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Brexit's impact on the horizon

What it might mean for CPG companies

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Introduction: A momentous day approaches for the UK

A momentous day in the history of the United Kingdom (UK) is fast approaching: March 29, 2019. On this date, the UK will most likely leave the European Union (EU) after being a member state for 46 years. Though the UK voted to exit the EU in June 2016 when nearly 52 percent of the participating electorate voted in favor of separation, many companies have not been planning for Brexit—due in large part to the uncertainties surrounding it. Nine months after the referendum, the UK government triggered Article 50, effectively starting a two-year period of negotiations to agree to the terms of the UK's exit from the EU. Approximately one year out from the exit date, there are a myriad of unanswered questions on exactly how Brexit will work, leaving many companies in an awkward position in preparing for a post-Brexit environment.

Virtually all companies will be affected in one way or another. Overall, it's likely that the implications will vary based on a company's individual situation. To be better prepared for the new and yet-to-be-defined agreements, consumer products (CP) companies could benefit from developing strategies using scenario planning to respond to the varied policies that may ensue. This discussion will focus on what Brexit may mean for CP companies, outlining potential implications for consideration.

The views expressed in this discussion are based on both primary and secondary research. Primary research consisted of interviews with Deloitte subject matter experts across the US, UK, and EU member firms who work on varied aspects of Brexit. In addition, an extensive literature review on the topic, including prior Deloitte publications, was conducted.

The promise and perils of participating in the EU

The UK entered the European Economic Community (EEC), which effectively became the EU, in January 1973. The UK's participation in the EU has long been a source of debate in the UK—before joining, while being a member, and now, post referendum. The controversy centers around significant (and sometimes emotionally charged) issues which have been used as justifications for joining and leaving the EU. The following briefly summarizes the top issues that are also factors in identifying possible implications for CP companies:

Economics and trade

It was anticipated that joining the EEC would be a boost to the UK economy. In the years between 1958 and 1973, the per capita GDP of countries closest in size to the UK—France, West Germany, and Italy—grew by 95 percent, whereas per capita GDP in the UK only grew by 50 percent. After joining the EEC, the UK's economy began catching up. Over the last four decades, the UK's GDP per person has grown faster than in France, Germany, and Italy.[1] One important element fueling this growth was free trade between the UK and other EU countries, providing unlimited access to new markets and consumers.

However, what may have worked in the 80's and 90's has not been as successful in recent years. The EU has not been able to address the economic problems that began emerging in Europe after the global recession of 2009. These issues include the value of the euro and high unemployment in Southern Europe.

While the global recession had a detrimental impact on most world economies, its effects were found to be more severe in countries like Spain and Greece that had adopted the euro.[2] The unemployment rate shot up to 20 percent in these countries, triggering a debt crisis. Almost a decade after the 2008 recession, the unemployment rates in these countries still hover around 20 percent. Some economists believe that the euro played a major role and that the UK was fortunate not to have opted for a common currency.

Further, an argument in favor of Brexit was that the UK has not been free to implement its own economic remedies while being a part of the EU.[3] Currently, though, the economic outlook for the EU is forecasted to be strong, with economies in the euro area and EU both growing by 2.4 percent in 2017, their fastest in the last decade. It's estimated that this robust performance will continue at a rate of 2.3 and 2.0 percent for 2018 and 2019, respectively.[4]

Sovereignty and immigration

Joining the EEC was seen as a way to protect the UK's sovereignty by solidifying its economy, which by all accounts happened. Further, in return for agreeing to abide by EU rules, the UK had a seat at the negotiating table, and its voice was amplified on the world stage.[5]

In recent years though, concerns that the EU would take away control from individual member states has emerged. The recent immigration crisis was one trigger that fueled this concern. EU treats nationality as a matter of cultural right and does not encourage member states to make independent decisions on immigration policies.[6] While EU leaders believe that aiding the refugees was a moral obligation, some UK leaders view immigration as a national issue affecting the internal life of the country. They felt that EU immigrants were hired for jobs that could have been filled by UK nationals and that they place an unfair burden on public services provided to those living in the UK.

