A BREXIT RISK BAROMETER FOR SME MANUFACTURERS

How tough could things get?

MENZIES
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MANUFACTURING
INSIGHTS REPORT

FOREWORD

With Brexit approaching, it is more important than ever that manufacturers plan ahead. Understanding how individual risk factors might affect their business model is critical and the degree of risk exposure will vary from business to business. Business leaders must take ownership of the situation and prepare a bespoke Brexit plan to support them through the changes that lie ahead.

Without a clear understanding of how individual risk factors might affect their business model, small and medium-sized manufacturing businesses are in danger of doing nothing and facing the consequences. Without the resources to invest in accurate business forecasting and modelling systems, it can be hard enough knowing what next month's figures will look like, let alone planning further ahead at a time of Brexit uncertainty.

It is possible that the long lead up to Brexit may have caused a lack of focus on forward planning and for some manufacturers, the low value of the pound has provided a welcome distraction in the form of an uplift in profits. Despite the uncertainty surrounding Brexit and the nature of any transitional arrangements, it is becoming clear that trading relationships with European customers and suppliers are unlikely to remain the same. Regardless of whether Brexit is hard or soft, SME manufacturers are bound to be impacted – it's just a question of how much.

Heading for a future outside of the EU, SME manufacturers trading in Europe need a plan that is matched to the risk profile of their business, and they need to act now.

Caroline Milton
Head of Manufacturing

BREXIT CONTINGENCY PLANNING - is it happening?

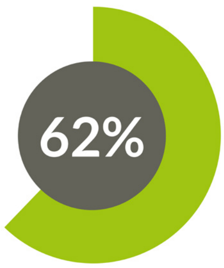
After months of waiting, the Government recently published a draft Brexit plan, setting out its proposals for a post-Brexit relationship between Britain and the EU. The plan contains a detailed draft Withdrawal Agreement governing Britain's divorce from Brussels.

Endorsed by the EU, the plan calls for an 'ambitious, wide-ranging and balanced economic partnership' between Britain and the EU after Brexit. However, the plan is subject to parliamentary approval and is unlikely to achieve this in its current form. It is also possible that further political instability could derail Brexit.

Still lacking any definite information about what future trading relationships with the EU might look like after Brexit, businesses should continue to plan ahead based on a range of potential scenarios.

The fact that the UK exported goods and services totalling £274bn to the EU in 2017 shows the level of investment that British businesses have in this marketplace. Furthermore, with over two million EU workers currently living and working in the UK, businesses are concerned they could lose access to this sizeable employment resource in the future as well as face short term challenges over identifying EU citizens' rights to work in the short term.

Statements made by some large, European corporates, such as Airbus and JLR, about how they might react in the event of a hard Brexit (by cutting jobs in the UK) have heightened concerns that current levels of trading activity and labour skills flow between the UK and Europe could be in jeopardy. Even more worryingly, the European Commission has advised European companies to think twice before using UK suppliers after Brexit.



of UK businesses have not carried out a Brexit risk assessment

Source: British Chamber of Commerce

The UK Government's decision to publish a series of technical notices in the second half of 2018, spelling out what action may need to be taken in the event of a hard Brexit, has accentuated fears of a worst-case scenario.

Most UK-based SME manufacturers know that they must do something to prepare now, but with so much political uncertainty, there is still a lack of urgency and understanding about where to start.

ONLY ONE THIRD

of UK businesses are preparing for Brexit

Source: British Chamber of Commerce

STEP ONE

RISK MAPPING

For a business reliant on EU imports, changes affecting tariffs and customs arrangements could pose a significant risk

- The risk profile of individual businesses will vary according to their structure, how they operate and the markets they service.
- Some risks are more evident than others. Research conducted by Menzies LLP with a group of 63 manufacturing business owners has revealed the top five risk factors as cash flow difficulties; breaks in supply; geopolitical uncertainty and its effect on trading activity; a lack of resources (management time and skilled people) and difficulties accessing finance.
- For a business reliant on EU imports, changes affecting tariffs and customs arrangements could pose a significant risk (either through delays and/or increased costs), whereas a business reliant on sales to a single, sizeable customer based in continental Europe could find that reliance on this trading relationship is its greatest risk factor.
- Understanding where risk lies is important and will help businesses to prepare a bespoke Brexit plan.

STEP TWO

FORECASTING

Cashflow forecasting should also be carried out regularly to ensure the business is managing working capital efficiently

- Once risks have been mapped, businesses working with their advisers can identify key indications from their own or open source information to act as a barometer and enable them to react quickly to potential challenges.
- This could be as simple as staying abreast of what key customers or suppliers are doing, or keeping track of statistics related to EU workers, which could indicate an increased pressure on skills is heading their way. Increasing global trade tensions could impact supply chains and businesses may need to assess their risk exposure.

