advocacy, December 2018, advocacy.sba.gov.
[2] McKinsey survey of 2,174 global executives, June 1–5, 2020.

Many small businesses in the United States will need to make extreme changes to survive. The broad themes are, by now, familiar and generally the same as with most large businesses: protecting the health and safety of employees and customers, adapting business models, investing in talent and technology, and adjusting staffing models and labor practices. But like Ginger Rogers, who danced the same steps as Fred Astaire, only backward and wearing high heels, small businesses will need to make all these changes at greater relative cost and with less working capital. Small businesses with slim margins have little room to invest in the business models and technologies that they will need to survive. It will take collaboration across the economy to keep them afloat.

This article covers the unique challenges and opportunities for recovery in three critical sectors: manufacturing, retail, and restaurants. Taken together, these sectors account for approximately 30 percent of small-business jobs in the United States. And while these sectors have distinct characteristics, much of their experience can be extrapolated to other sectors.

Facing pressure on already-slim margins

Many small businesses across sectors came into the COVID-19 crisis with low financial resilience. Among respondents to our survey, close to a third were operating at a loss or breaking even prior to the crisis.[3] EBITDA[4] margins are typically below 5 percent for small retailers selling staples, such as groceries, and below 10 percent for those selling discretionary items. Balance sheets for small businesses in manufacturing, retail, and restaurants also lack flexibility, since a significant portion of the costs for small businesses in those three sectors are relatively fixed. Occupancy costs, for example, are especially so for smaller businesses, which often lack the market power to renegotiate the terms of their leases. Along with fixed occupancy costs, small retailers have less flexibility in managing the material amount of cash tied up in maintaining inventory. It isn't uncommon for clothing stores to carry 90 days' worth of sales in inventory, which creates significant pressure on margins when inventory is seasonal, inventory has an expiration date, and customer demand is volatile.

Small manufacturers, whose working capital tied up in inventory often adds up to 20 percent of sales, also have the added cost of servicing their debt. They tend to rely heavily on financing for their investment and working-capital needs—and indebtedness is high. Our survey of more than 1,000 small businesses suggests that the cost of servicing their debt is, on average, 30 percent of revenue for small manufacturers, 11 percentage points higher than for more financially resilient industries, such as high-skilled professional, scientific, and technical services. The overall sector could take longer

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[3] McKinsey COVID-19 US Small and Medium-Size Business Financial Pulse Survey, May 5–12, 2020. The sample of 1,004 respondents covers a representative range of industries (North American Industry Classification System 2) and states. This article focuses on employer small businesses with at least one but fewer than 500 employees.

[4] Earnings before interest, taxes, depreciation, and amortization.

than five years to recover to precrisis GDP levels, depending on the economic impact of the COVID-19 pandemic. And their experience could be illustrative for other industries with high capital intensity, such as transportation, warehousing, or natural-resource extraction.

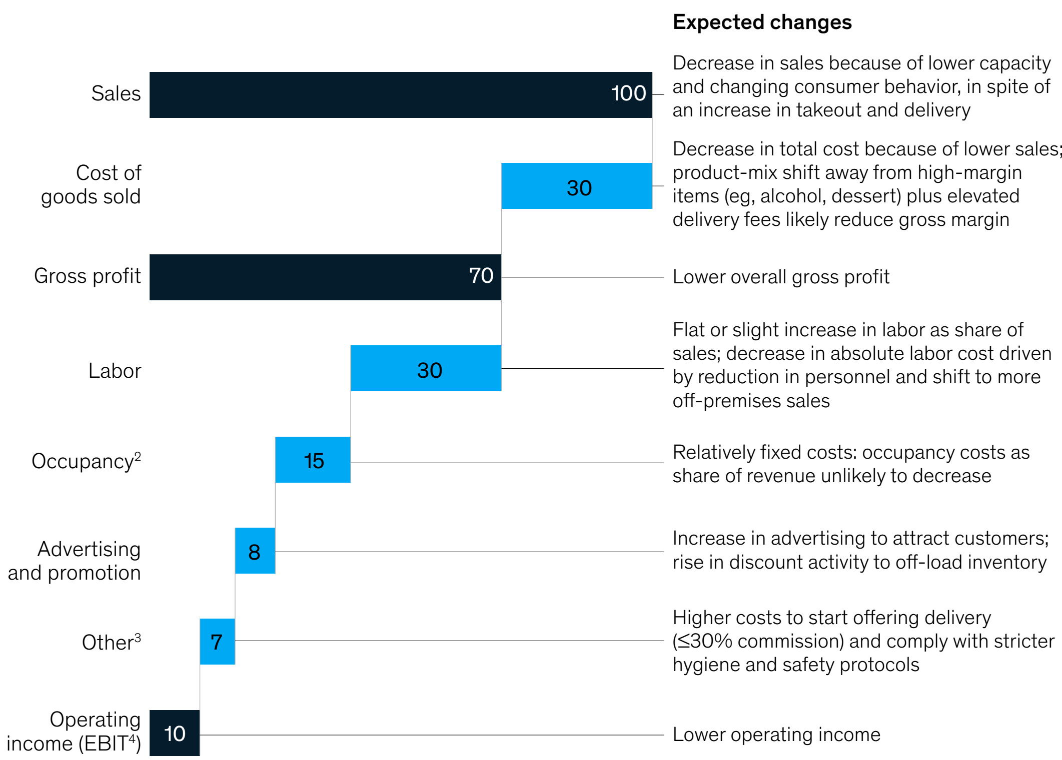
Restaurants, too, face margin challenges. A shift to a more off-premises world—delivery or carryout—is likely to erode their profitability by increasing packaging costs and hindering their ability to sell high-margin items, such as alcohol and desserts. And many small businesses were already vulnerable before the crisis. Nearly 40 percent of small businesses in the restaurant sector operate at a loss or just break even, according to our survey. And any increased costs for accommodating changed expectations would come with a bigger hit on relatively slim operating margins (Exhibit 2).

