

THE IMPACT OF BREXIT ON THE UK FOOD SECTOR: RESHAPING THE VALUE CHAIN



The UK food and beverage sector face unprecedented ongoing disruption and instability following the vote to leave the European Union. The impact is likely to be significant, as the food industry is by far the largest manufacturing sector, accounting for 16% of all manufacturing turnover (£83.7bn per year), and employing nearly 4 million people in the extended food value chain, contributing over £21bn to the British economy per year.

Immediate economic effects are here to stay

The after-effects of the vote to leave have already begun to impact businesses, driven primarily by the relative increase in the cost of imported ingredients, following the reduction in value of the pound against the Euro by over 10% since June 2016.

In early December, a manufacturer of both private label and own brand biscuit and cake products was forced into administration citing the inability to absorb double-digit cost increases and operate in the current financial climate. More recently, a well-known meat product manufacturer announced similar challenges. Businesses have dealt with currency fluctuation before, but it is expected that this devaluation will become structural rather than cyclical. Legacy currency hedging deals are already running out, and so businesses need to find new ways to reduce and limit their exposure in the short term from both a procurement and resale perspective. This cost impact is difficult to pass on to the consumers, who are used to low and competitive pricing, driven in part by the growing market share of discounters, and the introduction of new entrants.

Conversely, companies with large export markets are seeing an uplift in business as exports become cheaper. This short term benefit is unlikely to last however, as tariff rates are anticipated to be introduced, which will have a significant impact on the cost of both imports and exports. Some estimates suggest that the sector could see tariffs rise between 10% and 30% for many raw materials, ingredients, and finished goods across the food and agricultural products sector. The impact is particularly complex for pan-European organisations actively trading across borders, which have previously consolidated manufacturing into large sites, strategically located to take advantage of labour and raw material supplies.

The potential impacts of tariff increases are already being considered throughout the food value chain. Access to the single market and Common Agricultural Policy are key topics for British agriculture and produce suppliers, as outlined in recent announcements from the National Farmers Union (NFU). The announcements were backed by over 70 leading British food sector companies with combined revenues of over £92bn and employing nearly a million people (including Sainsbury's, Morrisons, Marks and Spencer, and Weetabix). Concerns about the viability of the EU market and access to labour from across the European Union, one of the major drivers of the voting turnout, is likely to be restricted and/or become economically unviable. Migrant workers, often on zero-hour contracts, will simply return to mainland Europe where they will get a better deal without currency fluctuation.

Either way, the currency impact is already being felt in the sector, as the reduction in value of wages for the EU workforce operating in the UK (120,000 people directly employed in the sector, 29% of total) means that jobs in the UK are simply not as attractive as they once were. The NFU has already warned of an imminent labour crisis following a sharp fall in the number of seasonal workers — overwhelmingly from the EU — willing to pick vegetables on Britain's farms.

The impending regulatory black hole

The lack of a clear plan from the UK government as to what might replace the support provided by the Common Agricultural Policy post-Brexit is adding to the widespread uncertainty in the sector.

Once the Article 50 announcement is made, likely in March 2017, there will be two years to make arrangements to establish UK-specific laws, regulations, rules, and policies governing topics such as quality, food safety, food security, and stewardship, to replace those currently in use. It is sensible and likely that existing policies will be used as a template, but that policies will diverge over time. This will inevitably lead to administrative and legal gaps between the way that the UK, the EU, and the rest of the world, govern their food sectors.

This has the potential to have a significant impact on suppliers and manufacturers as rules around topics such as customs licences, animal passports, and product provenance could potentially be complex and difficult to manage along the value chain and may encourage incursion of cheaper non-EU alternatives to existing imported products from EU, i.e. dairy from New Zealand and Australia, meat from South America and the Far East. This may lead to potential for food safety and quality risks, lack of trust across borders, and in the consumer community.

Robust and flexible operational processes and strong governance will be critical during the transition to the post-Brexit operating environment.

