PlanetRetail

Brexit becomes a reality

Implications for retailers and FMCGs

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FIVE THINGS YOU NEED TO KNOW ABOUT THE BREXIT

1	**The United Kingdom will leave the EU,** following its Brexit referendum on 23 June 2016. Unless agreed otherwise, **the UK will remain a EU member for a transitionary period** of two years which will allow businesses to adapt.
2	Either a weaker pound will hurt households via higher inflation, or higher interest rates will hurt corporate investment and housing. Either way, **there is a risk of the UK entering recession**.
3	**Consumer confidence will suffer and retail sales are likely to contract** in the UK as insecurity about Brexit consequences will translate into job worries. Almost overnight, the UK has appeared to have become European retail's new problem child.
4	**The more UK retailers rely on imports, the more vulnerable they are** as the pound weakens and supply chains need to be adjusted. Nearly 40% of food sold in the UK is imported. There is a **soft landing scenario** that might see the UK continue in a free trade area with the EU. However, as retailers and FMCG cannot rely on this outcome, they will sharpen the focus of their supply chains and narrow their regional scope.
5	The biggest long-term risk for retailers and FMCG is an accelerated **disintegration of the wider European community**.

OPPORTUNITIES AND CHALLENGES IN UK RETAIL

Scenario	Opportunities?	Challenges?
Economic growth impacted with possibility of **recession**	• **Discount retailers** with their strongly improved reputation on value for money • Grocery retailers with a presence in **channels close to consumers**, with fewer visits to out-of-town big boxes (to save on fuel and avoid temptations) • **Convenience** as a 'cocooning effect' sets in • **Private label** producers – especially those producing value/economy ranges • Retailers with **strong loyalty** schemes; offering wider benefits, additional price discounts or treats • Producers of **affordable luxuries** as consumers spend on treats • Products which offer an affordable **replacement for foodservice**, e.g. Self-serve coffee pods	• **Hypermarket operators** with higher exposure to big ticket non-food items amid prolonged job insecurity • **Foodservice operators** with consumers shifting behaviours towards in-home cooking • **Non-food retailers** specialising in non-essential, deferrable items
Weaker British pound	• Suppliers of '**local**', '**regional**' and '**British-made**' products benefiting from eroded competitiveness of imported goods • UK suppliers **exporting** overseas • **Discounters** with small product ranges who can switch a large proportion of sales to local buying by subsituting a moderate number of products • Those able to tap into purchasing from **low-wage markets** on the global stage (e.g. Asda as part of Walmart) • Retailers with **international operations** seeing revenue and profit boosted from oversea when translated to sterling (e.g. Tesco)	• Retailers relying on **import-heavy categories** such as food (with 39% of food sold in the UK imported, and with heavy exposure in fresh categories such as fruit, vegetables and dairy) • Hypermarket operators with higher exposure to **non-food items** invoiced in foreign currency (with biggest risk in USD transactions) • **UK divisions of global e-commerce operators**, as consumers switch from other European markets to purchasing in sterling • Formats relying on **international product choice** as a differentiator (e.g., scaling back of World Foods ranges in hypermarkets) • **Global grocers with UK operations** (e.g. Walmart, Costco, Whole Foods) – the contribution to group sales could decrease • UK retailers with **international loss-making operations**, seeing losses magnified by currency effects
Interest rate hikes to soften downward pressure on pound	• Retailers and suppliers with a strong dependence on **international supply chains**, avoiding even stronger inflationary pressure	• Retailers and suppliers of **DIY, furniture and household electricals** as housing market likely to be severely impacted

OPPORTUNITIES AND CHALLENGES IN UK RETAIL

Scenario	Opportunities?	Challenges?
Greater **regulations** and limitations in **free movement of goods and people**	• Those with **limited reliance** on international supply chains • Those with international supply chains capable of **reorganising flow of merchandise** swiftly • Those able to benefit from **negotiations and best practice sharing** on a European regional level (e.g. Asda as part of the EMD buying group)	• UK retailers with **high dependency on international supply chains** combined with weak outlook of subsituting suppliers domestically (clothing, consumer electronics, DIY) • **US retailers** viewing investment in UK as bridge into Europe (e.g., Whole Foods, Costco) • **E-commerce operators** whose fulfilment could be impacted amid spreading customer expectations of same-day delivery. • UK retailers and suppliers with significant proportion of **temporary European low-cost labour** • Retailers and suppliers suffering **loss of European immigration** of talent
Further disintegration of EU		• European-wide retailers and suppliers suffering a **negative impact on supply chains** with excessive waiting times at borders and growing currency risk

