# Brexit Monitor

pwc

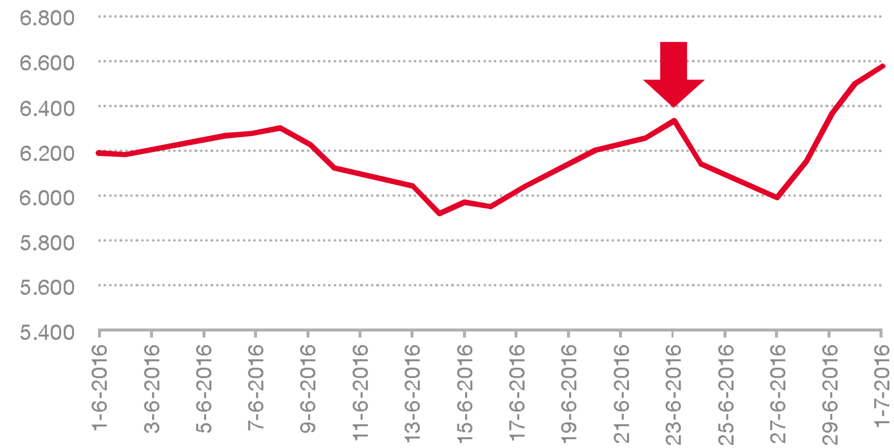
# After the shock

*The final impact of Brexit is yet unknown, but it will weigh on the economy, business activity and financial markets. The rebound of the financial markets may as such be premature. Once more and more specific economic indicators will be released, and provide insight in the impact of Brexit, volatility is likely to increase again. Whether this will again lead to severe market declines is hard to foresee, but not likely, as the greatest shock so far was the referendum outcome. This will not easily be surpassed by other news.*

### A 'dead cat bounce'?

After two relentless days of value declines on the global stock exchanges, share prices turned green again. The FTSE 100-index even surpassed its pre-Brexit level, as if nothing had happened in the two days following the 23rd of June. At least, measured in Sterling, as returns on UK shares in Euro were negative for the week after the referendum, due to a more persistent lower exchange rate. Apart from political bickering and high-level meetings of policy makers, not that much has indeed happened. However, the impact of the referendum result is not reflected yet in hard data, such as trade figures, confidence indicators and changes in investments, but this will change in the months to come. When this happens, markets will respond again, and volatility is likely to increase.

FTSE 100-index, 1 June 2016 to 1 July 2016

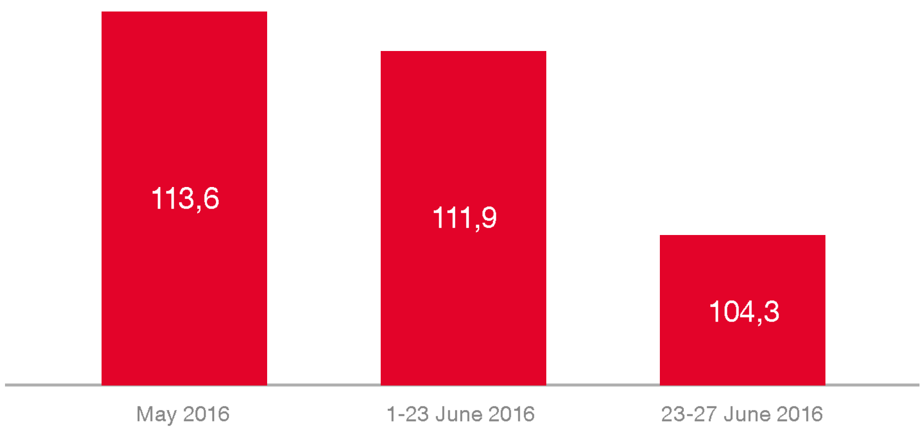



Source: FactSet.

There are preliminary, anecdotal indications that economic growth in especially the UK will be impacted by a decline in investment. Companies like Virgin, Siemens, Ryanair and Vattenfall have, in combination with lesser known names such as Encocam and DueDil announced to cancel investments in the UK, to put them on hold, or to direct them to other countries (on the European continent). Uncertainty about what is to come, will make businesses in general reconsider investments, also investment in other companies in the form of mergers or capital contributions, and will lead to delays at the very least. This will have a negative impact on economic growth as long as uncertainty persists.

