EY DKM

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Brexit watch

Monthly briefing on Brexit developments

In this issue

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Earlier this week MPs voted on various amendments to the UK Government's Brexit withdrawal plans. MPs voted, in a non-binding amendment, to reject a no-deal. While MPs voting to reject a no-deal outcome will dampen worries and risks surrounding a no-deal, Europe stands firm that the Withdrawal Agreement cannot be reopened. The Brady Amendment, which was a vote to change the Withdrawal Agreement and remove the Backstop will put the EU and UK at odds once again. The amendment calls for 'alternative arrangements' - which accomplishes little when the backstop is there specifically to deal with the failure of exactly such alternative arrangements!

The votes also had wider consequences. The Prime Minister (and the UK) increasingly appear to the world as an erratic negotiating partner. In the short term, the EU will view the last few weeks as confirmation of why the backstop is needed. Longer term, it is interesting to consider how countries will now view the UK in a trade negotiation. Specifically, how to conduct a negotiation with a counterparty who is willing to insist on something now, only for them to disavow it later?

The EU heaped more pressure on Brexit negotiations in mid-January by outlining in the event of a no-deal that it is 'pretty obvious' physical infrastructure would be required i.e. a hard border. Of course any mention of a hard border on the Island of Ireland does not sit easily with the Irish Government. Tánaiste Simon Coveney outlined that the government will not support the re-emergence of a border. A Government spokesperson also confirmed that they will not accept a hard border and therefore are not planning for one.

A press release from Minister Donohoe earlier in the week said that under a no-deal exit of the UK from the EU, the Irish economy could be 4.25 per cent smaller than current projections over the medium term. Employment would also be affected with slower increases and the unemployment rate could rise by 2 percentage points. The modest budget surplus projected for 2020 would turn to a deficit.

Outside of Brexit there have been growing calls from within Europe to scrap member states' veto on tax policy, an idea which was immediately rejected by the Government. Ireland's tax policy continues to be key to supporting competitiveness and changing to a weighted majority – rather than the current unanimous voting system – which will dilute and hinder fiscal policy sovereignty.

1 Political Developments

United Kingdom

Meaningful vote result

Theresa May began 2019 with her Withdrawal Agreement suffering a huge defeat in the House of Commons. While the Withdrawal Agreement was never expected to pass, the magnitude by which the 'meaningful vote' was voted down was on the upper end of expectations and was the largest defeat in the modern parliamentary era.

Opposition leader tables motion of no confidence

The failure by the British Prime Minister to get a workable solution to Brexit passed through the House of Commons led the Labour Party leader to table a motion of no confidence in the government, a vote which the government subsequently won. This vote was perhaps most notable for the relative lack of impact it had and further points to the inability of Labour to make a significant impression on the Brexit process or its associated politics.

The current state of affairs

Cross-party talks failed to find a solution to the deadlock and possibly contributed to the outcome on Tuesday of having a profusion of amendments being tabled. On Wednesday the British Parliament voted on a series of amendments to the Governments Brexit plan. The Cooper Amendment which could have facilitated the delay of Brexit by 9 months was defeated by 23 votes. The Spelman Amendment, which is a non-binding agreement to reject a no-deal Brexit, was passed by just 8 votes. The Brady Amendment which focussed on negotiating legally binding changes to the Withdrawal Agreement and remove the Irish backstop was passed by 317 votes to 301. Following the vote EY's Brexit outcome likelihoods changed. Extending Article 50 is now at a 60% likelihood, a second referendum decreased to 15% while a general election within the next 12 months is now at 30%.

Business reaction

Businesses and business organisations have been increasingly strident in January as they lose patience with the failure to provide clarity or a path to a deal (of any description). Chief Executive of the UK Chamber of Shipping has urged MPs to put aside party politics and focus on the bigger picture and what is best for the UK. Airbus re-entered the fray (after a high profile intervention in June 2018) and warned that 'no-deal' could lead to Airbus pulling out of the UK.

Countdown to Brexit

57Days

Ireland (NI & ROI)

Central Bank of Ireland Bulletin

The first Quarterly Bulletin of 2019 published by the CBI has outlined that a no-deal Brexit represents the worst-case scenario for ROI. The Bulletin examines the macroeconomic implications to ROI in the event of a no-deal Brexit. In this instance, there would be a 4 percentage point loss to economic growth in the first year. CBI analysis shows the long-term effect of a no-deal Brexit could be a 6 percentage point decrease in the level of ROI output over a 10 year period.

