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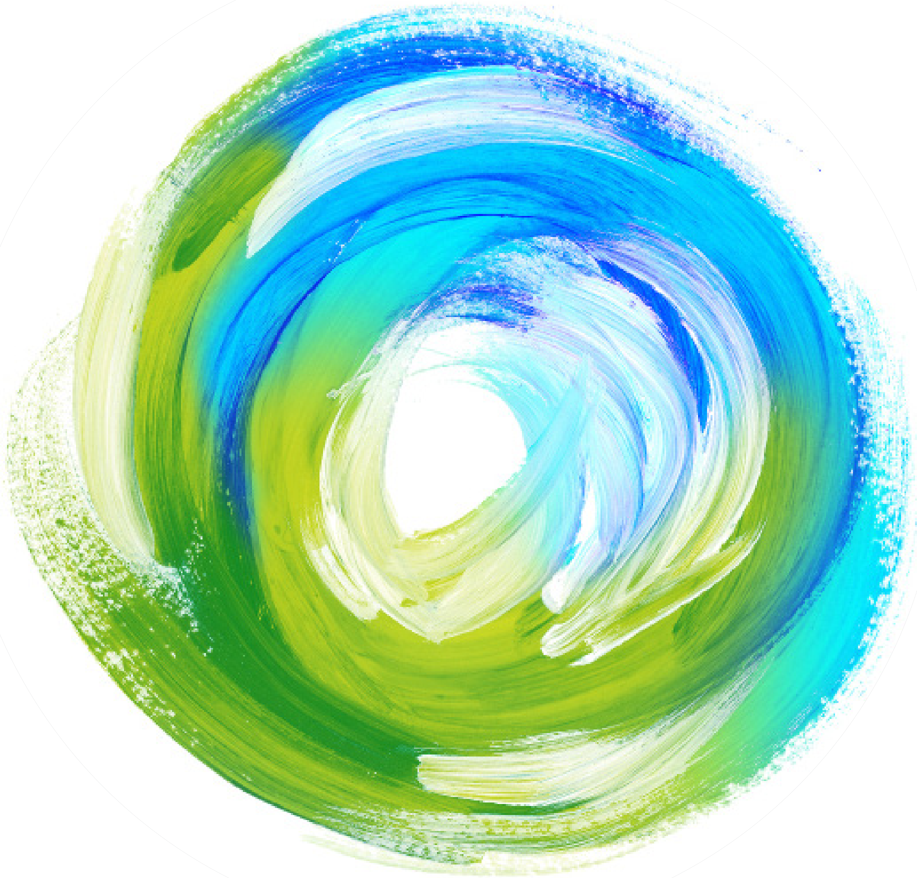

Tackling Brexit and COVID-19 together

October 2020

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Introduction: From Brexit to Brexit plus COVID-19

In 2019 Brexit was the centre of attention and UK firms were busy developing contingency plans for their business following EU Exit. But in 2020, as COVID-19 took hold, business attention was diverted and many of those working on Brexit were redeployed to dealing with the pervasive and immediate impact of the pandemic.

As the prospect of a 'V-shaped recovery' ebbs away, many business leaders now find themselves grappling with a tentative re-opening of the economy, while also being only weeks away from a sharp change in trading terms with the EU.

The UK's transition period with the EU comes to an end on 31 December 2020. With slow progress in negotiations, there is now a very real possibility that no trade agreement will be reached or the deal will be limited in scope. As both the UK government and the European Commission have said, whether there is a future relationship in place or not, there will be significant changes to the way the UK and the EU trade.