- Cashflow forecasting should also be carried out regularly to ensure the business is managing working capital efficiently and to avoid cashflow difficulties. This process involves understanding where cash is in the business, getting an accurate view of its underlying profitability and predicting any flashpoints that could impact on cashflow. In some instances, some simple structural changes could avert a potential cashflow crisis.

- The forecast should be flexed to model different business scenarios.

STEP THREE

DEVELOP A BREXIT PLAN

For businesses concerned about a drop off in orders, it may make sense to renegotiate contracts now

- Where there is a risk, there is usually some means of mitigation or a new opportunity, and either on their own or with the help of an adviser, SME manufacturers can put in place a bespoke Brexit plan.

- Whilst it won't be possible to eliminate Brexit related risks entirely, there are steps that most businesses can take now to avoid experiencing cashflow difficulties and alleviate potential pressures on their business.

- For businesses concerned about a drop off in orders, it may make sense to renegotiate contracts now, seeking to tie customers in for longer or consider switching to volume based purchasing in exchange for a lower price. Agreeing rebate orders over a certain value may also be possible.

- Structuring decisions may also need to be taken to de-risk the business model. For example, it may be possible to protect assets and shareholder value by placing them in a group holding company, separate from the trading company. A similar strategy could be adopted by businesses seeking to de-risk product innovation activity and protect intellectual property.

- If exchange rate fluctuations are a significant risk to the business, it may be possible to hedge risk or renegotiate arrangements in order to match the currency used for purchases and sales. Alternatively, it may be possible to form strategic alliances to pool the FX risk with other companies.

MENZIES' BREXIT BAROMETER

Menzies' Brexit Barometer is designed to help SME manufacturers to identify and mitigate ten common Brexit-related risks

FUNDING

IMPACT	ACTION
A 'no deal' Brexit could result in SME manufacturers no longer having access to European Structural Funding (ERDF and ESF). To replace these funding streams, the Government is planning to introduce a new UK Shared Prosperity Fund. UK businesses could also lose access to research and innovation funding programmes, such as Horizon 2020. The Government has provided a guarantee to underwrite Horizon 2020 projects already underway in the UK.	• Review funding arrangements • Consider impact of an immediate break in funding from the EU • Review Business Support Finder to identify other funding sources

INTELLECTUAL PROPERTY	Pan-European patent protection and rights of enforcement should continue to be available to UK manufacturers after Brexit. Other areas of intellectual property protection could pose more challenges – for example, trademarks and registered design rights. Businesses may need to take action to avoid the risk of brand assets being undermined or copied. Creation of new IP may be impacted by Brexit related factors including access to talented staff of which a number historically have been EU nationals	• Review IP portfolio • Consider impact of Brexit on existing and future IP assets • Consider whether any special visa schemes might be available to access talent (e.g. Exceptional Talent or Tech Nation Visa) • Explore whether Catapult Centres or other support mechanisms such as Knowledge Transfer Partnerships can be used to accelerate innovation
IMPORTS	In the event of a 'no deal' Brexit, UK manufacturers reliant on raw materials or goods sourced from continental Europe may be required to pay customs duties on these imports. These could be based on World Trade Organisation (WTO) tariffs. Depending on the category of goods being imported, the amount payable could be up to 10%. In addition, customs delays are likely, with an increase in border control checks. HMRC is in the process of introducing a Customs Declaration Service (CDS). From 29 March 2019, customs declarations will be needed when goods enter the UK. In addition, a safety and security declaration may be required by the logistics provider. In the event of a 'no deal' Brexit, HMRC intend to allow the postponement of accounting for input VAT on goods imported. This means the VAT incurred can be declared on via the companies VAT return, rather than at the border.	• Consider alternative sourcing strategies – eg. partnering with other manufacturers, if using the same products or based in the same location to minimise the cost impact of stock holding • Consider the use of bonded warehousing to delay VAT payments. • Review exposure to import tariffs • Consider the need to register for an EORI number • Understand what commodity codes will be required for customs declarations • Consider how customs import declarations will be submitted • Consider the impact of potential delays as a result of border checks • Consider having an overseas investment base to minimise the number of times goods cross borders • Evaluate UK material sources and consider if time and cost efficiencies can be achieved
EXPORTS	Exporting goods to continental Europe is likely to attract tariff payments after Brexit. This could increase the cost of bringing goods to market in the EU significantly. UK manufacturers may need to consider whether it is possible to reduce the number of cross-border goods movements and consider the financial impact of absorbing any cost increases. HMRC is in the process of introducing a Customs Declaration Service (CDS).	• Consider reducing cross-border movements and plot goods movements • Consider outsourcing manufacturing processes or the potential to acquire or set up a facility in continental Europe • Consider the need to register for an EORI number • Consider how customs export declarations will be submitted