In manufacturing, retail, and restaurants, the added cost of complying with new hygiene and safety protocols could be onerous. The cost of cleaning supplies and disinfectant wipes—which more than half of restaurant customers now expect to be provided—are less likely to be negotiable for smaller businesses, which are less likely to qualify for the bulk-pricing discounts available to larger ones. The

Exhibit 2

For small restaurants, the costs of adjusting to changed customer behaviors would take a big hit on a relatively slim operating margin.

Illustrative profit-and-loss statement of independent restaurant with <50 employees, $ (indexed to $100 before COVID-19 crisis)



[1]Does not account for public and private sector interventions.
[2]Such as rent, utilities, and insurance.
[3]Such as compliance, certification, accounting, and card processing.
[4]Earnings before interest and taxes.

same is true for smaller retailers and, more generally, for most customer-facing small businesses in other industries, including arts, educational services, entertainment, and recreation. Small groceries would need to invest approximately 1 percent of their revenues to cover the cost of additional labor and cleaning products. And space constraints will make it harder for independent retailers than larger retailers to carry out required physical distancing.

Revenues, too, are at risk. A weekly survey conducted by the US Census Bureau found that nearly 50 percent of manufacturing companies are reported to have experienced a decrease in revenue in the first week of June 2020. In a recessionary environment, we anticipate consumers to curb their spending on nonessential goods and services: the same US Census Bureau survey found that two-fifths of retail companies experienced a decline in revenue at the start of June. For restaurants, capacity is a particular issue. In many states, such as California, Florida, Illinois, Michigan, and Texas, official return-to-work guidelines for food-service establishments require tables to be separated by at least six feet of physical distance. The smaller the restaurant, the more significantly such restrictions will limit the number of customers that can be served. Even an average medium-size restaurant typically needs to operate at 75 percent capacity to break even. And while some cities are cutting red tape to allow restaurants to set up tables on sidewalks and public squares, such moves aren't always welcome by the neighbors and may affect local tax revenues.

Adapting new business and operating models

Navigating the current crisis and thriving in the next normal will require significant changes in business and operating models for all businesses. Since early in the COVID-19 crisis, around 60 percent of restaurants in the country have added curbside pickup, and more than a third of consumers who have ordered food for in-store or curbside pickup were first-time users of the service. Independent retailers have also innovated rapidly to adapt to the new environment. Retailers that were deemed essential, especially grocers, began offering curbside pickup, limiting the number of customers in their stores, adjusting their hours, and sometimes creating special time slots to cater to the most vulnerable populations. To further maintain physical distance, many experimented with new payment methods and apps. Retailers that were deemed nonessential—those selling apparel, for example—experimented by rapidly uploading products to their e-commerce websites, offering free delivery, and extending return policies.

Yet sustaining such actions in the medium term could be difficult, especially for small businesses. Large restaurants can make changes to operating procedures and marketing techniques to return to stability—but such changes can be onerous to smaller ones. Operationally, small restaurants and retailers alike could adapt by increasing promotional activities, offering temporary price reductions, adjusting their product mix or menus to focus on high-value items, and potentially renegotiating terms with their suppliers to preserve their margins. That, too, will be easier for larger chains with deeper marketing resources and the ability to run data-driven promotions. Larger retailers may be able to increase promotional activities and take a margin hit to attract and retain customers, clear their inventory, and free up working capital. In apparel, for example, our analysis suggests that 56 percent of available products at US fashion retailers at the end of April 2020 was offered at a discount, nine percentage points higher than the same time in 2019. But smaller retailers, which have less financial flexibility, may not be able to compete on price and promotions.