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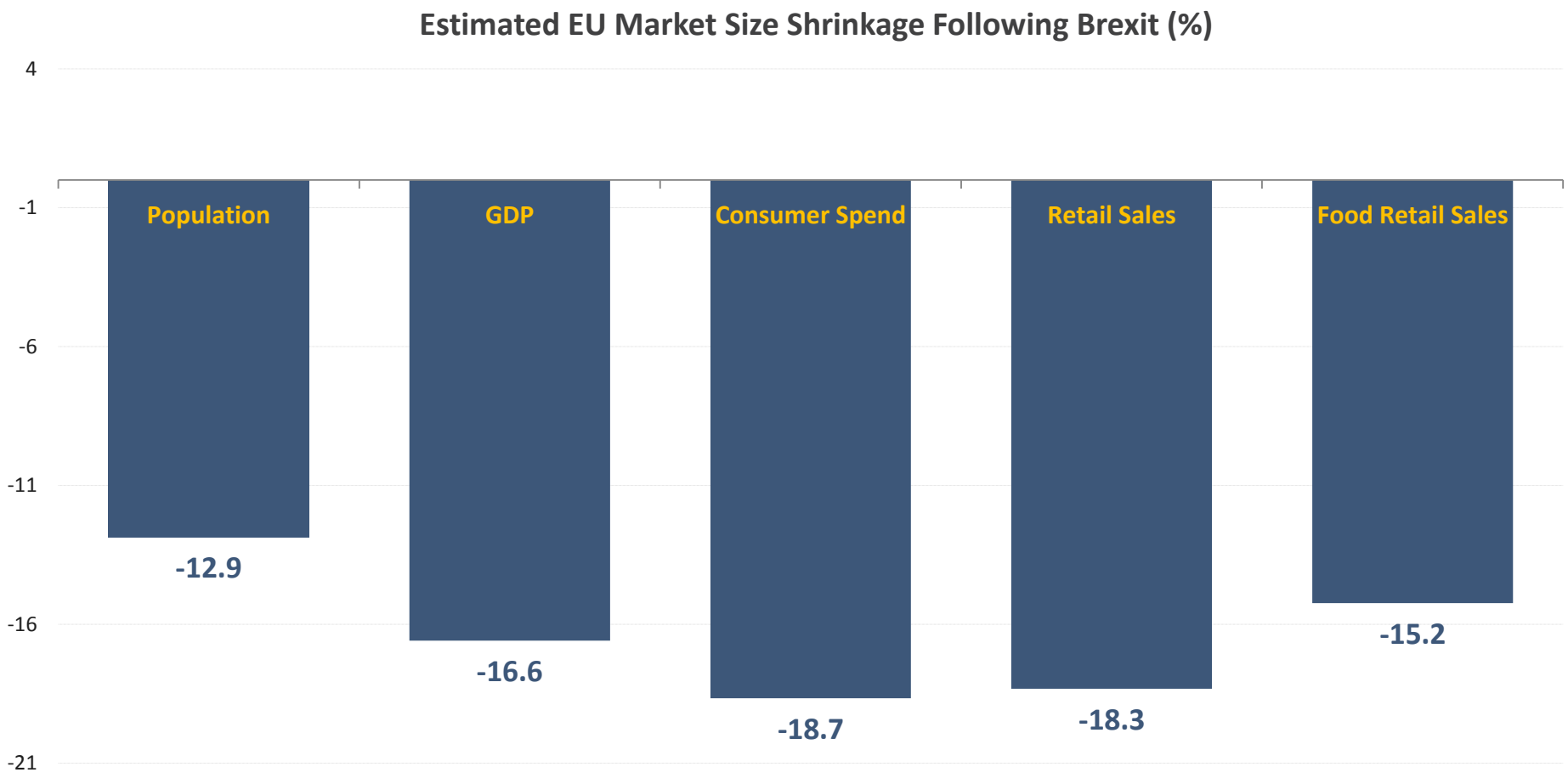
THE BREXIT ROADMAP

- **The UK will leave the European Union** after its Brexit referendum on 23 June 2016 saw leavers secure a majority of 51.9%.
- Nonetheless, the UK will **remain a member of the EU and its free market for a transitionary period**.
- As of today, this **transitionary period is likely to last for two years**, although exit procedures may be accelerated.
- Once the UK has left, **the EU will lose around 17% of its economic firepower**, which means there are strong implications on both sides.
- For retailers and FMCG, open borders are generally a good thing. **In a positive scenario, the UK would remain associated to the EU free trade area** even after its Brexit. But there is a risk this may not happen.
- As planning insecurity is the worst for businesses with a long-term focus, **retailers and FMCG will spend the next two years preparing for all scenarios**.

