

R&C Trendwatch

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Brexit from a retail and consumer perspective

Executive summary

- *Brexit will give rise to both challenges and opportunities for retail and consumer companies, depending on the extent to which they rely on access to Europe's single market for trade, labor and other inputs.*
- *In the two years following the implementation of Article 50, until negotiations are complete, the legal and trading arrangements governing consumer products and their supply chains will remain the same.*
- *Increased value-seeking among consumers will be good news for private label goods, affordable luxuries and discount retailers.*
- *Weaker sterling will boost UK export opportunities, while firms interested in expanding their footprint in the UK may see opportunities to buy assets at a lower price.*
- *Over the medium term, the pressures of weaker sterling could force companies to pass higher input costs along to the consumer.*
- *The uncertainty over what terms will govern future British trade relations, within and outside of the EU, means companies that have part of their supply chain in the UK should plan for different scenarios and prepare to engage governments to protect their interests.*
- *Retail and consumer goods companies should also prepare for potential changes in regulations governing consumer protection, data protection, product law, copyright/intellectual property and marketing.*
- *Retail and consumer goods companies may want to engage trade associations and other organizations to lobby governments.*

Introduction

The UK's historic vote on June 23 to leave the EU surprised many, both in Britain and mainland Europe. Businesses are coming to terms with the implications, especially given the uncertainty surrounding the exit process and how this will change the UK's relationship with the EU and its other trading partners. From a retail and consumer goods sector perspective, the implications are not clear cut. There will be both challenges and opportunities, depending on a company's structure and the extent to which it relies on access to Europe's single market for trade and labor. This report describes how the Brexit process is likely to evolve and how Brexit will affect four areas of concern for retail and consumer businesses: the economy, trade, tax, regulation and legislation, and people and organizational strategy.

The Brexit process

The UK government will trigger Article 50 of the Lisbon Treaty no later than the end of March 2017 to begin the formal process through which Britain will leave the EU. The Article 50 process requires the remaining 27 EU member states to agree on Britain's exit terms within two years. This negotiation period could be extended if all member states agree on the necessity for further negotiations. Britain does not have a vote on those terms.

EU Treaties cease to apply to the UK after two years even if an agreement on Brexit has not been reached. Prime Minister Teresa May is hoping, therefore, to initiate negotiations before Article 50 is invoked, but as yet this strategy has been met with resistance from Brussels. As far as business is concerned, apart from the immediate challenges surrounding the British economy and currency, there will be little material change to the trading and legal relationship with the EU in the two years following the implementation of Article 50, until negotiations are complete.

*This publication is produced in collaboration with **Eurasia Group** (www.eurasiagroup.net). Eurasia Group is a leading political risk research and consulting company.*

The UK economy

The economic uncertainty caused by Brexit means that consumer goods manufacturers and retailers in the UK will have to navigate an environment of more cautious spending, more value-seeking and increased deferral of non-essential purchases, especially big-ticket items. Even so, recent years have shown that there are distinct opportunities across certain segments in times of low economic growth. These include private label goods, affordable luxuries and products emphasizing convenience, value for money and a home alternative to a more expensive option such as food and beauty service product replacements. These might include high quality home brew coffee and home hair coloring, for example. In the retail sector, discounters are likely to continue to win market share as customers shop around for the best value available.

The post-Brexit drop in the value of sterling has mixed implications. Its immediate effect is to boost UK export opportunities by making British-made goods more affordable. The farming industry should experience a boost, before Article 50 negotiations are completed in the next couple of years, as the UK is a net exporter of food. In addition, UK retailers with a large international presence that report their earnings in sterling are likely to see a significant increase as the exchange rate works in their favor. Firms interested in expanding their footprint in the UK may also see economic uncertainty and the weaker pound as an opportunity to buy assets at a lower price.

The challenges posed by weaker sterling will play out in the medium term as companies are faced with higher prices for imported goods and global commodities. Higher energy costs in particular, will hit households and businesses alike, unless the government negotiates favorable energy markets terms for the EU or weighs in with subsidies.