Sentiment in Great Britain is also expected to take a hit, and via consumer expenditure, the rest of the economy too. In a Bloomberg survey held after the UK voted 'out', almost three quarters of the respondents said they expect the economy will slip into a recession. Of the 25 economists consulted by Bloomberg about the timing of a recession, about half indicated this will take place this year, while the remainder expects the recession to start next year. The YouGov/CEBR Consumer Confidence Index slumped with 6,8% in the period June 23-27 and compared with the first three weeks of June (see graph underneath). This is an early indicator of the impact on sentiment of Brexit, and other indicators will have to confirm whether general sentiment indeed took a hit of this magnitude.

YouGov/CEBR Consumer Confidence Index, May and June 2016




Source: YouGov.

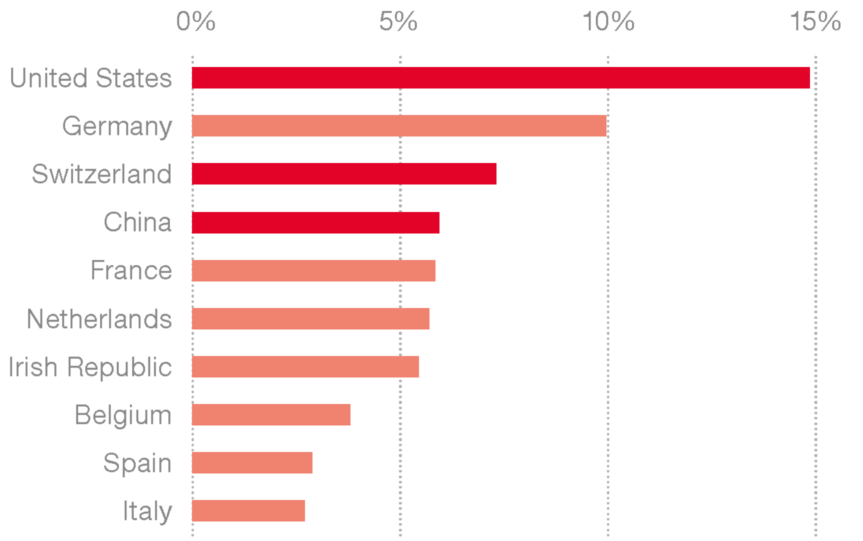
### ***Trade channels***

Trade relations between the UK and the EU will strongly determine the impact Brexit will have on countries, sectors and ultimately companies. Future demand and supply of goods will not only depend on exchange rates or the economic situation on either side, but also the format or nature of trade relations after the UK has left the EU (see our scenarios underneath). The latter is and will be an uncertainty, at the very least during the coming months. Decisions about the (re)location of production will on the longer term determine how trade relations will play out with respect to sectors and companies.

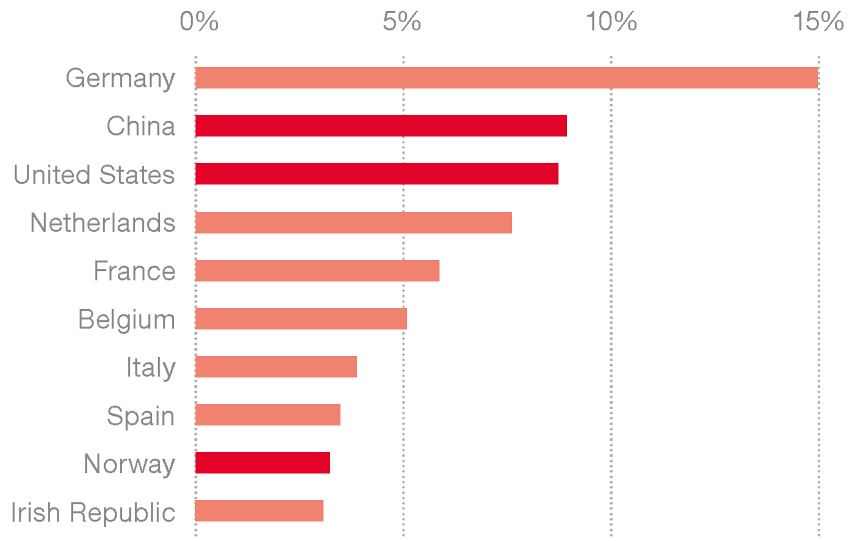
Among the top-10 trading partners of the UK in 2015, seven countries are part of the EU. In the same year, about 44% of UK export was directed to EU-member states, while approximately 53% of total imports originated in EU-countries. Germany and the Netherlands export significantly more to the UK than is imported from the country. Depending on the price elasticity of the export products, these countries might witness a deterioration of their terms of trade with the UK, due to an increase of the value of the Euro versus Sterling. Dutch flower exporters already reported a decline in demand from the UK for relatively expensive flowers and plants.