UK employees turn to ROI

Recent research from the recruitment website Irishjobs.ie has shown that, in the past year, the number of UK based employees applying for jobs in ROI has increased by a third. Job seekers from the UK now account for over a quarter of all international visits to the website. As ROI draws closer to full employment and with the CBI's forecast for ROI unemployment set to reach 4.9% in 2019, it looks like the job market could undergo a new surge in human capital.

NI business community reacts

The business community in NI has said that a no-deal outcome would be an unmitigated disaster for the economy and society of NI. Chief Executive of Retail NI, Glyn Roberts, has said it is not acceptable for the UK Parliament to continue to create uncertainty. New analysis by the Confederation of British Industry has outlined that a no-deal Brexit could cost the NI economy approximately €5.7bn over the next 15 years. The Confederation of British Industry analysis also highlighted that NI's manufacturing and agri-food sectors are particularly exposed to higher tariffs and trade costs.

Europe

Politicians in Dublin have warned there is no room for manoeuvre on the issue of the backstop. On Monday this comment was mirrored by the European Commission, which stated the backstop component is not open for renegotiation.

2 Industry watch

Ankit Thakkar

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Introduction

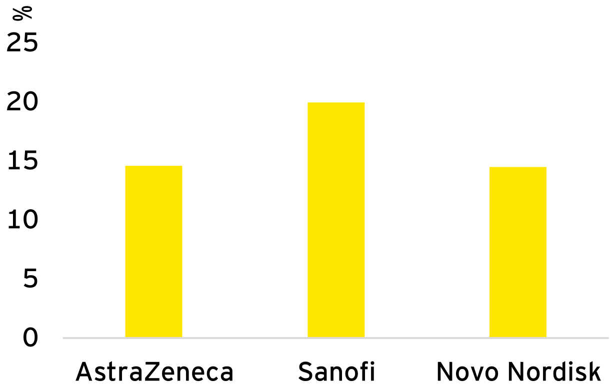
One of the industries expected to be significantly impacted by a no-deal Brexit is the pharmaceutical industry, which contributes over €34 billion to the UK's GDP. The European Federation of Pharmaceutical Industries and Associations (EFPIA) signalled a 'very, real, tangible, and immediate' threat to public health in the UK as well as in the EU as a result of a 'disorderly' Brexit and the disruptions in the pharmaceutical industry.

Impact on the pharmaceutical industry

Every month, 45 million packs of medicines are exported from the UK while 37 million packs are imported into the country (~1 billion packs per year). To put this in perspective, the UK exported €1.5 billion worth of pharmaceutical products to Ireland whereas imports from Ireland stood at €2.6 billion in 2017. The Association of the British Pharmaceutical Industry (ABPI) has asserted that there will be a disruptive impact on the supply chain of medicines due to a no-deal Brexit, and therefore asked the pharmaceutical companies to make this the top priority. For the same purpose, the British Government has asked the pharmaceutical companies to have at least 6 weeks of additional backup of medicines.

Accordingly, major pharmaceutical companies like GlaxoSmithKline, AstraZeneca, Pfizer, Sanofi, have been preparing for the worst-case scenario and are stockpiling medicines. For instance, AstraZeneca's management (in an interview with the BBC) commented that, as a safety net, they will increase the amount of finished medicines available to pharmacies and hospitals in EU countries and are increasing the stock of medicines to 20%. Likewise, French multinational Sanofi – the leading supplier of insulin – has highlighted that it will increase its stock for a range of medicines from its usual level of 10 weeks to 14 weeks, implying a 40% increase in backup stock. Similarly, the Danish pharmaceutical company, Novo Nordisk, has doubled its stock of medicines from a usual 7-8 weeks level to 17 weeks, according to Bloomberg.

Inventory as a percentage of revenue



Source: S&P CapitalIQ

Another key issue is the lack of clarity on licensing and drug packaging regulations. Currently, pharmaceutical companies in the UK register their products with the European Medicines Agency (EMA) for marketing in the EU. However, in the event of a no-deal Brexit, the licensing procedure might become more bureaucratic as the companies would have to have their products registered with both the EMA and the Medicines & Healthcare Products Regulatory Agency (MHRA) separately. As a result, firms are transferring licenses to avoid this new process. Merck Sharp & Dohme (MSD)'s Vice President (Regulatory Affairs), Alan Morrison, told The Scientist that the company has been transferring centralised licenses to other MSD marketing authorisation holders in the EU from the UK for as many as 40 of its products. Furthermore, The Scientist reported that UK companies like AstraZeneca and GlaxoSmithKline have been spending millions of pounds to make arrangements to accommodate new regulations on drug packaging.