THE EUROPEAN UNION WILL BE REDUCED IN SIZE BY A SIGNIFICANT AMOUNT



Brexit will cut the size of the European Union significantly. With income levels in the UK above EU average, the amount by which the Union will shrink will be greater in economic output than in terms of population.

To give an example, while the population will shrink by 12.9% following the Brexit, EU-wide consumer spending and retail sales will drop by around 18.5% each.

Source: Planet Retail

RISKS TO THE UK ECONOMY AND RETAIL

- **The weaker pound** will make imported goods and services more expensive. This **will drive inflation and hurt British households**.
- **The pound may weaken further and stay weak** in a reflection of prolonged insecurity in the financial markets, as well as weak foreign direct investment.
- In an attempt to mitigate this, **interest rates** might rise. However, there is a risk this **might hurt the property market** and associated retail and service sectors.
- Either way, **expect the UK economy to take a hit and come close to, or enter, recession.** It is too early for precise forecasts, though.
- The Economist Intelligence Unit expects **UK retail to contract by 3% in real terms in 2017** (probably resulting in flat or slightly negative growth in nominal terms) and have a hard time in the years following.
- In other words, the outlook for UK retail is that it will become **European retail's new problem child** in the years ahead.

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SHORT, MEDIUM AND LONG-TERM IMPACT

- **Immediate implications of the Brexit vote** will, and already do, involve the **free movement of services** – mainly visible in Britain's vital financial sector.
  - While the stock markets took a heavy hit, the pound fell to a 30-year low on the day the poll results were published. Over time, there is an outlook of sustainable pound weekness which will hit imports and drive inflation.
- Import and export activity, relating to the **free movement of goods**, is likely to be reduced over time, as part of a creeping process, and should therefore become visible as a **medium-term consequence** of the Brexit.
  - Possible trade barriers as well as diverging product standards should, therefore, hit retailers and FMCGs as they – more than most other industries – rely on open borders in the 21st Century.
- In the **medium to longer term**, the **free movement of people** should be felt in the British economy, partly in the shape of a lack of workforce in agriculture (potential drop in saisonal workforce immigration), but mainly in the shape of fewer EU talents entering the UK retail and FMCG job markets.

IMPLICATIONS FOR RETAILERS

- The Brexit will have implications for retailers in both Europe and the UK. Generally, **the more reliant a retailer is on UK-European trade, the more affected it will be by the Brexit.**
- While the soft landing scenario might see the UK remain associated to the EU's free trade area, **retailers cannot afford to rely on this**. They must prepare for alternative scenarios.
- Going forward, **supply chains will feature a sharper focus on predictable economic areas** providing reliable political frameworks and currencies.
- **This will see European retailers buy less from the UK** – not overnight, but as part of a gradual process stretching over the next two years.
- With **UK retailers aiming to avoid upward inflationary pressures**, they will cut down on imports. In grocery retail, **fruit & vegetables and dairy**, often sourced from the EU, are high-risk categories for price increases. Nearly 40% of food sold in the UK is imported.
- After the costly reorganisation of supply chains, **consumers should be left with reduced product choice** at both ends of the Eurotunnel.
- As hypermarkets and supermarkets feature a higher proportion of imported products than discounters, **inflationary pressures might accelerate further the spectacular rise of discounters Aldi and Lidl in the UK**.

IMPLICATIONS FOR FMCG

- Again, in a gradual process over the next two years, **continental European retailers will sharpen their buying focus and buy less from the UK**.
- Some of the **loss of export volumes should be mitigated by the weak pound**, making British products more competitive on the continent.
- At the end of the day, however, expect job losses in UK manufacturing, with export-dependent **FMCG businesses likely to undertake rationalistaion and restructuring programmes** in an attempt to adapt to new client bases and streamline supply chains.
- While the world's leading FMCG manufacturers appear commited to the UK, **new FDI from the EU can be expected to drop sharply**.
- For **FMCG brands from the EU**, the impact of losing UK business will typically be manageable.

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THE LONG-TERM RISKS

- For most British and European retail and FMCG businesses, **Brexit should be manageable** – not least thanks to the generous transition period.
- **The biggest risk**, however, lies in the Brexit heralding the **advent of accelerated European disintegration**.
  - Populist parties in France, The Netherlands and Denmark, among others, are promoting their own Brexit referendums - with a real chance of this happening
  - The Netherlands, Finland and Greece could leave the Eurozone (some more enthusiastically, some less voluntarily)
  - Russia sanctions remain in place
  - Risk of refugee crisis flaring up again, leading to excessive truck waiting times at borders of Austria, Italy, Greece, Hungary etc.
- **Retailers and FMCGs need open borders and predictable currencies to operate efficiently**.
- **There is a risk Europe might lose some of these advantages** on a scale far beyond the Brexit over the next few years.