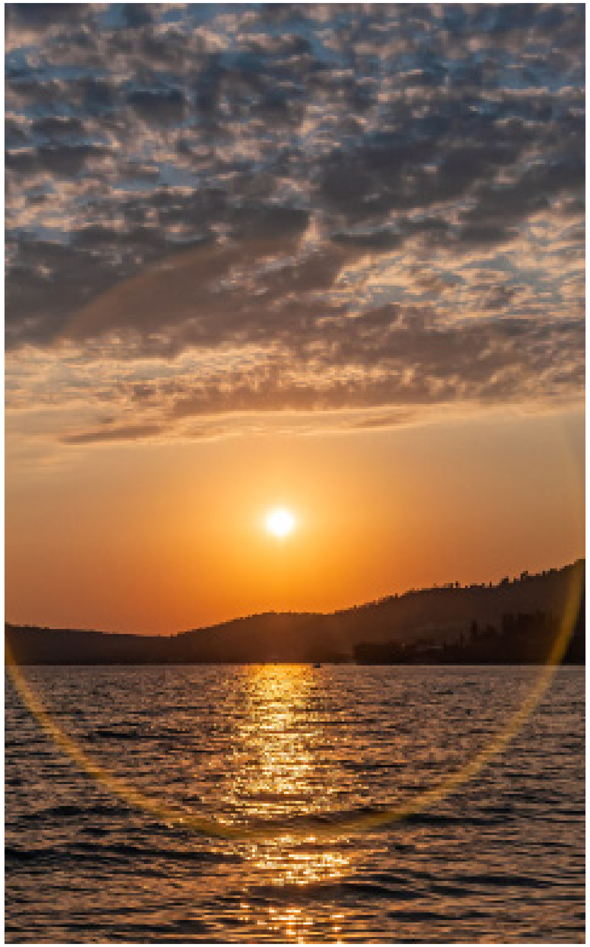
And, as COVID-19 has entirely changed the economic context of Brexit, business leaders will need to consider the interplay between the two.

There is no doubt the initial economic shock from COVID-19 is significantly larger than any immediate impact that will come from Brexit. In particular the impact on demand (both domestic and foreign) due to lockdowns has been more significant than anything seen previously. But Brexit will also have pervasive and longer-term effects.

For business leaders reviewing their plans there are three major questions:

- Does your business have a plan in place for the end of the Brexit transition period and all the changes Brexit brings?
- Does your business plan take account of COVID-19 and its interactions with Brexit?
- Do you have the resources needed to cope with the balance sheet and resource challenges posed by COVID-19 in the context of Brexit?

This paper will focus on the interaction between Brexit and COVID-19 in three important areas – supply, people and resourcing – using sector-specific examples and case studies from our own work to examine how the combined crises manifest themselves in businesses' day-to-day operations, and how businesses can react.