If we look at the most important product categories traded, motor vehicles stand-out as the commodity with the highest share of trade between the UK and EU. The UK is not only an important producer of motor vehicles and parts, but also an important sales market for vehicles (the second in Europe behind Germany). The EU is the main export market for the UK, accounting for 57.5% of vehicle exports. Currently, no tariffs apply to the trade in motor vehicles between the UK and EU, but this could change depending on the trade agreement that will be closed after the UK has left the EU. Toyota, that exports nearly 90% of the

Top-10 export destinations of the UK (% of total export)




Top-10 import origins of the UK (% of total import)




Source: HM Revenue & Customs.

cars it manufactures in the UK, warned before the referendum that its car prices could rise with 10% if duties will be levied in the future.

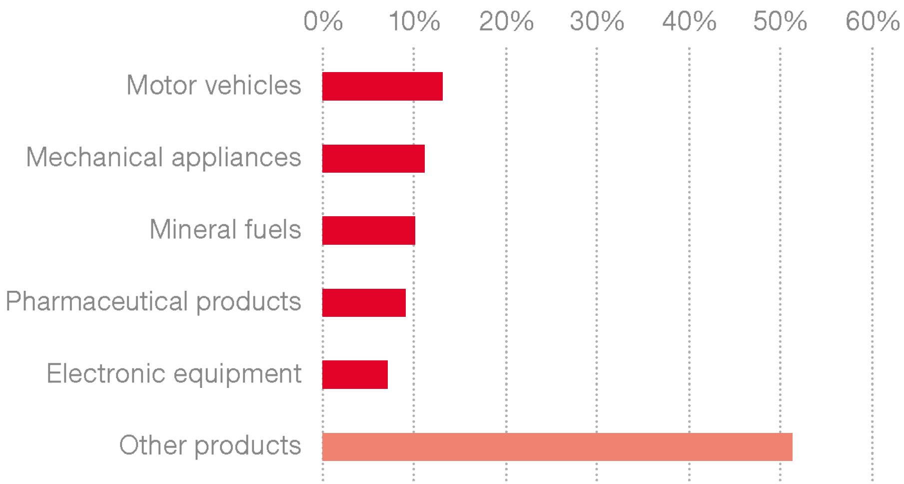
In the past decades companies have invested in the UK as a (production) platform from which the continental European markets could be accessed. Depending on the outcome of any future trade agreements, this position could lose attractiveness in comparison to locations in the EU, especially Eastern European countries. For some industrial companies, such as Airbus, which produces many components for aircraft in the UK, it is still unclear how Brexit will affect their pan-European supply lines.

The pharmaceutical industry in the UK may be impacted by a change in licencing procedures in order to be able to sell medicine in EU-member states. Pharmaceutical companies can get approval for medicine via the European Medicines Agency (EMA), after which the products can be marketed throughout the EU. Separate approvals by national regulatory bodies is then not required. If Britain leaves both the EU and the European Economic Area, it cannot use this centralised approval procedure via EMA, and will probably be confronted with more bothersome approval trajectories. On top of this, EMA is currently located in London and may very well move to an EU-member state once Brexit is a done deal.

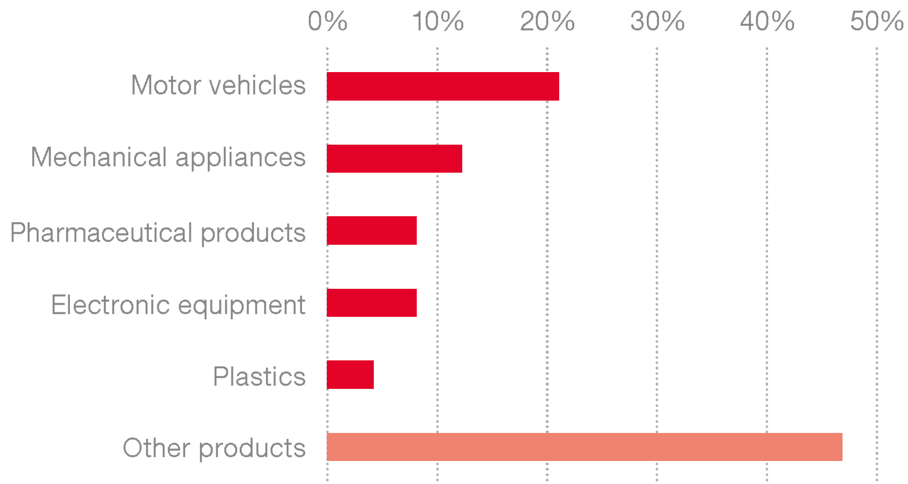
The UK is an important oil exporter, but a debate about the ownership of oil and gas reserves with Scotland may create uncertainty about this position. Scotland overwhelmingly voted in favour of staying in the EU and is not at all amused with the referendum outcome. It is now contemplating a new referendum on its own about Scottish independence, this in order to remain in the EU. Oil and gas exploration in the North Sea may get into choppy waters if Scotland becomes independent and makes a claim on fields.