A no-deal Brexit is also expected to impact the free movement of people. Companies like Eli Lilly, who have a major base in Cork, are anticipating a lower proportion of non-UK applications in the UK after Brexit. On the other hand, The Independent stated that firms like Sanofi are moving staff from the UK to other locations in the EU to prepare for no-deal Brexit.

Conclusion

A survey conducted by the EMA in September 2018 on 180 market authorisation holders signalled alarming concern that pharmaceutical firms are not fully prepared for Brexit. While the companies are actively undertaking measures to brace themselves during the transition phase, there is a high level of uncertainty that the actions taken in relation to the transfer of licensing and making arrangements for new drug regulations may not be completed in a timely manner.

3 Business developments

The narrative of extremes

The return of political leaders to Westminster after the holiday season and the ensuing vote to reject May's Withdrawal Deal and subsequently to seek alternative arrangements to the Northern Ireland 'backstop', have done nothing to allay businesses' rising concern. With two months left until the UK exits the EU, it is alarming that no material way forward has been devised. Simultaneously, there is mounting discussion of stopping Brexit altogether, even among politicians and business leaders. This emerging narrative of extremes – that of 'no-deal or no Brexit' – is compounding uncertainty and frustration.

Current Brexit outlook

	% likelihood (as of 30 January 2019)	Increase/decrease in probability since December issue?
WTO (no-deal)	25	↑
Free Trade Agreement	15	↓
Customs Union	10	↓
Hybrid arrangement	35	↑
Stopping Brexit	15	No change

Source: EY

Our current outlook

The myriad of possibilities is apparent. Despite public and political opinion actively objecting to a no-deal, the Cooper Amendment to reduce the possibility of this by instructing May to request an extension of Article 50 was rejected by MPs this week (albeit by only 23 votes). No-deal has not been taken off the table as the Cooper Amendment had hoped, but rather is a growing possibility. Although the Spelman Amendment - which states that the UK will not leave the EU without a deal - was passed, this carries no legislative force. Furthermore, even if Article 50 were to be extended, there would still be no guarantee that an eventual no-deal scenario would be averted. Therefore, until such a time as a deal is agreed, businesses must continue to plan for the worst. At this stage, 'Brexit fatigue' is inevitable, but mitigation strategies have never been more important. Previous issues of Brexit Watch have touched on outsourced models to minimise sunk costs, if the worst case scenario never materialises.

EY capital agenda blog

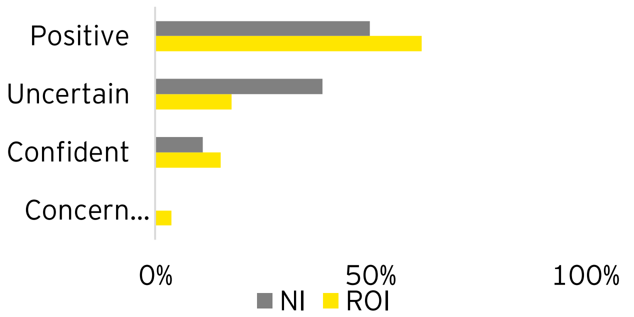
The final Profit Warning Index from 2018 reflected the material impact that uncertainty is having on businesses. With an average share price fall of 22.6% accompanying each profit warning, this is a record which exceeds even the falls preceding the 2008 financial crisis. Even more telling is the emergence of profit warnings in new sectors, as well as the exacerbation of already prevalent sectors. Namely, the percentage of retailers issuing warnings reached a decade-high record, representing a 50% increase on Quarter 4 2017.

These figures very starkly depict investors' current sentiments; an unsurprising self-fulfilling of political volatility and market fatigue, which was touched on in October's issue of Brexit Watch. However, given the potential for an anti-climactic Brexit deadline, involving a deal, transition period or extension of Article 50, there could be upside potential for businesses and investors alike in the months ahead.

EY client sentiment

This positive, resourceful attitude is reflected in a range of in-house surveys. Based on tracking our client sentiment, it is extremely encouraging that only 3% said 'concerned', as opposed to the 74% who said 'positive' or 'confident'. No respondents described their clients taking any actions such as divestment or lay-offs. Perhaps current uncertainty and falling confidence indicators (partly reflected in falling share prices as detailed above) are being viewed as mere volatility or speculation, and as such businesses are too occupied with other issues to linger on this. Of course, as the below table suggests, uncertainty is prevalent, particularly amongst NI based clients. Whilst this may mean temporarily pausing investment plans, it is encouraging that retrenching actions are not taking place. Having said that, many clients are closely focused on cost reduction and efficiency measures.

How would you best describe your current mood?'



Source: EY sentiment survey

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