Inter-connected economic shocks

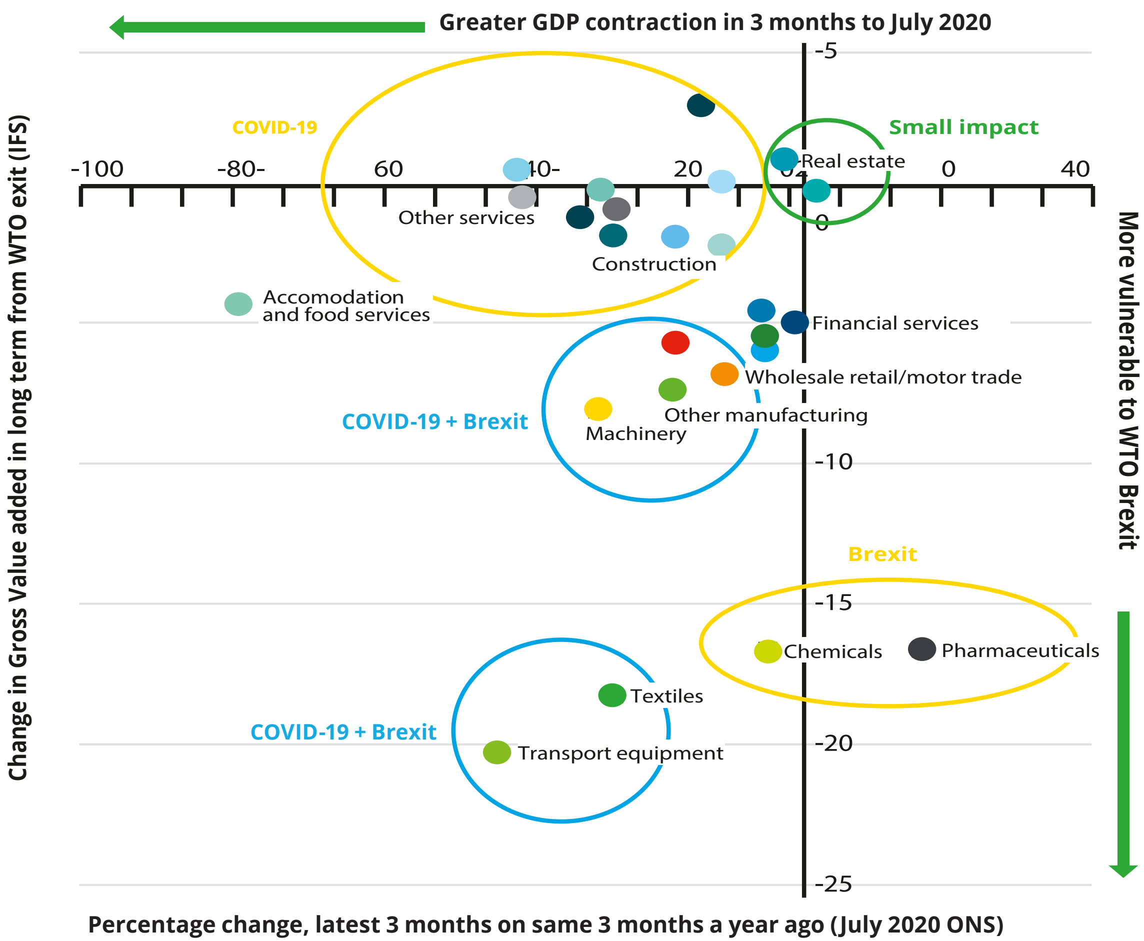
It is apparent COVID-19 and Brexit are very different types of economic shock. COVID-19 has provoked some of the steepest GDP declines ever in the UK and other European economies. The path of recovery is uncertain, but it is likely many of the impacts will eventually prove temporary, even if there may also be hard-to-predict, longer-term socio-economic impacts, such as changes to supply chains or in the ways in which people and organisations work.

Brexit, by contrast, is likely to bring mostly more predictable changes to the way the UK trades with the EU and some of its other trade partners, but these changes will be permanent.

The immediate hit to demand and growth from COVID-19 is unquestionably larger than that of Brexit. But the interaction on the supply side is more nuanced and complicated. Both economic shocks will impact supply chains, often in different ways, meaning they may well compound each other.

As the heat map shows, the two shocks often have their largest impacts on different sectors. This means overall the impacts of Brexit and the pandemic leave very little of the economy unscathed. Moreover, some sectors are vulnerable to both the pandemic and Brexit.

COVID-19/Brexit economic impact heatmap



Sources:[1,2,3,4]

Supply chain

Supply chains are the area in which we see some of the biggest interplay between Brexit and COVID-19, and automotive is probably the clearest example of a sector hit hard by the combined challenge. It illustrates what other sectors face, though in most cases less intensively.

Automotive – front of the grid for a twin hit

This sector is highly dependent on fluid trade. A car produced in the UK will often have in excess of 30,000 parts, many of them imported from the EU and beyond.[5] The number of times inputs and components cross between the UK and EU in the course of the production of a car makes Brexit particularly challenging. In some cases it has meant shifting supply chains because they are no longer optimal or cost effective, but for the most part it means building in additional processes and resources to deal with the new documentation and checks required. Given many large automotive firms trade globally, they are often familiar with these processes and have been able to manage them, but they still amount to increased costs.