EU regulations and their associated costs

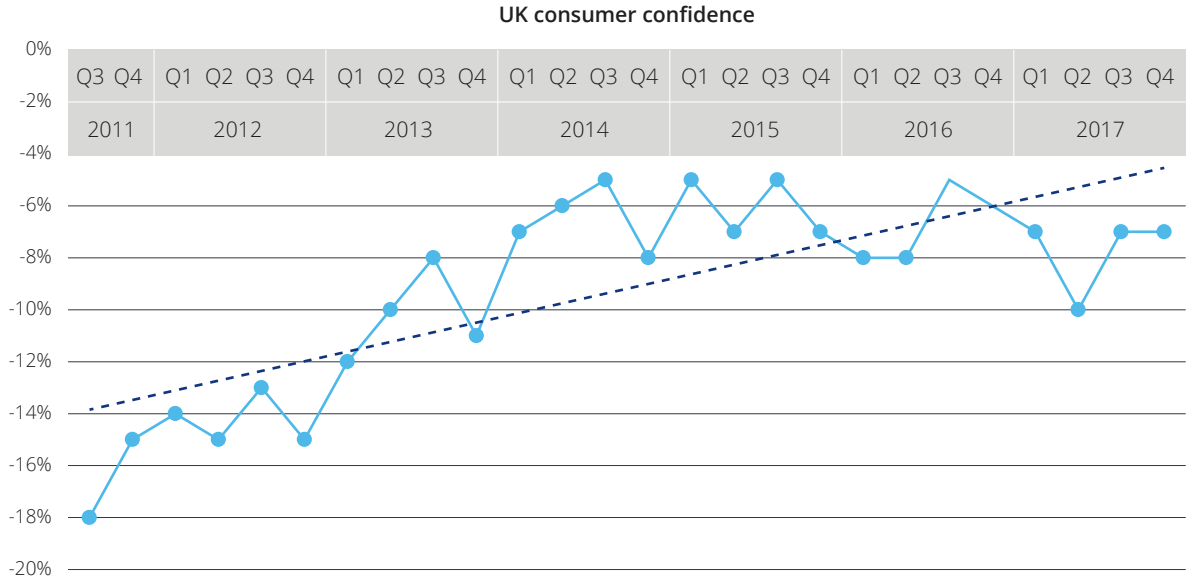
Those in favor of Brexit believe the cost associated with EU regulations are a burden to the UK economy. Although there isn't consensus on the actual amount, some estimates suggest that participation in the EU costs $880 million every week (equivalent to 600 million pound sterling).[7] Some believe that benefits from streamlined and aligned regulations outweigh the costs, while others argue that the single European market has provided a competitive environment that has propelled UK firms toward greater innovation, improving the quality of products and services while opening up new markets for them.[8]

Brexit's potential impact on the UK economy remains unclear

An analysis of economic indicators since the Brexit vote suggests both consumers and businesses have yet to feel material impacts, even though shifts have occurred in consumer confidence and retail sales. It's not clear what these foreshadow for the UK economy, but companies would likely benefit from being prepared for any eventuality. Consumer confidence in the UK, as measured by The Deloitte Consumer Tracker,[9] continues to be in negative territory since 2011 despite positive and negative fluctuations.[10] In the build-up to the referendum, consumer confidence stalled, remaining at a consistent minus eight percent in Q2 2016. Post referendum, though still in negative territory, confidence grew significantly to minus five percent, before a sharp decline to minus ten percent in Q2 2017. But through Q4 2017, confidence has seen a recovery and was one percentage point higher than after the referendum at minus seven percent.[11] Inflation measured by the Consumer Price Index fell for the first time in 6 months to 3 percent from a 5-year high of 3.1 percent in November 2017. Some believe that inflation had risen as an effect of the falling sterling since the Brexit vote. However, some moderation in the rate is expected as the effects of the fall in sterling begin to move out of the system.[12]

The Brexit vote had little near-term impact on retail sales, which remained buoyant following the referendum. The retail sales have only marginally improved—a 1.6 percent YOY increase in January 2018 over early 2017—and the view for the rest of 2018 is forecasted to be subdued.[13]