In upcoming issues of the Brexit Monitor we will pay more attention to the effects Brexit have on sectors and companies.

UK export to the EU: top-5 commodities, April 2016




UK import from the EU: top-5 commodities, April 2016




Source: HM Revenue & Customs, UK Overseas Trade Statistics April 2016.

## *What is next?*

For the coming months the following stages can be distinguished:

- The UK government has a democratic duty to give effect to the decision to leave. It is therefore very unlikely the referendum result will be disregarded.
- The mechanism for an exit is Article 50 of the Treaty of European Union. The key steps in the process are:
  - The UK notifies the European Council of its intention to withdraw. This is unlikely to happened before a new prime minister has been chosen (currently scheduled for the beginning of September).
  - The European Council agrees by consensus the guidelines for the European Commission to negotiate the withdrawal.
  - Final agreement needs to be agreed, by both the EU members (qualified majority of 20 out 27 members or 65% of the population), and the UK.
  - EU parliament needs to approve the deal with a simple majority .
  - Under Article 50, the withdrawing country has two years to complete negotiations and any extension to this will require unanimous consent from EU members.
- As well as negotiating a withdrawal, the UK will need to agree post-exit arrangements with the EU. It is unclear from the Article 50 wording whether these negotiations are included in the two year period.
- During this period a number of other factors could also play out: possible retaliations from the EU in the form of more onerous terms being imposed (as a deterrent for other EU sceptic countries); further votes and/or calls for renegotiations.

> Trade relations between the UK and the EU will strongly determine the impact Brexit will have on countries, sectors and ultimately companies.

## *Brexit scenarios*

We have identified four scenarios that could occur and that capture the different degrees of integration that the UK may have with the EU in the future. The scenarios could take different specific forms, but those considered in most of the existing evidence have broadly gathered around one of the following scenarios.

Each scenario offers or requires a strategic response in order to protect or grow the value drivers in a business.

Our approach to planning is centred around a framework which considers the impact of each scenario on the value drivers and considers the nature of the impact in terms of time, value and probability.

Based on this framework organisations can then start to identify critical paths and also position themselves to respond quickly to any scenario as it emerges rather than react after it has emerged.

| | EEA member (Norwegian option) | Free trade agreement (FTA) | Bilateral agreement | No access agreement (WTO/MFN) |
|---|---|---|---|---|
| Situation | The UK remains part of the EEA and keeps the four freedoms of labour, capital, goods and services. FS passporting applies | UK negotiates a Free Trade Agreement (FTA) with the EU | The UK enters into a bilateral integration treaty with the EU | The UK does not establish any new trade agreements with the EU |
| Potential implications | UK will need to make a substantial contribution to the EU budget and comply with EU social, employment and product regulation | Tariff-free trade between the UK and the EU in goods (but not services). UK grandfathers all existing FTAs between the EU and third-party countries | UK will have access to some areas of the Single Market, at the cost of adopting the relevant EU regulations | Only WTO terms are still applied – UK goods and services would be treated in the same way as US ones in the EU |

***These scenarios are the most likely, however a number of variations could be negotiated***

## *Potential risks and business actions*

Our Brexit Decision Framework translates the risks arising from a UK exit from the EU into tangible business actions. How does your organisation relate to the UK and via which channels may your business be impacted? Where can opportunities arise? Based on this, you may plan actions in response to a potential events.

### Importance of UK for business

**How important is the UK to your organisation?**
**In terms of:**

- Strategically: does your organisation use the UK as a gateway to the broader region?
- Revenue: where are your organisation's largest consumer markets in Europe?
- Operationally: what is the manufacturing / supply chain footprint in Europe?

***Identify the importance of the UK to your businerss. Four options:***

| | | | |
|---|---|---|---|
| European business with international exposure | European business based in the UK | Third country business based in the UK | Third country business based in the Europe |

### Scenarios and channels

**Through which channels would Brexit feed through into?**

- What Brexit scenario resonates with you?
- How would each impact channel evolve within this scenario?