Brexit tariff uncertainty

Uncertainty on tariffs is a big worry for business. With 53 per cent of UK-assembled car exports and 69 per cent of UK-built components exported to the EU, a 10 per cent tariff on exports (which would be the EU tariff UK exporters would face if a Free Trade Agreement is not reached) is projected to cost £1.8 billion.[6]

Even if a Free Trade Agreement is agreed, dealing with new rules of origin will be complex for automotive firms given a finished vehicle can have inputs from all over the world. The shift to electrification has meant a higher proportion of car parts are often sourced from electronic or battery firms in Asia, meaning these cars may find it harder to reach the likely threshold for UK/EU content to qualify for any preferential tariff. The UK had sought to tackle this issue by agreeing 'diagonal cumulation' for countries which both the UK and EU have an FTA, meaning car parts from Japan for example could count towards meeting the threshold to qualify for any preferential tariff. The EU has rejected such an approach and as such, even in a deal scenario, some cars (especially electric cars) will still face tariffs.[7]

What is the COVID-19 demand hit?

Automotive is also a bellwether for the precipitous drop in consumer demand. And demand for vehicles has plunged due to COVID-19, with new car registrations down by 40 per cent in January to August compared to a year earlier[8]. The lack of consumer demand has cascaded through the automotive supply chain. Some suppliers have ceased production. Others have restarted, but are operating well below full capacity[9]. Brexit could further hinder recovery in ways detailed above.

How are supply chains being remade?

On the supply side, the Brexit/COVID-19 interactions in automotive are significant. Suppliers are struggling to operate under COVID-19 restrictions due to a reduced workforce or difficulty maintaining safety in the workplace[10]. Others have found it easier to keep factories closed until demand picks up further.[11] Some smaller suppliers have gone bankrupt, so new suppliers have to be found at short notice. This is increasing supply chain uncertainty and raising costs.

At the same time the automotive sector, like many, is re-evaluating supply chains in response to Brexit and COVID-19. There is renewed focus on diversity over pure efficiency. The sector is looking for a new quality in its supply chain: resilience. There may also be a trend towards greater nationalisation of supply chains and therefore de-globalisation, even if this increases slightly the cost of components.

Could the new context have a silver lining?

The combination of significantly depressed demand and increased cost and uncertainty within supply chains shows how COVID-19 and Brexit will affect automotive. Yet there are some potential interactions which mean Brexit, in the new context of COVID-19, may reduce the impact for automotive firms. Depressed demand, reduced trade and fewer cars and components moving between the UK and EU means the level of potential disruption from new procedures and potential border delays at Dover may be lower. For some sectors, Brexit at a time of depressed trade might ease the pressure on manufacturers and suppliers at that single point in time.

The Deloitte perspective: review your supply chain assumptions and next steps

- Understand your supply chain. Firms which do so thoroughly are better able to cope with the twin economic shocks. Clarity and visibility in the supply chain make it possible to analyse and respond more quickly to COVID-19 and Brexit.
- Looking ahead, adjust your supply chain with both Brexit and COVID-19 in mind. Chief Operating Officers are reconsidering their global sourcing arrangements. But moving parts of their supply chain into the EU, or even to other countries with which the EU has agreements, must also take into account the changes at the end of the year as a result of the UK leaving the Customs Union and Single Market. While moving part of a supply into the EU made sense during the transition period (as no changes have come into force) it may not make sense afterwards. Similarly, the UK may sign trade agreements with countries with which the EU does not yet have an agreement – such as the US, Australia and New Zealand - which could present opportunities that did not exist before the end of the transition period.

People

Both Brexit and COVID-19 are changing the labour market

Free movement of people between the UK and EU is ending. As part of implementing Brexit plans, and in order to be ready for the new regulatory requirements next year, a number of banks, and other firms operating in heavily regulated industries, intend to move people from the UK to the EU as the end of 2020 approaches.

How do Brexit and COVID-19 impact labour supply?

Given the potential for further COVID-19 lockdown measures, there is no guarantee it will be possible to move people across the UK and EU, and staff themselves may be unwilling to move in the pandemic.[12] This in turn raises a whole host of knock-on implications, with individuals potentially becoming a tax resident in the new country earlier than planned, or employees not being ready to move. Delaying moves, however, threatens gaps in service provision.

