



DEEP DIVE: BREXIT BRIEFINGS 8- IMPACT ON TRADE AND RETAILERS' SUPPLY CHAINS

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This is the eighth report in our *Brexit Briefings* series.

- 1) This report investigates the impact of Brexit on UK trade relationships with the European Union (EU) and on the supply chain operations of UK-based retailers. The possible outcome of the negotiations between the UK government and the EU will determine the impact of the decision to leave the EU on the international supply chain of British retailers. In the report, we identify the Most Favored Nation and the Swiss Options as the most likely scenarios.
- 2) The report also discusses the main opportunities and threats of the post-Brexit scenario for British retailers' supply chain operations. In particular, we identify a zero-tariff import system regime that could be implemented by the British government and the possibility of sourcing from cheaper countries outside the EU as the main advantages, while the devaluation of the pound is a probable threat.
- 3) Finally, we provide an overview of the main strategies that retailers are considering implementing to prepare their supply chain operations to a future outside the EU. These include making the supply chain more efficient, hedging currency and switching from suppliers based in the EU to suppliers based in India, China and the UK.

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EXECUTIVE SUMMARY

The UK's departure from the EU will likely have a significant impact on trade between the UK and the rest of the world. Consequently, it will affect how British retailers with international operations manage their supply chain.

This report investigates the impact of Brexit on UK trade relationships with the EU and on the supply chain operations of UK-based retailers. It is part of a *Brexit Briefings* series of regular reports that analyze the impact of the decision of the British electorate to leave the European Union on the UK's economy, consumers and retailers. The focus of our series thus far has been the near term; before the UK actually leaves the EU. In this report, we turn and look at the longer term and the post-exit scenarios for sourcing.

Supply chain management for British retailers with international operations could be affected by the type of trade agreement produced by the negotiations between the UK and the EU. If there are restrictions on trade with the EU, retailers that rely on European suppliers could switch to alternative sources from outside the union.

At the time of writing, the arrangement between the UK and the EU is still undefined; negotiations have not started yet.

This report discusses:

- 1) The possible scenarios that could regulate UK-EU trade relations in the future. We identify two scenarios—the Most Favored Nation and the Swiss option—as the most likely to emerge from the negotiations. These options also raise doubts about the UK's access to the European single market.
- 2) The implications of the new trade scenario for British-based retailers, with particular reference to the impact on their supply chain operations. A zero-tariff import system implemented in a post-Brexit UK and the possibility for retailers to source from cheaper countries are the main opportunities in the possible post-Brexit climate. Rising supply chain costs and the devaluation of the pound are the two main factors that will weigh on retailers' international sourcing operations.
- 3) The strategies UK-based retailers are implementing, or plan to implement, to prepare their supply chain operations for the post Brexit environment. Making the supply chain more efficient, hedging currency and switching from EU-based suppliers to India-, Chinese- and UK-based suppliers are the main strategies retailers are considering.

Supply chain management for British retailers with international operations could be affected by the type of trade agreement produced by the negotiations between the UK and the EU.

Retailers are taking advantage of the opportunity offered by the Brexit to make their business operations more competitive.

INTRODUCTION: BREXIT CAN MAKE SUPPLY CHAIN OPERATIONS MORE EFFICIENT

This report assesses the possible impact of Brexit on the trade relationships between the UK and the EU and on the supply chain operations of British-based retailers.

The report is part of a *Brexit Briefings* series that analyzes the impact of the decision of the British electorate to leave the EU. However, while the focus of previous reports in the series have been on the near term impact of the decision on the economy and on retail, this report looks at the longer term and formulates post-Brexit scenarios and the possible consequences on the supply chain operations of British retailers.

The strategies that UK retailers are implementing or are considering implementing to prepare their supply chain to the post-Brexit trading environment are also illustrated in the report.

The main findings of the report are that a zero-tariff import system and the possibility for retailers to source from cheaper countries are the major opportunities in the possible post-Brexit climate, while the main challenges on retailers' international sourcing operations are likely to be the rise of certain supply chain costs and the devaluation of the British pound.



Source: Shutterstock

We show how retailers are taking advantage of the opportunities offered by Brexit to make their business operations more competitive, in particular by increasing the efficiency of their supply chains, by hedging currency and by switching to more efficient suppliers outside the EU, in countries such as India, China and even by going back to source more from UK suppliers.