And if sterling's weakness leads to persistently rising inflation, interest rates could be raised, making home owners and those in debt more cautious about their finances. The Economist Intelligence Unit estimates that by 2020 nominal retail sales in the UK could be 6% lower than under non-Brexit conditions.¹

Trade

While a weaker pound boosts British trade today, the future outlook is unclear as Britain's trade relations with the EU and the rest of the world are negotiated. The following table outlines four possible scenarios for the UK leaving the EU.

Table 1: Possible scenarios for the UK leaving the EU

	UK-EU Free trade agreement (FTA)	WTO	EEA membership (similar to Norway)	Bespoke bilateral deals (similar to Switzerland)
Preferential access to single market	Medium – UK would retain free trade in goods with the EU, but non-tariff barriers such as divergence in standards and regulations could emerge	None	High – EEA countries have access to the Single Market	Medium – the Swiss agreements cover trade in goods but not in services.
Influence over EU regulations	No	No	Some – no voting rights but limited formal engagement. Some autonomy in other areas	No
Application of EU regulations and directives	The UK would have to comply with EU regulations for any goods traded through the FTA	Technically no, but product exports to the EU would still need to meet EU product standards.	Yes, including social and labour law (Working Time Directive)	Technically no, but required in practice if domiciling in other territories (e.g. Swiss banks operation out of UK)
Contribution to EU budget	No	No	Yes, but smaller	Yes, but smaller
Independent immigration policy	Yes	Yes	No – all four freedoms retained	Some autonomy, but Switzerland cannot restrict EU immigration
Independent trade policy	Yes – UK may negotiate FTAs with other countries	Yes – UK may negotiate FTAs with other countries in financial services and other services	Yes – UK may negotiate free trade agreements (FTA) with other countries	Yes – UK may negotiate FTAs with other countries

Source: PwC and Eurasia Group analysis

¹ The Economist Intelligence Unit, Out and Down: Mapping the Impact of Brexit, 2016, p. 14, retrieved at: http://pages.eiu.com/rs/783-XMC-194/images/BrexitJune2016.pdf?mkt_tok=eyJpIjoiWmpVek1qZzVOREEoTlRBYsInQiOiJtUW1tMEUzUFlMNzZ4akk2cTU5bFhMalNXU1U5dDkkoT3Z5TDFXakorV09zKoRsQjM5THIPcSt4dU5GYJcL3F6NFlhbk9UdHhXQRuRk1rbXoiRoVmSXRJd2FqZic3RFBwTo9Fd3lpeXpNZGM9Ino%3D

At October's Conservative party conference, Prime Minister May hinted at her intentions to take the UK out of the Single Market. In putting a stop to the free movement of labor (unlimited EU immigration), the UK would have less favorable trade and business relations with the EU. May has vowed to negotiate "the right deal" for Britain in the form of a bilateral UK-EU deal, but what this means in practice is not yet clear. Critical to the UK economy overall will be negotiations on so-called 'passporting rights' that enable UK registered businesses to provide a range of financial services across the EU and the wider European Economic Area.

Leaving the Single market would affect retail and consumer goods businesses that have EU-wide supply chains relying on open borders for the free movement of goods. At the moment, there is no way of knowing what terms will govern future British-EU trade relations, so it would be wise to take a close look at supply chains and identify where they are likely to be most affected by Brexit.

Leaving the Single Market would likely lead to higher trade tariffs on at least some goods and some industries have been vocal in their concerns. In September, the trade association for UK carmakers backed a warning from Nissan's chief executive that higher tariffs in EU-UK trading relations could threaten Britain's vehicle manufacturing industry. Carlos Ghosn said that the UK government would have to provide compensation against higher export tariffs if it was to attract further investment from Nissan.

For retail and consumer goods businesses outside the EU, in Asia, Africa or North America, future trading relations with Britain are also uncertain given that they are currently determined by EU norms and regulations. The companies best placed to weather this uncertainty will be those with efficient and flexible supply chains. And because all trading relationships with Britain will be up for renegotiation, this will be an opportunity to lobby governments to achieve favorable terms.

Tax, regulation and legislation

May announced plans for a 'great repeal bill' that would go into force by the time the UK leaves the EU, repealing the 1972 European Communities Act which gives direct effect to EU law in the UK. The bill would also transpose all existing EU laws into domestic legislation, thus providing some certainty and continuity as far as regulation is concerned.