In many cases those employees which had agreed to move from the UK to the EU had planned to do so only partially, for example quasi-commuting for a few days a week. But this is obviously much more complicated during COVID-19 for many of the same reasons above, and means some employees may reconsider their decision to move.

Another result of COVID-19 is a shift to more people working from home, or elsewhere, to provide services virtually, in some cases across borders. This is linked to the challenges in shoring up the continuity of services. Some employees may be anticipating they would be able to fulfil their role remotely and stay in the UK rather than move abroad. However, while that might be allowed during the transition period, given the UK is essentially still part of the EU. Once this is over it may be that the services provided are no longer allowed to be provided virtually or remotely across borders. This would certainly be the case for most financial services as most regulation is set at the EU level and, unless the UK is found to have an 'equivalent' level of financial services regulation (though that looks almost impossible by the end of the year), many services will need to be provided from within the EU to serve EU clients.

How does the UK's incoming immigration policy complicate matters?

The UK has already set out the broad details of its new immigration system. Industries such as retail, which typically rely on lower-skilled workers, will face difficulties due to the imposition of salary thresholds and skills requirements which did not previously apply to EU nationals. This may be mitigated somewhat by the Migration Advisory Committee's recommendation that certain jobs – ranging from social care to bricklaying – are added to the 'shortage occupation lists' allowing for lower immigration thresholds/requirements. Additionally, there may also be an opportunity to source workers from other parts of the world more easily. In any case, workforce planning faces a sea change.

COVID-19 has brought other changes to the labour market: far-reaching in the short term, potentially significant, too, in the longer term. Transport operators have been challenged to provide safe transport to and from the workplace. Hiring new workers has presented a unique set of obstacles too. Sourcing workers from abroad has become more challenging with the various patchwork of travel restrictions and lockdowns. Business across borders has stalled, with an almost complete halt to fly in and fly out services. Posted or frontier workers have begun to work from home instead of on location.

How can a slack labour market help?

Unemployment is expected to increase sharply once the government furlough scheme comes to an end. This will impact consumer spending power and demand and also threatens, if unemployment is sustained, to harm workers' long-term productivity. Firms may find the labour market at the end of the Brexit transition period radically different. Previously, near-record employment levels were expected to continue, leaving little slack in the labour market. That has now changed markedly and may mean firms looking to hire domestic workers have more options.

Deloitte perspective: Do staffing requirements need to be rethought?

People and labour supply decisions are going to be complex in many sectors, even those which seemed little troubled by Brexit and longer-term restrictions.

Hospitality, tourism, travel and related services are prime examples. These sectors have seen a very significant drop in consumer demand due to lockdown, travel restrictions and health concerns. They are not expected to see as significant impacts from Brexit. But we are seeing interactions which need to be considered. These sectors tend to be reliant on lower-skilled workers and workers from abroad, often with foreign language skills. Sourcing them has already become harder due to COVID-19 and will become further complicated by Brexit.

We recommend firms:

- Review whether EU nationals currently hold a sponsor licence and, if not, whether they need one. If a sponsor licence needs to be obtained, companies should quickly familiarise themselves with what this involves. Processes will need to be put in place, staff nominated and pre-licensing audit preparation will need to be undertaken in case the company is selected for one.
- Review how many EU nationals are flying into the UK, and vice versa, each year. Determine how the new immigration requirements are going to be adhered to, for example by:
  - Ensuring travel policies are updated and communicated to employees.
  - Making sure systems are in place to identify the visa required.
  - Clearly assigning responsibility for who will manage visa applications, etc.
  - Ensuring the responsible party receives training to make/manage these applications.
  - Adjusting cost-estimates to ensure travel is budgeted for correctly.
  - Reviewing project timeframes to allow time to obtain work permits, etc.
- Carry out a strategic review of how you deliver work. If the current strategy involves frequent business trips between the EU and UK the additional immigration related cost should be assessed and mitigating actions considered. This could involve more remote work or strategic local hires to cut down on UK/EU travel.
- Use this as an opportunity to review the mobility function more generally. If UK nationals will be obtaining work permits to carry out projects in, say, Italy on a regular basis, make sure the company is up to date with its payroll and social security obligations in Italy. The increased visibility immigration officials will have over travellers will be shared with tax authorities. This risk therefore needs to be pro-actively managed.