Factories will also need to adapt to address the operational challenges of meeting health and sanitation requirements. To protect employees, the manufacturing floor must be rethought to allow distance between workers. Factories may need to experiment with a "pod" system, assigning operators to fewer machines but giving them greater responsibility for tasks within their work areas. Such a system can reduce contact with staff and equipment outside the pod. Both modified physical infrastructure and optimized operating procedures that limit the number of individuals each employee must interact with will help meet physical-distancing guidelines. In many cases, workers will also require additional personal protective equipment and regular health testing, including temperature checks prior to entering the building.

For small retailers, a refreshed business model could help with adapting to changing consumer behaviors. Millions of consumers are up for grabs. Disruption in the marketplace, whether driven by supply-chain challenges or by changes in shopping behaviors, have led 15 to 20 percent of consumers to switch stores. About half of those who switched report that they are planning to continue using their new store, according to our US Consumer Pulse Survey. But customer behaviors may also put small retailers at greater risk: customers are taking fewer trips but increasing the size of their baskets. That favors one-stop shops, such as big-box stores, and could be detrimental to smaller retailers that offer a more limited selection of products. To compete, smaller companies may need to find new ways to differentiate their value proposition: focusing on "hyperlocal" demand trends, competing on service quality instead of price, or building customer loyalty through marketing campaigns that engage the local community.

Adopting new technologies

The most effective way for small businesses to meet new hygiene and safety expectations is to design effective contactless experiences. For example, the restaurants that have fared better since the onset of the COVID-19 crisis have often turned to their digital capabilities and investments in technology to reset their channel mixes to increase takeout and delivery, build loyalty by enabling customers to order through their first-party apps, and increase the flexibility of their supply chains. An international restaurant group managed to keep a majority of its US restaurants open during the crisis by serving food through drive-through, delivery, and takeout channels. New menu items even drove a net increase in sales for some of its brands in the first quarter of 2020.

Among retailers, too, those that have performed well since the beginning of the crisis were those that leveraged their superior digital capabilities. Target, for example, saw comparable store sales grow by more than 10 percent in the first quarter of 2020, reflecting a 141 percent increase in digital sales, while physical-store sales rose less than 1 percent. While the barriers to sell online are low, competition from large retailers is also fierce. Software-as-a-service tools and platforms such as Amazon, Etsy, and Instagram make it relatively simple to reach customers and sell online. Even those digital options come at a cost to operating expenses, such as the expense of taking professional product photographs, as well as the costs of strong back-end order processing, seamless logistics for delivery and returns, and high standards of customer experience.

For many small businesses, adopting new technology will require significant changes. In manufacturing, for example, the scale of the necessary digital shift is massive. Between 40 and 50 percent of US manufacturing assets will require upgrading for digital readiness—and the transition may come sooner now that the COVID-19 crisis has disrupted the sector. Additionally, other tech investments, including digital training courses for workers and digital floor walks and performance-management tools to reduce in-person check-ins, may become necessary. Because smaller, lower-tier supplier businesses are the least technologically enabled today, much of the potential gains from digital adoption in the sector lies with them.

Searching for solutions

One thread that runs through all of the challenges is that smaller businesses seldom have the resources to make significant investments, which all solutions are likely to require. Even if business-model changes and new technologies offer small businesses an avenue toward survival in the post-COVID-19 world, many lack the capital, people, and access to technology that their larger counterparts enjoy. It will take innovation and participation from across the economy to help small businesses thrive.