Figure 1. Net percentage of consumers who said their level of confidence has improved in the past three months



Source: Deloitte Consumer Tracker Q4 2017

The impact of Brexit on CP companies: A complex issue

Negotiating the terms of Brexit is a highly complex process that is continually evolving and changing as March 2019 approaches. For CP companies, there are implications related to a calculus of interrelated factors, including:

- The terms of exit and any transitionary arrangements
- The nature of the ongoing relationship model between the EU and the UK (sometimes referred to as "hard" or "soft" Brexit)
- Company location—inside or outside the UK
- Market access and both tariff and non-tariff restrictions
- Supply chain
- Talent
- Product labelling laws

Brexit models: "Hard" or "soft"

The finer details of the Brexit negotiations are dependent upon the actual Brexit model agreed upon between the EU and UK. There is not an agreed definition of either "hard" or "soft" Brexit, but they are commonly taken to mean:

A **"hard"** Brexit: Under this model, Britain would give up its membership of the EU single market and no longer be bound by EU trade statutes. Trade with EU member nations would either follow World Trade Organization (WTO) rules or be governed by the terms of a free trade agreement between the UK and the EU. The UK would likely resume full control over its own immigration system and could treat immigrants from the EU as it would immigrants from any other country. Under this scenario, highly disruptive changes would be implemented, perhaps within a short period of time.

A **"soft"** Brexit: This is interpreted as any number of possible arrangements that might be negotiated with the EU representing anything less than a full withdrawal. In a "soft" scenario, the UK might continue to be a part of the Customs Union of the EU, following the EU rules while not being a part of the EU—this would not qualify as Brexit in a strict sense. This potentially implies the UK would likely maintain full compliance on goods and services imported and exported with the EU single market. Going forward, this would still likely require considerable tracking of goods and services, adding complexity and costs to the bottom line.

Market access and tariffs

Over time, the EU market has played an important role in the growth and development of the UK's export market: the EU accounts for approximately half of all UK exports of goods and 40 percent of total exported UK services.[14] While part of the EU, the UK enjoys the free movement of goods between the UK and EU without paying any duties or tariffs; access for service providers is considerably smoothed by the removal of many (but not all) non-tariff barriers. In addition, there are simplified procedures for trade with EU member nations. Once Brexit is implemented, this will change. But its exact nature will be dependent on the nature of the ongoing trade relationships as described.

A "hard" Brexit scenario, for example, could result in the imposition of an elaborate set of tariffs and trade barriers, potentially resulting in increased manufacturing costs that may result in a rise in the price of finished goods, which either CP companies or consumers would likely absorb. A "soft" Brexit scenario could prove less costly. Either scenario, however, will likely result in increased complexity and costs of doing business, which may ultimately impact the bottom line.

Company headquarters—inside or outside the UK

The impact of Brexit on CP companies will vary based on the extent of a company's exposure and involvement with the UK. While companies fall on a wide spectrum of exposure to the UK, companies headquartered in the UK are likely to be impacted to a larger extent compared to global companies headquartered outside the UK. The impact will be in terms of market access, non-tariff barriers and tariffs relating to the sourcing of raw materials, the operations, the market for end products, and ultimately financial performance.

For the UK-based companies sourcing local materials for domestic consumption, Brexit may have little impact.[15] In fact, there could be an opportunity for these CP manufacturers to first aggressively increase their penetration in the market and then drive for an increase in market share relative to imported goods. However, for those CP companies that operate with a more complex supply chain across borders, it's a different story.[16]

Supply chain considerations

The impact of Brexit on supply chains is another major cause of concern for many CP companies that do business across borders. Again, the extent of impact on supply chains and the movement of raw materials and finished goods will depend to a great extent on the Brexit model agreed upon. For those CP companies with operations limited to the UK, the scale of the impact will likely be low, while for companies who rely on a multi-country supply chain, it will be more complex. For example:

- New tariffs will add more costs to the process of moving goods across borders, impacting profitability
- IT systems will need to be upgraded to document import/export declarations
- All of this will result in longer times for goods to move across the border and could result in the need for companies to warehouse products in new facilities, resulting in more complexity and costs
- Perishable goods, in particular, will suffer due to the increased time needed to cross borders