UK-EU TRADE ARRANGEMENT SCENARIOS

As a result of the decision of the British electorate to leave the EU, the UK faces the prospect of seeing its access to the European single market restricted. The Brexit result also provides an opportunity to forge trade agreements with other countries around the world without delegating this power to the European Commission.

In recent years, the UK has increased its trade with emerging and advanced non-EU economies. The proportion of trade with the EU has fallen since 1999.

Figure 1. UK International Trade (Goods and Services) in 2015

UK exports to EU	£223.3 billion
UK imports from the EU	£291.1 billion
UK exports to non-EU countries	£288.2 billion
UK imports from non-EU countries	£257.1 billion
Share of all UK exports that go to the EU	44%
Share of all UK imports that comes from the EU	53%

Source: Office for National Statistics (ONS)

The EU is an important trading partner for the UK. Fifty-three percent of all goods and services imported to the UK currently comes from the EU. The UK had a trade deficit with the EU of £67.8 billion in 2015, according to the ONS. The UK imports more from the EU than it exports to the EU. As a result, the EU also relies substantially on the UK as a trading partner. This should give the UK government a position of strength in the Brexit negotiations.



Source: Shutterstock

However, the importance of the EU as a trading partner for the UK is decreasing. In recent years, the UK increased trade with emerging and advanced non-EU economies. The proportion of trade with the EU has fallen since 1999, according to the ONS.

At the time of writing, the UK and the EU have not started negotiating. Therefore, we still do not have a clear idea of what arrangements will regulate the trade between the UK and the continental block.

In our first *Brexit Briefing* report, we defined the possible scenarios that could emerge from the Brexit negotiations. These are summarized in figure 2.

Figure 2. Possible Outcomes From the EU-UK Negotiations on Trade

Agreement	Implications for the UK
Most Favored Nation	UK faces the EU's common external tariff.
European Economic Area membership (Norwegian option)	Free access to the EU single market, but obligations to adopt EU regulations, contribute to EU budget and accept free movement of EU citizens.
Bilateral trade agreements (Swiss option)	The UK and the EU would negotiate a number of sector-specific trade agreements.
UK-EU Free Trade Agreement	Free access to the single market, but with no influence on EU standards and regulations.
UK-EU Custom Union (Turkish option)	Custom-free trade with the EU, but EU external tariffs would be applied on UK trade with non-EU markets.
Association Agreements (Balkan option)	Preferential access to the EU single market.

Source: London School of Economics and Political Science/Citi/Fung Global Retail & Technology

We believe the Swiss option is the most likely of the existing scenarios. It is the one that provides more flexibility to accommodate the positions of the UK and the EU.

The Norwegian option and the UK-EU Free Trade Agreement would guarantee the current status of free access to the EU single market for UK goods and services. There would therefore be no significant implication for trade and supply chain management. However, the two options are unlikely. The EU is unlikely to grant free access to the single market with no obligations for the UK, such as with a free trade agreement. It is also unlikely the UK would accept the Norwegian option because it would go against the British electorate's will.

The Turkish and Balkan options are also unlikely; they were conceived for developing countries that apply for EU membership, and are unsuitable for the UK.

We believe the Swiss option is the most likely of the existing scenarios. It provides the most flexibility to accommodate the positions of the UK and the EU. The UK is likely to embark on a period of continued rounds of negotiation with the EU, as Switzerland has been doing for a long time. This process is not hassle-free, as the Swiss case demonstrates. For instance, the Swiss electorate voted to limit the movement of EU citizens to Switzerland as a result of previous bilateral agreements with the block, in a 2014 referendum. Now, two years later, Switzerland and the EU have still not reached terms to implement the electorates' will because of Brussels' resistance to accept limitations on the freedom of movement of EU citizens.

The World Trade Organization's Most Favored Nation option could also happen, although it would imply the failure of both parties to reach any sort of agreement. This option and the Swiss-style route would mean the UK's trade policies would have to be revised. This would likely have significant implications

on how companies, including retailers, manage their supply chains and from which countries they will source their products.