ACTIONS TO TAKE FOR FMCG

- Evaluate Brexit risk on a **customer-by-customer basis**, taking into account
  - Currency exchange risks and opportunities
  - Free trade risks
  - Access to financial markets
  - Shifting retailer supply chains
  - Shifting and more thrifty consumer behaviours as job worries grow
- **Streamline buying and logistics** to control costs as **inflationary pressures** will enter the supply chains of UK-based manufacturers
- As an EU-based manufacturer, prepare to **subsitute UK-based retailer clients with grocers across the EU** and in emerging markets, starting the **transition early** with a two-year horizon in mind
- Monitor **potentially diverging regulatory frameworks** around **data protection, food safety, environmental standars, food labelling**.
- **Enter dialogue with retailers**, finding solutions for best and worst case scenarios amid a landscape of uncertainty and swings in consumer moods

MARKET ANALYST QUOTATIONS

- **Capital Economics:** *"The outcome clearly creates considerable short-term uncertainty which is likely to weigh on the UK economy in the coming quarters. Nonetheless, we maintain the view that the ultimate damage will be rather smaller than some of the more pessimistic projections have suggested. After all, the UK will remain inside the EU for at least two years and possibly longer."*
- **Economist Intelligence Unit:** *"The UK is currently experiencing a short, sharp economic shock but what will follow for UK retailers will be a period of sustained uncertainty."*
- **Tony Shiret, Haiton Securities:** *"The question is the extent to which this triggers a demand recession – I think there's a good chance of that."*
- **Roberto Lobue, Menzies LLP:** *"This unpredictability should not be used as an excuse for complacency. Responding to this decision will require some urgency, particularly in areas like supply chain relationships. Retailers have to remain competitive and need to be able to react quickly as and when the picture of life outside the EU becomes clearer."*
- **Diane Wehrle, Springboard:** *"Consumers don't like things that don't secure and we're in an unprecedented period when no one knows what's going to happen. Anything that creates barriers to trade cannot be a positive for retail."*
- **Stephen Springham, Knight Frank:** *"As the last recession proved, retail sales patterns do not religiously track GDP performance. Consumers may tighten purse strings and realign spending priorities, but they will not stop spending altogether. Retail sales performance will remain erratic.[…] The retail sector may well benefit from 'bargain hunting' investors from overseas, taking advantage of any fall in the value of sterling."*
- **Clive Black, Shore Capital:** *"We expect sterling to be weak against the dollar, an easy call; its performance against the euro is more imponderable but has important implications for the fresh food segment in the UK in particular – Aldi and Lidl, for example, import much more of their groceries than the UK supermarkets, so do they suffer lower margins or increase prices?"*

RETAIL AND FMCG QUOTATIONS

- **British Retail Consortium:** *"Without clarity, retailers, other businesses and hence the economy will suffer from a prolonged period of uncertainty […] Retailers should be prepared for the possibility of significant swings, particularly in the exchange rate and consumer confidence."*
- **Lidl UK:** *"We appreciate and respect that a Leave decision has been made by the British public. […]We have been working hard in the background to plan for this scenario, so we are very well prepared. […] We will continue to invest in our UK expansion plans for new stores, new warehouses, and new jobs."*
- **Sir Ian Cheshire:** *"We don't know how long it will take to renegotiate trade deals […] If the exit is awkward it could take a very long time and it's an enormous spanner in the works in terms of knowing how to price and resource properly."*
- *"I'm disappointed but I'm not a believer in the end of the world reaction. It is the less attractive option but we have to get on and deal with it."*
- **Richard Pennycook, The Co-Operative Group:** *"Our message is positive - we've been through a period of uncertainty and we now know the outcome. Now we need to get on and seize the opportunities."*
- **German retail association HDE:** *"The Brexit will lead to a loss of confidence in the idea of a joint European free trade area."*
- **German export federation BGA:** *"The Brexit referendum marks the beginning of a prolonged period of uncertainty. That is poison for business."*
- **Henkel CEO Hans Van Bylen:** *"I feel sad about the decision because I believe that the EU is more successful as a strong economic area. However, we are a global business. The immediate consequences for our business in the UK are certainly manageable, as the UK accounts for only 2% of our sales. The long-term consequences of the Brexit are hard to predict, though."*
- **Mars:** *"Even though we have supported a UK within the EU, today's referendum will not impact on our involvement in the UK, as well as its extension."*
- **Mondelez International:** *"Our brands are very popular with British consumers and we are planning to continue to manufacture in the UK."*

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