For retail and consumer goods companies this means that regulations governing consumer protection, data protection, product law, copyright/intellectual property and marketing will remain unchanged even after the UK leaves the EU until parliament chooses to amend or introduce new regulations. Regulatory uncertainty is unlikely to pose a challenge in the immediate term. Eventually, however, in some areas, British and EU regulations may diverge and, where this is the case, companies may face some costs in meeting two separate sets of standards.

VAT is another area where currently the rate set in the UK is derived from EU legislation. This means that in the future VAT rates will be more susceptible to the policy choices of different governments, creating a degree of uncertainty.

One of the big potential downsides of Brexit may be Britain's exclusion from the Digital Single Market (DSM). After leaving the EU, Britain will no longer have a say in which strategies to pursue in achieving the goal of a single market for digital transactions. The DSM aims to encourage e-commerce across borders by harmonizing regulations around selling online, increasing cross-border consumer protection and efficiencies around parcel delivery, reducing geo-blocking practices that hinder price transparency and increasing consumer choice.

The DSM also facilitates cross-border business to business transactions by innovating around ways for firms to provide services using online platforms. In addition, the DSM is in the process of legislating around 'big data' in order to

help European firms become more competitive, while protecting the rights of consumers. Though the UK is likely to reach some kind of agreement to enable it to participate in this market, the nature of the future relationship is uncertain and being outside the DSM may prove to be a disadvantage.

People

The UK government's commitment to reducing immigration of EU citizens to the UK could mean a reduction in the pool of available labor, particularly cheaper labor. Retailers and consumer goods manufacturers with a high dependence on minimum wage workers will likely feel the pinch and may have to offer other incentives to attract and retain low-cost workers. At the other end of the wage-scale, companies will have to consider bureaucratic costs like work visas when filling more senior company positions in the UK with talent from the rest of the EU. These challenges will play out over the medium to long term, as there are some indications that EU members already living, working and settled in the UK will be allowed to stay.

Organizational strategy

Companies with bases both in the UK and abroad will need to adopt strategies to balance the risks and opportunities related to Brexit, to ensure minimal disruption from the changes to the economy, trade, regulatory environment and labor market. The economy and trade will likely require more immediate attention over the next couple of years, while the regulatory environment and labor market dynamics are likely to play out in the longer term.

Each company's strategy will have to be tailored to that business's unique needs and potential opportunities. Risks may include weaker returns from UK sales as a result of economic impacts, persistent uncertainties surrounding imports and exports to and from the EU, a lack of clarity governing regulations in the long term, decreased access to shared European resources like the DSM, and a shortage of low-cost, but high quality labor from other European countries.

On the other hand, there are significant opportunities for UK-based manufacturers and for those who export their goods as long as sterling remains relatively weak. There are also opportunities for discounters and distinct product segments that emphasise value. Looking at the bigger picture, Brexit also provides an opportunity to review supply chains and increase efficiencies and flexibility.

In terms of overall strategy, Brexit has highlighted how political risk has increased within the EU. There are concerns that other countries, like the Netherlands and Austria, could follow the UK's example, threatening the EU's very survival. While this is unlikely, the perceived risks may encourage retail and consumer goods businesses to explore opportunities further afield, in developing markets with higher GDP growth, favorable demographics and a lower or equivalent level of political risk.

Implications and strategies

- **Position your company to take advantage of a weak British pound:** Where possible, hedge against weak sterling and look for investment opportunities that are good value now and would benefit your company in the long run.
- **Keep apprised of EU-UK negotiations and trade deal scenarios:** Brexit is a process with many moving parts. The only way to assess the effect is to stay informed of events, progress and particularly of political positions coming from Westminster and from Brussels.
- **Engage the government to protect your interests:** Whether on trading terms for certain goods, access to European labor or access to the DSM, be sure to voice your position and concerns to both the UK and European governments. There is an opportunity to influence the details of the future relationship between UK and the EU.
- **Consider scenario planning:** Scenario planning of possible outcomes and reactions may be desirable, depending upon an assessment of the significance of business in the EU.
- **Plan for weaker consumer sentiment over the next two years:** Prioritize sales and marketing strategies that are successful during times of weak consumer confidence and look at how savings can be made across supply chains where possible. Carefully consider which costs may be passed on to your customers.

Resources

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