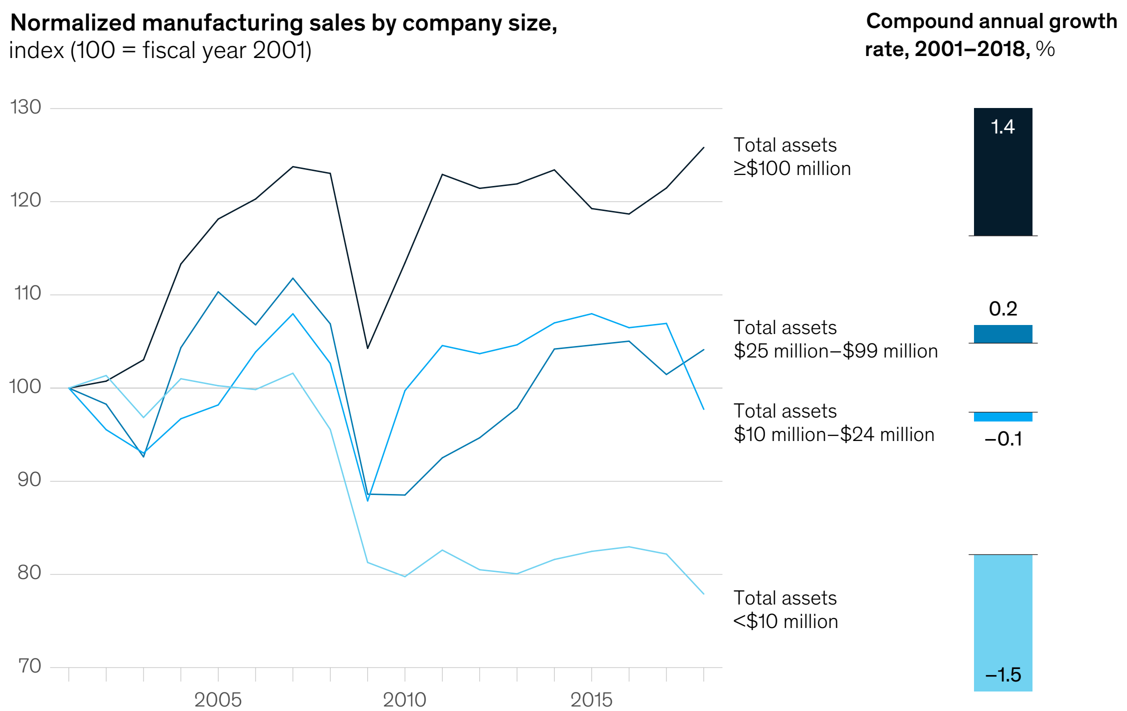
Here again, small businesses are challenged compared with their larger counterparts. Less able to invest in equipment and facility upgrades, small and medium-size manufacturing companies have about 40 percent lower productivity relative to large businesses. Operational modifications are costly—particularly when significant changes to a factory layout are required—and small businesses have limited cash on hand to invest in such changes. For those that are unable to fund necessary safety modifications immediately, operating at partial capacity, which carries its own cash-flow implications, may be the only viable option. Among small manufacturers, two decades of revenue growth at roughly one-fifth the pace of larger manufacturers make smaller businesses less attractive than larger ones to investors (Exhibit 3). Without capital inflow, small manufacturers will find it difficult to fund the upgrades needed to bring their production lines into the modern era of tech-enabled manufacturing.

Some market-based solutions already exist. For example, independent restaurants might digitize their businesses by using aggregators to increase their visibility, reach potential diners, and outsource their delivery. Factories might use tech-enabled "digital twins" to simulate factory operations under changing operating conditions. Upskilling workers via digital curriculums to give them the capacity to flex into more roles can also help mitigate risk. New innovations could go even further to help small manufacturers build out their digital lean tools or to help retailers digitize their call centers. Aggregators, for example, often charge a commission of up to 30 percent for independent restaurants, while some national chains have been able to negotiate a much lower commission of 5 to 7 percent.

Beyond small businesses' ingenuity to adapt to newer business models, they may find support elsewhere. Large companies can play a significant role in supporting small suppliers, customers,

Exhibit 3

Larger manufacturing companies have outperformed smaller ones.



Note: Real data adjusted for inflation using FRED Producer Price Index for manufacturing.
Source: US Bureau of Economic Analysis; US Census Bureau; McKinsey Global Institute analysis

and service providers. Large tech companies might, for example, offer free online-advertising credit. Aggregators might help by offering additional onboarding support or spotlighting small, independent restaurants on their platforms. Large manufacturing businesses may find that they are well positioned to provide demand guarantees to smaller companies, assist in technology and productivity diffusion, and deliver capital financing. Large companies often depend on small businesses as lower-tier suppliers, so financial fragility constitutes a longer-term supply-chain risk for large manufacturers. Bringing US small businesses into the digital age would be valuable to all parties, as it would improve efficiency and strengthen the domestic supplier base.

There may also be a role for public administrators. Some cities, such as Boston and Detroit, are already identifying business and financial resources for small businesses online and facilitating collective-buying arrangements for personal protective equipment. Regulators may also play a role in ensuring fair business practices and guarding against predatory pricing and other moves that threaten the market share of small and independent retailers. Some combination of public and private aid may also be necessary for small restaurants, especially offering technical and financial support they'll need to compete with larger ones that can build contactless solutions at scale.

In manufacturing, regulators might also play a role in ensuring that US small businesses have access to international markets, both as a source of demand and a way to reduce costs through imports. At the end of May 2020, two-fifths of respondents to our global Manufacturing and Supply Chain Pulse Survey believed that manufacturing in Asia will recover within two to three months. Ensuring that smaller companies have access to those markets, particularly in a regions that are ahead on the path to recovery, can benefit smaller manufacturers with a limited domestic market.

The survival of US small businesses across the economy will require new business models and technology solutions that few have the resources to finance. The COVID-19 crisis has exposed financial frailties that have built over time, and the next normal could impose additional burdens. Adapting to such challenges will require that small businesses find new business and operating models and accelerate the adoption of new technologies. But those solutions will not be easy and will require an economy-wide effort to provide financing, restore demand, and improve small businesses' capability and resilience.

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