***Identify which Exit scenario to apply: FTA, EEA (Norway), Bilateral (Switzerland) or WTO***

| | | | | | | |
|---|---|---|---|---|---|---|
| Trade & supply chains | Regulation | FDI | Labour market | Tax and fiscal impacts | Un-certainty | Sector-spcific |

### Business impacts

**How would these impact your organisation's business model and value chain?**

- What is the potential impact on each aspect of your organisation's organisation?
- What are the risks? And are there any opportunities?

| | | | | | | |
|---|---|---|---|---|---|---|
| **Revenue model** (market access, marketing, pricing) | **Supply chain** (logistics, manufacturing, procurement) | **Finance/ treasury** (corporate structure, financing, exchange rate risks, investor relations) | **Talent model** HR, Mobility, Reward) | **Legal and regulatory** (compliance, product specifications, health a & safety) | **Technology** (IT systems, Digital and Information, Data Protection, out-sourcing contracts) | **Tax** (Direct taxes, Indirect taxes, Withholding taxes, Tax structure and strategy) |

### Blueprint for action

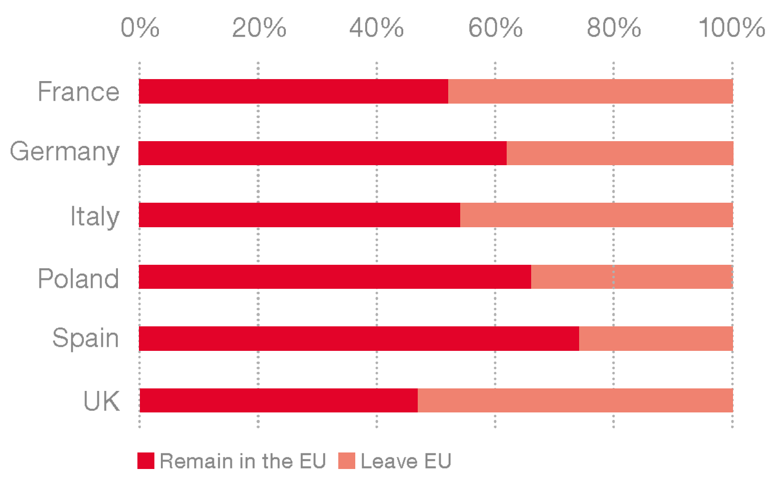
***How can your organisation proactively respond to these anticipated impacts?***

What strategic choices are available? Which one should I pick? How do I execute this within my organisation?

## ***Lessons to be learned, work to be done***

The unification of Europe is meant to remove ancient divides among the people of the region, and by doing so, to remove barriers, inefficiencies and the chances of conflict. As the memory of wars in Europe fade, it is easily forgotten what unification brought Europe. And what is might bring in the future, as a unified Europe is better able to compete with other (unified) regions of a similar size. An important lesson of the referendum is that the differences in voting behaviour are unlikely to be unique for the UK. Divisions may very well surface in similar conditions in the rest, or should we say 'remainder' of the EU too.

Would you vote for your own country to leave the EU?




Source: Bertelsmann.

Shortly after the UK referendum end-result was announced, calls for an identical referendum in the Netherlands, France and the Czech Republic were made. These appeals are a reflection on the other side of the North Sea of the forces behind Brexit. At the beginning of June, 38% of Dutch surveyed by TNS NIPO were in favour of a referendum concerning EU membership, but 33% would vote for 'Nexit', while 49% would vote for 'remain'. In the week of the UK referendum, 41% of Dutch surveyed by Ipsos were in favour of a referendum concerning EU membership. If a referendum about EU-membership takes place in the Netherlands, 66% would vote for 'remain' according to the same survey. According to a Bertelsmann survey held in April 2016 (see graph underneath), support for EU-membership is still strong in countries like Germany, Spain and Poland, but less so in France and Italy. The same survey indicated a majority for 'leave' in the UK.

A referendum in Italy in October this year, and general elections in the Netherlands, France and Germany next year, may show some popular repercussions from Brexit. If parties that strive for an exit from the EU, gain much influence in advance of upcoming elections, we can expect unrest and uncertainty to surface again. European politicians now seem to be aware of this, but will they be able to sufficiently address the divergent concerns and ambitions of the electorate? Brexit demonstrated that many people are not easily convinced by what seems to be undeniable rational arguments.