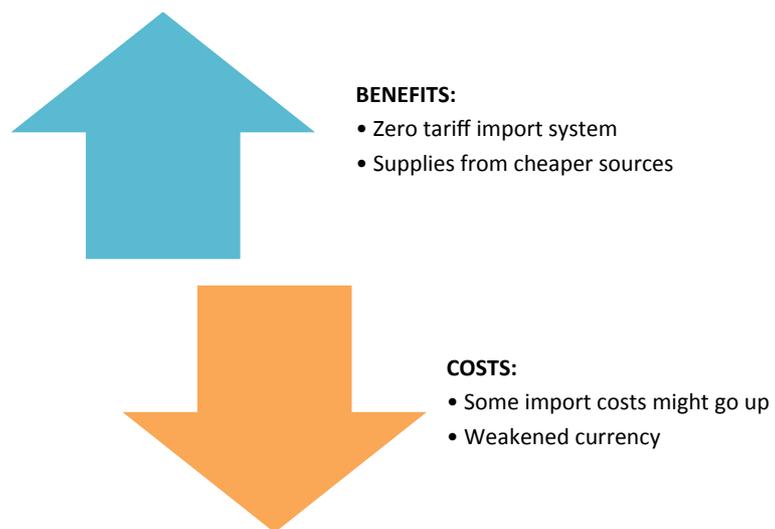
HOW BREXIT MIGHT AFFECT UK RETAILERS’ SUPPLY CHAINS

Assuming solutions similar to the Swiss or the Most Favored Nation options emerge from the negotiations between the UK and the EU, the main consequences of Brexit on British retailers' supply chain would be:

- **The UK could opt for a zero-tariff import system.** If the UK becomes a champion of free trade once it is out of the EU, the government could decide to impose zero tariffs on imports. This would reduce the cost of goods imported and would have a positive impact on the cost of the supply chain for retailers. Under EU rules, the non-weighted average import tariff for imports from outside the EU was 2.1% in 2014, according to the World Bank. However, for categories such as garments, the tariff was as high as 12%.
- **The UK could source from cheaper countries.** As a result of a zero-tariff import system, British firms could source from more price-competitive countries, such as from key manufacturing regions in Southeast Asia.

British firms will be able to source from more price-competitive countries.

Figure 3. Likely Benefits and Costs of Brexit on the British Retail Supply Chain



Source: Fung Global Retail & Technology

The possibility of the UK losing free access to the European single market will further depress the value of the pound.

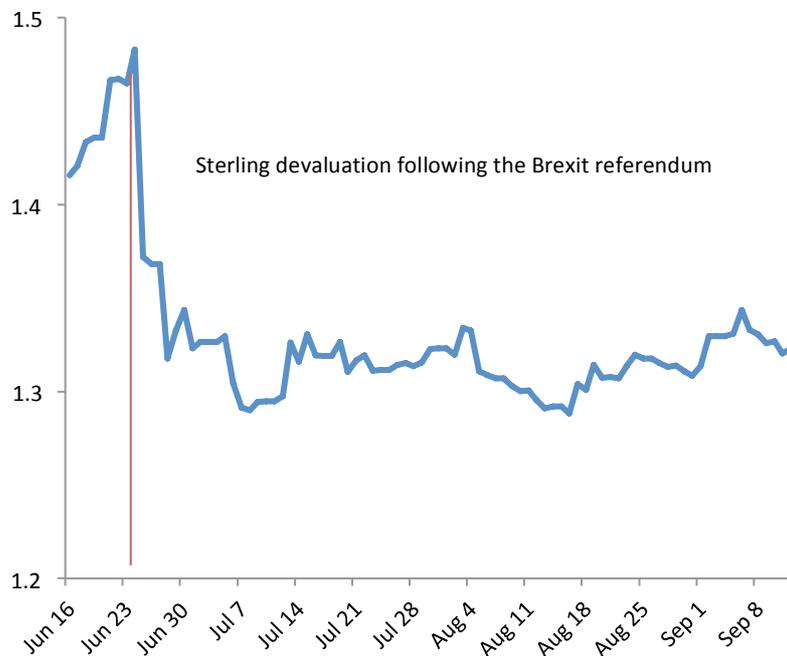
- **Some import costs might increase.** Although UK companies would reduce some costs of imports if they source in a zero-tariff regime from cheaper countries outside the EU, other sourcing costs might increase. For instance, transportation costs would be higher if the new cheaper sourcing destination is farther away than the old suppliers based in the EU. Of course, importers will switch to cheaper countries only if the cost of goods is competitive enough to offset the higher cost of imports.



Source: Shutterstock

- The devaluation of the pound might increase the cost of overseas supply.** The British pound has already depreciated against the US dollar following the Brexit referendum. It is probable as the negotiations between the UK and the EU progress, the possibility of the UK losing free access to the European single market will further depress the value of the pound. The devaluation of the British currency will make overseas supply, which is in many cases traded in US dollars, more expensive.