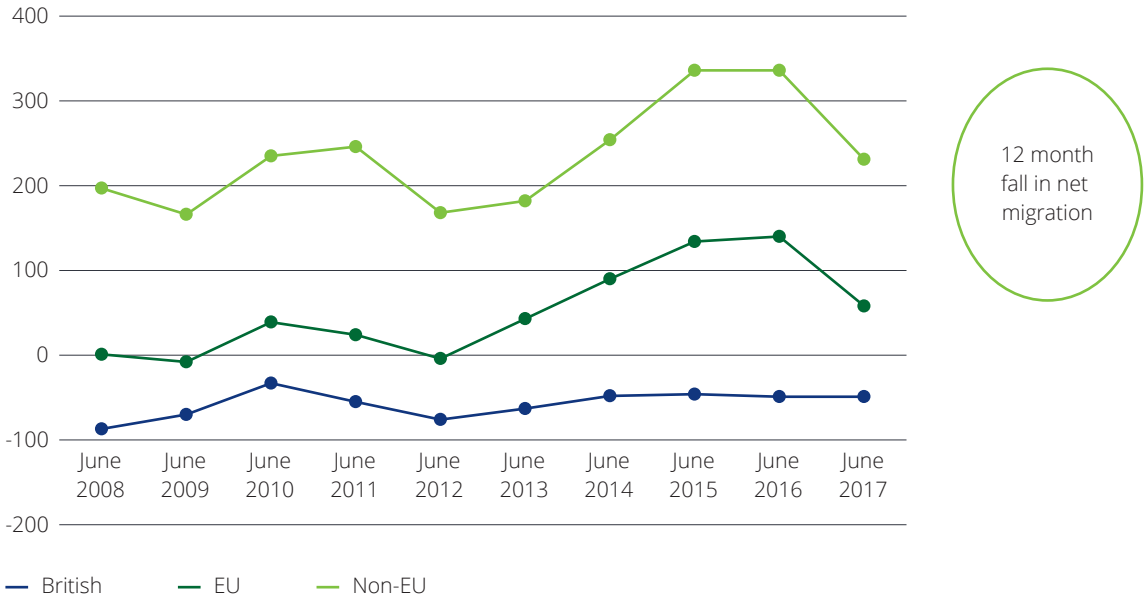
These changes will likely have the greatest impact on CP companies with more elaborate supply chains, rendering current processes inefficient and costlier, and increasing the timeframe for moving goods from the country of origin to the destination.

The impact on talent

When the details of Brexit are finalized, there will likely be considerable implications regarding access to talent across borders, regardless of the skill level involved. This has the potential to result in severe labor shortages, particularly among semi-skilled and unskilled laborers. For example, in a "hard" Brexit scenario in which EU immigration would likely be significantly curtailed, there are insufficient UK nationals to replenish the vacancies left by EU workers; further UK workers may be unwilling to accept labor-intensive jobs traditionally done by EU laborers.[17]

Not surprisingly, EU immigrants have understood that their fates hang in the balance pending decisions on immigration. As a result, fewer new EU workers are coming to the UK, and anecdotally some EU workers in the UK have chosen to return to their home countries. Even so, historical data on immigration between the UK and EU indicates more EU citizens are still coming into the UK rather than leaving, showing EU net migration is adding to the UK population. This helped fuel the anti-immigration sentiment that in part influenced the Brexit vote.

Figure 2. UK net migration by citizenship, years ending December 2007 to June 2017, thousands



Source: Long-Term International Migration (LTIM) estimates, ONS

If EU nationals wish to stay in the UK, there will likely be stringent requirements such as working on a visa and possibly demonstrating exclusivity of skills. For global companies, mobility of existing higher-skilled professionals from the UK to EU could involve the re-assessment of contracts, benefits, remuneration, etc. If the UK can no longer access the best talent, there's concern that the UK could lose its status on the world stage. For example, if finance or technology jobs are moved from London to neighboring countries, it may take a generation or more to bring them back.