Resources

Business leaders are having to deal with the financial shocks from both COVID-19 and Brexit. The pandemic has dealt a heavy blow to balance sheets and cashflow, with a decrease in profitability and sharp rises in corporate debt.

Company finances are being stretched...

The exact duration of COVID-19 will vary sector by sector and depend on the nature of the economic recovery – which will itself hinge on the struggle with the pandemic. Renewed partial lockdowns or tightening or easing of social distancing, for example, will determine whether some sectors, such as leisure and hospitality, are able to resume normal operation. Emergence of an effective vaccine would be likely to prove transformative. Resources, in terms of both cash and people, have been stretched to their limit. At the same time, firms across the economy have had to set aside funds and other resources to manage the period up to and immediately after the end of the Brexit transition period. This will stretch balance sheets still further.

...as well as the staff who provide crisis expertise

The two economic shocks are also stretching the same human resources: the expertise needed to plan for Brexit is the same as that needed for COVID-19. The unexpected arrival of the pandemic means there are real question marks about whether firms have the financing, capacity and people to carry out their Brexit plans in the way they had envisaged.

We have also seen some firms run down Brexit stockpiles during COVID-19. They need to rebuild them in a still more challenging environment - the best example is the pharmaceutical sector. Securing some medicines is proving difficult in the current exceptional circumstances. Having already prepared twice for 'no deal', some firms are increasingly reluctant to prepare again, especially when it comes to stockpiling. This sentiment has been exacerbated by COVID-19, where cash reserves are more important than ever. Significantly increasing stockpiles has a large cash flow and profit impact for businesses, and some are simply choosing to keep cash on reserve rather than build up stock (for which there may or may not be demand).[13]

Deloitte perspective: re-evaluate forecasts, resources and locations

We recommend the following to businesses managing their resources in the wake of COVID-19 and Brexit:

- Ensure your financial forecasts consider the impacts from both Brexit and the pandemic and the complex interplay between the two when it comes to corporate costs.
- Ensure you have sufficient resources to plan for and implement any necessary changes. Existing Brexit plans should be reviewed in the light of new resource constraints presented by COVID-19.
- Reconsider your company's locations, use of digital technologies and guidance to staff on remote versus office working.

How are Brexit and COVID-19 pushing in the same direction?

The combination of the two economic shocks is forcing firms to reconsider their footprint. Business leaders are re-evaluating their real estate and operations in the City of London. Large financial services firms began this process after the 2016 Brexit vote, with many considering whether it would be more cost efficient to move back-office functions out of London.

COVID-19 has added extra impetus to this trend, with a sharp increase in the use of digital and remote technologies, and a sudden, greatly increased move towards home working. It will be important to evaluate how this trend develops. Eventual recovery from COVID-19 is certain to lead to many workers resuming work in offices. But not all will and for many that do, not as often as before.

At present the changes we are seeing in plans for business locations and home versus remote working are an example of where the interplay of influences from COVID-19 and Brexit are pushing in a similar direction.

Closing thoughts: Move fast to re-evaluate plans, people and resources

The combination of Brexit and the COVID-19 pandemic confronts firms with an extraordinary challenge. There are a few key takeaways for business from our analysis:

- Time is short, businesses are not fully prepared and concrete Brexit plans are needed immediately. These should be across the board from supply chains and people, but also include regulatory and tax issues.
- Even if you have Brexit plans in place, they need to be reassessed given the changing context. Plans which may have made sense in the pre-COVID-19 context may not make sense now. Issues which might have seemed minor in the previous context may be of another order of magnitude when interlinked with COVID-19. Strategic decisions made fast as a result of COVID-19 will need assessing in the Brexit context.
- The resources available and allocated to implementing Brexit plans should be looked over again. Do the same teams really have the capacity and expertise to deliver at this point in time given all else that they have to manage?

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