Reshaping the value chain for customers and businesses

The economic and regulatory impacts of Brexit, short term and long term, will clearly impact both product costs and the complexities of the administrative burden, but will also shape the way value chains are constructed and operated from a cross-border perspective, and indicates that a keen eye should be focused on preparing now for these likely impacts. The effects of Brexit are being felt now across the sector and will continue to evolve as the Brexit process continues. Most businesses cannot afford to wait to 'see what happens'.

Access to European-wide large scale integrated manufacturing will become more complex for FMCG and food manufacturers due to need to address tariff and customs requirements, and the introduction of any new and/or different UK laws and policies driven out through the Brexit process.

For example, in a potential future state, milk produced in the Republic of Ireland which is transported a few miles over the border in to Northern Ireland for conversion to an intermediary product, then re-shipped back to the Republic for finishing and sale would incur both import and export duties, and the associated pain of handling customs processes and administration, for the sake of the location of legacy manufacturing facilities which under the current regime are able to take advantage of the single market, i.e. no tariffs or customs constraints.

The example illustrates that the UK could potentially be excluded from pan-EU supply chains, and may encourage the establishment of local facilities to serve local markets, both within the UK and the EU, which presents both opportunities and challenges. However, the Brexit negotiation outcomes and the scale to which the UK is included or excluded from EU trade agreements will be a key driver in this realignment.

In spite of the challenges associated with Brexit the UK is currently, and is likely to remain, a net importer of food and beverages (approximately £20bn differential), and as such these supply lines will need to remain in place in order to provide enough food for both consumption and manufacturing requirements.



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Therefore, a range of alternative operational and product cost reduction and revenue enhancement tactics are likely to come into play, in order to overcome the economic and regulatory barriers:

- **Value engineered recipes and products** – Some manufacturers are already “re-engineering” their products to make them smaller. For example, substituting ingredients for cheaper or alternate versions i.e. oil instead of butter, reducing product size but retaining the original price. This is a risky strategy, however, from a brand reputation and quality perspective.
- **Sourcing from outside the EU** – Products which are currently uneconomic from outside the EU may become more viable and attractive to UK retailers and manufacturers, dependent on the outcome of tariff and trade negotiations, i.e. dairy from New Zealand and Australia, meat from South America and the Far East. This has the potential to maintain the cost base, however, could pose supply chain security and quality risks, especially as the administration of product value chains becomes more complex and difficult to track.
- **Relocation of production activity** – Production for the UK market is likely to be conducted within the UK in the future, to avoid import tariffs on finished goods. Other constituent imported ingredients may still attract a tariff, but these should be lower than for finished goods, resulting in the potential for increased price points for UK consumers.
- **New product development and adjustment of product range profiles** – If input and tariff costs increase, it is likely that the retail price for food products will also need to rise. This may lead to an increase in the development and availability of alternative products (substituted ingredients, recipe changes, etc.) enabling the retailers to offer a similar product at a lower cost, whilst retaining the same retail price point.
- **Supplier collaboration** – There is intense competition between retailers for the hearts, minds and wallets of UK consumers which impacts shopping baskets across the country, keeping a cap on price rises. For many food retailers however, the effects of Brexit will increase the commercial stress with their suppliers around price and cost. The recent public fallout between Unilever and Tesco around price increases is reflective of the stress felt within the industry. Recognising that this is genuinely a shared problem and finding new ways to collaborate can help take costs out for both of parties without reducing the value for customers.
- **Technology investment** – In order to limit the impact of labour cost risks, and to increase productivity to keep production costs under control, some businesses may choose or need to invest in new and additional technologies and production capabilities. The added benefit could also be expansion in to product lines currently not in production.

What does the future hold?

Looking to the next stage of the Brexit process, the good news is that the food and beverage sector should be an important part of the British government's negotiation strategy, and could play a significant part of the deal with the EU due to importance and value of trade.

Of course, the realities of the impacts of Brexit, for better or worse, will only be revealed in terms of tariffs, trade agreements, regulations, and so on, as the negotiations proceed. However, in the intervening time (estimates of upwards of ten years of instability), businesses need to address how to operate both in the transitional phase, and prepare their organisations for the conclusion of Brexit negotiations.

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