Brexit's Impact on Business

The decision by British citizens to exit the European Union sent a shock wave throughout Europe and the world. It also created an atmosphere of palpable uncertainty for business. Is post-Brexit UK still a good place to do business? What are the longer-term prospects for multinational firms? The following article should help business leaders navigate through some of the implications of Brexit and how to respond.

After an initial surge, the British economy has now started to feel the Brexit bite

When the second largest economy in Europe voted on 23 June 2016 by 51.9% in favour to leave the European Union (EU), it sent a shock wave throughout the United Kingdom (UK), Europe and the world. Most economists had predicted a severe economic downturn. Yet, in the immediate aftermath of the vote, the British economy performed better than expected, boosted by strong consumer spending and the Bank of England's decision to lower the cost of credit.

By the time the official EU withdrawal process was triggered by Prime Minister Theresa May on 23 March 2017, however, the British economy was starting to feel the Brexit bite: GDP growth fell to 0.3% in the first quarter of 2017 - more than half the previous year - the trade deficit widened, and inflation was on the rise. The UK's ability to sustain one of the highest growth rates and lowest unemployment rates among Europe's mature economies appeared under threat.

Well aware of the risk of prolonged Brexit uncertainty, the UK government has been performing a belly dance with business since the historical vote. For instance, a carefully crafted "Welcome to Great Britain and Northern Ireland" communication campaign has positioning the country on the forefront of "game changing" technology. Moreover, the government has pledged to lower its corporate tax rate from 20% to 18% by 2020 and reduce the budget deficit from 5% to 3%. However, these signals have not been sufficient to stem the recent economic dip.

What are the real longer-term prospects for multinational firms based in the UK? How can these prospects best be assessed? The answer depends first on the rationale for investment.

The overall rationale for investment in the UK is now less attractive than it was before the vote for Brexit

There are typically five main drivers that influence corporate investment decisions:

1. Accessing a market
2. Participating in a global or regional value chain
3. Innovating through accessing relevant technology, skills, know how, and brands
4. Lowering production costs
5. Accessing natural resources and raw materials

As in the case of many other advanced industrialised countries, firms have primarily invested in the UK over the last century for the first three reasons: market size, trade, and innovation. Lower production costs and accessing raw materials are typically investment rationales associated with countries in earlier stages of development.

As long as the UK remains a member of the European Union, firms maintain access to Europe's largest English speaking country and a market of 510 million people supported by free trade agreement with the EU.

But what happens once the UK has left the EU? Unless the UK government is particularly skillful in its negotiation, the directly accessible market for UK based firms will be reduced from 510 million to 65 million. The Brexit process will require a new trade deal with Europe (which accounts for half of the UK's exports) and this is unlikely to be achieved within the 2 year limit. Trade negotiations will need to address tariffs, customs procedures, and a plethora of environmental, health and safety standards.

Accessing all the right skills could be another potential challenge. Although they will continue to have access to talent from Britain's leading universities, without free movement of labour – the main sticking point for pro-Brexit voters – firms will face a more restricted access to the best brains in Europe.

Confronted with a diminished market size, an uncertain trade and investment regime, and more restricted access to talent, the future outlook for investment in the UK appears less bright.

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When considering the investment rationale to access relevant technology, skills, know how, and brands, each sector has its own attraction points. The United Kingdom has developed longstanding capabilities and know-how in sectors such as financial services and pharmaceuticals. The relative strength of these sectors has been further reinforced by easy access to the European market and the ability to attract the best brains in Europe. Let us consider the cases of these two sectors in turn.

The UK's financial services industry – including retail banking, investment banking, corporate law, accounting and related consulting services – is the uncontested leader in Europe and accounts for approximately 12% of the country's GDP. However, there is now a risk that the City could lose its "passport" right to sell its services to continental Europe, including selling euro denominated products or providing legal advice on a merger between two companies.

According to one estimate, up to 50% of business with Europe, or 20 billion euros in revenue, could be at risk[1]. The reality is likely to be something in between. However, many financial firms are not waiting to find out. Companies such as Morgan Stanley and Goldman Sachs have already begun to move part of their operations to other cities in Europe, such as Dublin or Frankfurt.

Pharmaceuticals and life sciences, including medical devices, is another important sector for the UK. An estimated 10% of global pharmaceutical R&D is performed in UK, third in the world after USA and Japan[2]. Yet this sector is also highly dependent on EU legislation and could be disrupted by Brexit in a number of ways[3]. First, access to the European pool of pharmaceutical researchers and EU funding for R&D research is likely to be more limited. The cost of clinical trials should rise relative to other European countries if the UK is not included in the new EU Clinical Trials Regulation that facilitates the transfer of clinical trail results across Europe. New medical devices produced in the UK will likely face a lengthier validation process to meet the European Medical Devices Directive standards. Even the geographical enforceability of patents registered in the UK could become questionable in European jurisdictions. Pharmaceutical and life science companies that have invested in the UK for R&D and market access to Europe could thus face a host of challenges.

Firms will need to take proactive measures to hedge their Brexit bets

Across different sectors, Brexit raises the level of uncertainty and the cost of doing business in the UK. All firms, in particular those with significant UK investment, cannot afford to just "wait and see" what will happen. So what to do? When navigating through Brexit, companies should take a proactive approach to sounding the waters before taking action. Following these five steps should help: Map & assess impact, develop scenarios, model, revise and decide (see figure below)

Navigating through Brexit waters

- Confirm business rationale for UK presence
- Identify all areas of industry impacted (e.g. funding, skills, certification, trade etc)
- Map all linkages between industry areas impacted & current business
- First estimate of impact on business

- Develop Brexit scenarios and their implications for the sector concerned
- Develop business decision scenarios in response to Brexit scenarios
- Detailed sizing of the impact for each scenario / model

- Design model linking business decisions with impact according to each Brexit scenario
- Impact is adjusted in real time according to each decision

- Update the scenarios and model based on significant new evolutions and data (e.g. Theresa May's hard Brexit speech in Jan 2017 or triggering article 50 in March)

- Leverage model results through interactive management sessions to make business decisions on current / future UK investment)

Source: Whiteshield Partners

1.Oliver Wyman at http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/oct/OW%20report_Brexit%20impact%20on%20Uk-based%20FS.pdf
2.The Economist Intelligence Unit, June 2014
3.See excellent study by E&Y on the Brexit implications for this sector: https://www.pwc.nl/en/brexit/documents/pwc-brexit-monitor-pharma-life-sciences.pdf

It is order to make sound decisions you should model Brexit's impact on your business, taking into account all the different ways in which your sector and firm are impacted, the likelihood of different Brexit scenarios taking place and the sensitivity to your business decisions on the bottom line. The work should be done with the active participation of the management team, including representatives from both the UK and continental Europe.

Don't wait to take action

Sticking your head in the sand of Brexit UK is gamble not worth taking. The risks are too high. While there are still many uncertainties regarding the exact shape that Brexit will take, there are also a number of parameters that are clear: freedom of trade with Europe, access to skills, and sector-specific regulations are all likely to become more complex, raising the cost of doing business. The question is to what degree. Firms across sectors should assess the exact consequences for their businesses and make decisions accordingly. As for the UK government, it rapidly needs to articulate a convincing value proposition to firms that compensates for the consequences of Brexit - or face an inexorable decline in investment in the UK.