	From 29 March 2019, customs declarations will be needed when goods leave the UK. If you are VAT registered it is expected that you will be able to continue to zero-rate sales of goods to the EU.	• Consider the impact of potential delays as a result of border checks • Consider what import tariffs your EU customers may incur, and the impact of your competitiveness/ pricing
PEOPLE	UK manufacturers are unlikely to have unrestricted access to low-skilled EU workers in the future and in the short term may face challenges in determining the right to work where individuals have not yet applied for settled status. Some EU workers could choose to leave even though the UK Government has given assurances that those already living and working in Britain will be allowed to stay. Low-skilled EU workers could become a more sought-after commodity, which could lead to shortages and drive up wage costs. The UK Government has also indicated its support for proposals to raise or remove the cap on highly-skilled migrants. This could increase global mobility and provide an opportunity to source highly-skilled workers from countries beyond the EU, although this may come at an increased cost due to visa and right-to-work requirements.	• Review recruitment strategy and people risks • Consider incentives to increase retention of existing EU workers • Consider whether any special visa schemes might be available (e.g. Exceptional Talent or Tech Nation Visa) • Consider global recruitment and carry out an assessment of the costs of visa, permits to work, relocation fees and likely timescales • Consider investing in talent development and measures to ring-fence/support migrant workers
INVESTMENT	SME manufacturers have become more cautious about capital investment since the EU referendum. This cautiousness is being fuelled by uncertainty about the direction the UK economy will take after Brexit. A study by the EEF reveals that three quarters of SME manufacturers are planning to hold or cut investment levels in the next two years. There has also been an increase in the number of businesses planning to 'hold off completely'. Under investment in technology could impact the performance of SME manufacturers after Brexit. There is a risk that businesses could fall behind if competitors invest in game-changing technologies such as data analytics, automation and robotics.	• Review investment plans and consider the timing of investments to optimise tax planning opportunities. This is particularly relevant due to the £1m Annual Investment Allowance (AIA) that has been introduced in the recent Budget from January 2019 to December 2020 and could provide a significant short term cash benefit • Consider them against various economic scenarios • Consider alternative opportunities (e.g. Catapult Centres) to access machines particularly when exploring new products or looking at low volume manufacturing

INTERNATIONAL EXPANSION	In view of uncertainty about the UK's future trading relationship with the EU, some UK manufacturers may wish to expand into other overseas markets. Before doing so however, it is important to take advice about market demand in new territories and take steps to understand regulations, the tax landscape and any other local requirements. Preparatory steps could take longer in some countries than others.	• Assess opportunity in target territories • Weigh up the costs and risks linked to these markets • Consider admin, expertise and resourcing costs • Seek support, guidance and advice from those who have made the move overseas • Seek support and guidance from Menzies international network, HLB International
SUPPLY CHAIN	Over reliance on a large customer or supplier could increase Brexit-related risks. These risks include disruption due to supply chain changes, potentially leading to a break in supply. UK manufacturers should spread their risk where possible and stay close to all key customers/suppliers to gain an insight into their plans and understand their financial robustness. It may be necessary to impose credit limits or other controls.	• Assess supply chain risks both from a customer and supplier perspective • Consider alternative strategies to spread or otherwise control risks • Consider how to resource closer supply chain management/ build strategic alliances (e.g. consider sharing unused apprenticeship levy) • Look to secure renegotiated contracts with customers/ suppliers, seeking to mitigate risks
CURRENCY	Exchange rate changes can have a big impact on trading performances, particularly if an SME manufacturer is sourcing goods from Europe or the US and paying for them in Euros or US dollars.	• Assess risks linked to exchange rate volatility • How could volatility impact business forecasts? • Consider aligning trading currencies • Consider using an FX agent or hedging to further mitigate the risk of volatility
REGULATIONS & CERTIFICATION	The UK Government is planning to introduce new UK legislation during the Brexit transition period. The UK Withdrawal Act will come into force, repatriating European statutes into UK law and ministers will be able to make corrective changes. Legislative steps will also be taken to ensure EU and UK legislation remains aligned in the future. Depending on the products being manufactured, new regulatory approvals or certification may be required before goods can enter the EU marketplace.	• Assess risks linked to legislative change • Assess risks linked to removal of EU regulatory controls/certification • Ensure contracts and international terms and conditions show that you are an importer or exporter

AFTERWORD

UK manufacturers need to take action to prepare for Brexit and they will need to start by getting a better understanding of the financial impact its risks could pose.

Assessing risks, improving business forecasting and alleviating pressure on cash flow can all help to inform decision makers and equip them to make the right choices at the right time.

Rather than attempting to do this alone, SME manufacturers should seek external support to steer them through Brexit and beyond.

CONTACT

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