Figure 4. British Pound/US Dollar Exchange Rate June 16–Sept. 15, 2016



Source: USForex

British retailers will have to reconsider suppliers and the countries from where they source their products in a post-Brexit environment.

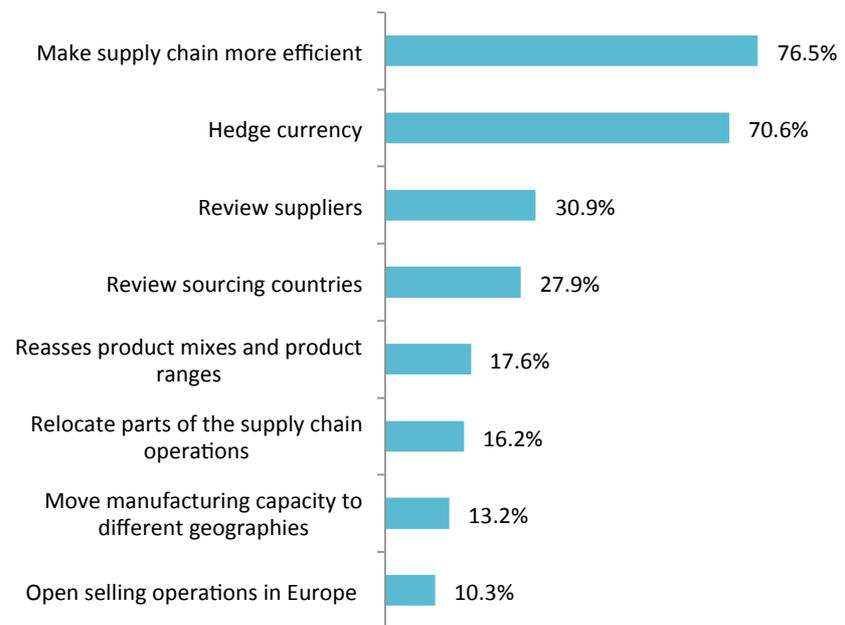
UK RETAILERS PLANNED RESPONSE TO THE POST-BREXIT SCENARIO

In the aftermath of the Brexit referendum, retailers are preparing to reap the benefits and face the challenges the new trade scenario of a UK outside the EU could bring. Following the Brexit referendum, most retailers are reviewing, or considering a revision to, the way their supply chain operates, according to a survey conducted by research firm, Conlumino.

A large majority, 76.5%, of the retailers interviewed by Conlumino said they will take advantage of the Brexit shake-up to make their supply chain more efficient and cost effective. Hedging currency is another popular strategy to manage the supply chain risk. Of those surveyed, 70.6% of respondents said they would hedge currency to counteract the impact of a weaker pound.

British retailers will have to reconsider suppliers and the countries from where they source their products in a post-Brexit environment. Of those interviewed by Conlumino, 30.9% of retailers said they will consider changing suppliers and 27.9% of respondents will look for products from different countries. It will come as no surprise to learn Europe is expected to lose the most British retailer supply business.

Figure 5. UK Retailers Planned Supply Chain Strategies For a Post-Brexit Environment



Source: Conlumino

In a post-Brexit environment, the UK might become a more attractive manufacturing base and source of agricultural products, despite the generally higher production costs.

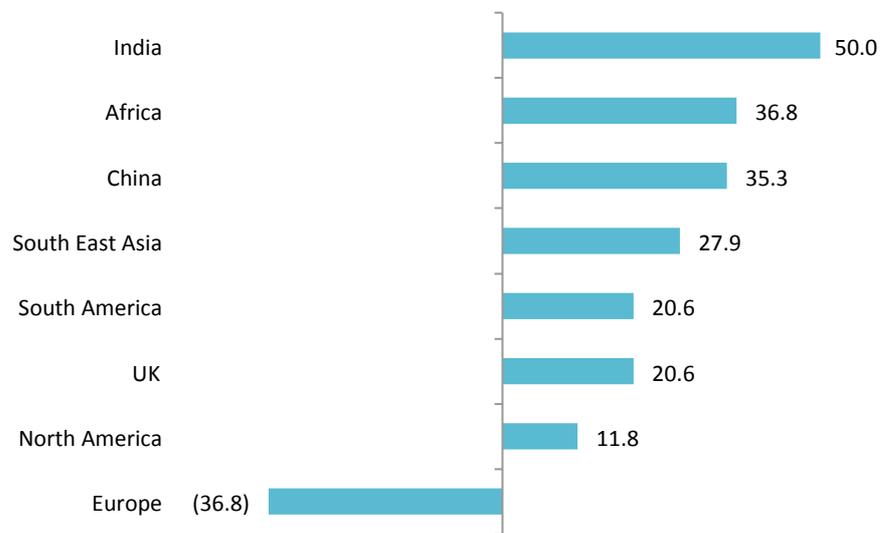
As you can see in Figure 6, India and China are two of the countries retailers said they will consider in their search for alternative suppliers. The two Asian countries already host reliable and efficient suppliers' networks, which makes them clear valid alternatives to existing European manufacturers. The appeal of Africa will increase by the same proportion, 36.8%, as the loss incurred by Europe. The geographical proximity of African countries is attractive to retailers looking to source products, including fresh food and fast-fashion apparel.