Product labelling and safety

The EU standards for product labelling and safety are among the strictest in the world, requiring complete transparency for consumers. The EU could use these standards as a non-tariff restriction to market access. At present, since the UK and EU follow common standards, product labelling is perceived as a relatively easier issue to address. But it's unclear whether these standards will be maintained once Brexit is implemented. Relaxing the EU standards may represent potential cost savings for UK-based companies, although there likely will be costs associated with revising UK labelling even if it appears beneficial to do so.

Potential strategies to mitigate and prepare for Brexit implementation

With March 2019 in sight and still so much to be decided, CP companies could benefit from scenario planning in which they lay out the scenario of maximum change and identify ways to mitigate any negative impact while maximizing positive outcomes. The potential strategies can vary for each company and circumstance, making this a customized process. What follows is a summary of preliminary thoughts on the topics addressed in this discussion:

Brexit model: "Hard" or "soft" – To begin with, companies could benefit by preparing for a "hard" Brexit. This sets the stage for outlining potential outcomes on all other issues discussed in the following paragraphs.

Market access and tariffs – In any Brexit scenario, there likely will be an increase in the costs associated with the movement of goods between the UK and EU due to tariffs, which will either be passed on to consumers or negatively impact a company's profitability. CP companies could benefit by outlining in advance how these additional costs will be dealt with to help ensure that their goods remain competitive in the EU market. As an implication of Brexit, it may no longer be viable for certain companies to manufacture their products in the UK. It may be beneficial to produce products in the EU, or other countries, then sell them back to the UK.

Location of company headquarters – For large multinational CP companies, who face a number of regulatory issues across the world, Brexit could very well be treated as a "local" issue affecting a single market. Whereas UK-based companies with cross-border supply chains will likely face a much more complicated situation.

Supply chain – As noted, UK-based companies with a multi-country supply chain are likely to be impacted more than companies that have a simpler and UK-specific supply chain. Brexit is likely to make movement of goods through existing supply chains more complex, costly, slow, and difficult to execute.

To accommodate this, it may be necessary for companies to invest in surplus storage and warehouse spaces at multiple locations to counter for delays in the movement of goods. Companies that deal in the movement of perishable food items will likely be most affected, given their limited shelf life. Finally, the extent and complexity of the changes needed to IT systems to cope with the almost inevitable increase to administration once companies need to make import/export declarations for goods moving between the UK and the EU should not be underestimated.

Talent – CP companies in the UK that employ EU nationals in all types of positions from highly skilled workers to manual labors could benefit from continually assessing the impact Brexit will likely have on their employee populations. A first step could be to quantify the number of employees affected by potential changes to the UK's immigration laws. Since many EU nationals will likely be impacted, and some are already leaving the UK due to uncertainty about their positions, companies will likely need to plan for a scenario in which there's a depletion of both types of talent. A drain of crucial talent can impact the core functioning of a company. CP companies might consider the extent to which they are willing to sponsor visas or work permits for EU nationals in the UK.

To address the shortage of highly skilled professionals, companies might need to explore sourcing talent from countries outside of the EU or even relocating operational units outside of the UK. The depletion of lesser-skilled EU workers is a tougher challenge for companies to address since many UK workers are unlikely to want to work in such jobs. In this scenario, CP companies may want to consider applying for special status for these workers (where they qualify).

Product labelling and safety – UK-based CP companies will likely have to assess the benefits of continuing to adhere to EU standards for product labelling and safety. On one hand, since EU standards for product labelling and safety are among the strictest in the world, UK companies may want to continue to adhere to EU standards to help ensure continued access to EU markets. However, post Brexit, there could be a gradual dilution in standards for any number of reasons—from lowering product production costs to changes in marketing communications. CP companies could benefit from a cost-benefit analysis to assess the costs of making a change and the increased profits resulting from the change.

In closing, with roughly one year remaining until Brexit is implemented, there's ample time for CP companies to be more proactive in planning. The continued uncertainty CP companies face while waiting for specific policy decisions should not be an impediment to preparation. Through scenario planning, companies can be steps ahead in the planning process and in a stronger position than they otherwise would be on March 29, 2019.

Endnotes

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