British retailers are also expected to source more products from the UK. Of the companies surveyed, 20.6% said they will consider using more domestic sources.



In a post-Brexit environment, the UK might become a more attractive manufacturing base and source of agricultural products, despite the generally higher production costs. For example, retailers could consider the attractiveness for British consumers of, “locally grown” food, and manufactured goods, “made in the UK.” They might also see lower transportation costs, higher quality products, faster speed to market, and easier relations with suppliers who are close by and speak the same language. Most significantly, a weaker pound might make domestic products cheaper compared to foreign goods bought in US dollars, for example. This trend could revive British agriculture and manufacturing, and benefit the UK economy.

Figure 6. UK Retailers Prospected Increase in Post Brexit Sourcing Activities (Net Percentage Change)



Source: Conlumino

UK retailers had different reactions to the result of Brexit referendum. Most see opportunities, others admit challenges.

UK retailers had different reactions to the result of the Brexit referendum. Most see opportunities, others admit challenges, but the overall sentiment appears positive judging from the comments retailers have made to analysts and the press. We collated some of these in the table below.



Figure 7. Selected Retailers’ Comments on the Impact of Brexit on Their Operations

Travis Perkins says Brexit will bring opportunities to improve supply-chain efficiency.

Retailer	Impact of Brexit on Operations
Next	Increased efficiencies to come from new and developing sources of supply such as Bangladesh, Cambodia and Burma. Greater competition between more traditional sources of supply, particularly in China, and newer manufacturing regions.
Travis Perkins (Wickes)	Brexit will bring opportunities to improve supply-chain efficiency. The retailer will also consider more UK sources.
Debenhams	More difficult to import products due to the unfavorable exchange rate.
Ann Summers	The UK government should keep access to the EU single market and negotiate the best trade deal possible.
The Co-operative Group	We need to move on and seize the opportunities.
Carpetright	If people aren’t moving as a result of a Brexit-induced recession, they may well be improving.
Dreams	There will be challenging times, but we remain confident.
B&M European Vaue Retail	We see it as business as usual with no direct impact on our business. The whole of UK retail will see some pressure on imported goods, but it’s a level playing field so it doesn’t change the fundamentals of our business.

Source: Retail Week/Funa Global Retail & Technoloav

UK retailers see the possible post-Brexit scenario as an opportunity to accelerate their strategies to make supply chain operations more efficient and cost effective.

KEY TAKEAWAYS

Brexit could bring opportunities and threats for UK-based retailers with international supply chain operations.

Although the post-Brexit playing field will be defined by future negotiations between the British government and Brussels, we believe the most likely scenarios are ones that will limit UK access to the European single market, at least in the medium term.

If we assume negotiators reach a Swiss-style or Most Favored Nation trade agreement, British-based retailers will have the opportunity to review their existing suppliers in favor of cheaper producers from countries outside the EU. A post-Brexit UK should also guarantee a zero-tariff import system, which would benefit UK retailers. On the other hand, UK retailers will face the possibility of higher import costs and a weak pound, which would make sourcing more expensive. These costs, however, might be offset by savings generated from cheaper sources.

UK retailers see the possible post-Brexit scenario as an opportunity to accelerate their strategies to make supply chain operations more efficient and cost effective. To counteract the devalued pound, most retailers will adopt strategies to hedge currency. Finally, the post-Brexit environment might unleash the opportunity for retailers to review their sourcing destination in favor of suppliers based in China and India. Brexit might even encourage British retailers to increase their network of domestic suppliers and sell more home-grown food and, “Made in the UK,” products.

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