

Brexit: Building a Strategic Response

The U.K.'s pending departure from the European Union has dominated media and public debate over the past few weeks. While the rights and wrongs of Brexit are still being argued, most observers appear to accept that the referendum decision will have far-reaching repercussions not only for the U.K., but also for Europe and the global community — fundamentally altering the political, economic and commercial landscape.

For businesses, strategy always necessitates making calculated guesses about the future. Brexit makes the job harder by removing many of the constants of the past few decades. No wonder Brexit is top of the agenda in all boardrooms, demanding a deep rethink of corporate initiatives and priorities. The critical question is how to do it.

In times of significant discontinuity, one approach to business strategy stands above others: Scenario Planning. It is a powerful method for dealing with uncertainty, allowing executives to move away from making mere forecasts, and instead developing a number of scenarios that describe alternative ways in which the future might unfold. Scenario Planning is not about predicting what will happen, but “making choices today with an understanding of how they might turn out”¹. It can enable

business leaders to take back some control of their destiny by considering the implications that different futures will have for markets, customers, competitors and other stakeholders, and making plans for each eventuality.

Four Possible Futures for a Post-Brexit World

This paper sets out four possible scenarios for a post-Brexit future, based on how key elements influencing the future of Europe play out (see Figure 1). We explain the repercussions for businesses over the medium to long term, and highlight how L.E.K. Consulting's approach to Scenario Planning can help boards and executives prepare for the challenges ahead.

The strategic implications of the scenarios are profound, with significantly different opportunities and risks for companies, markets and industries. They are necessarily high level and individual companies will find huge value in developing their own, more specific and detailed scenarios built around the uncertainties particular to their own environment. This is especially important, as the key is not to predict the most likely scenario, but to understand how scenarios and their various components may or may not play out — and to define the appropriate strategic response in each case.

The Knowns and Unknowns

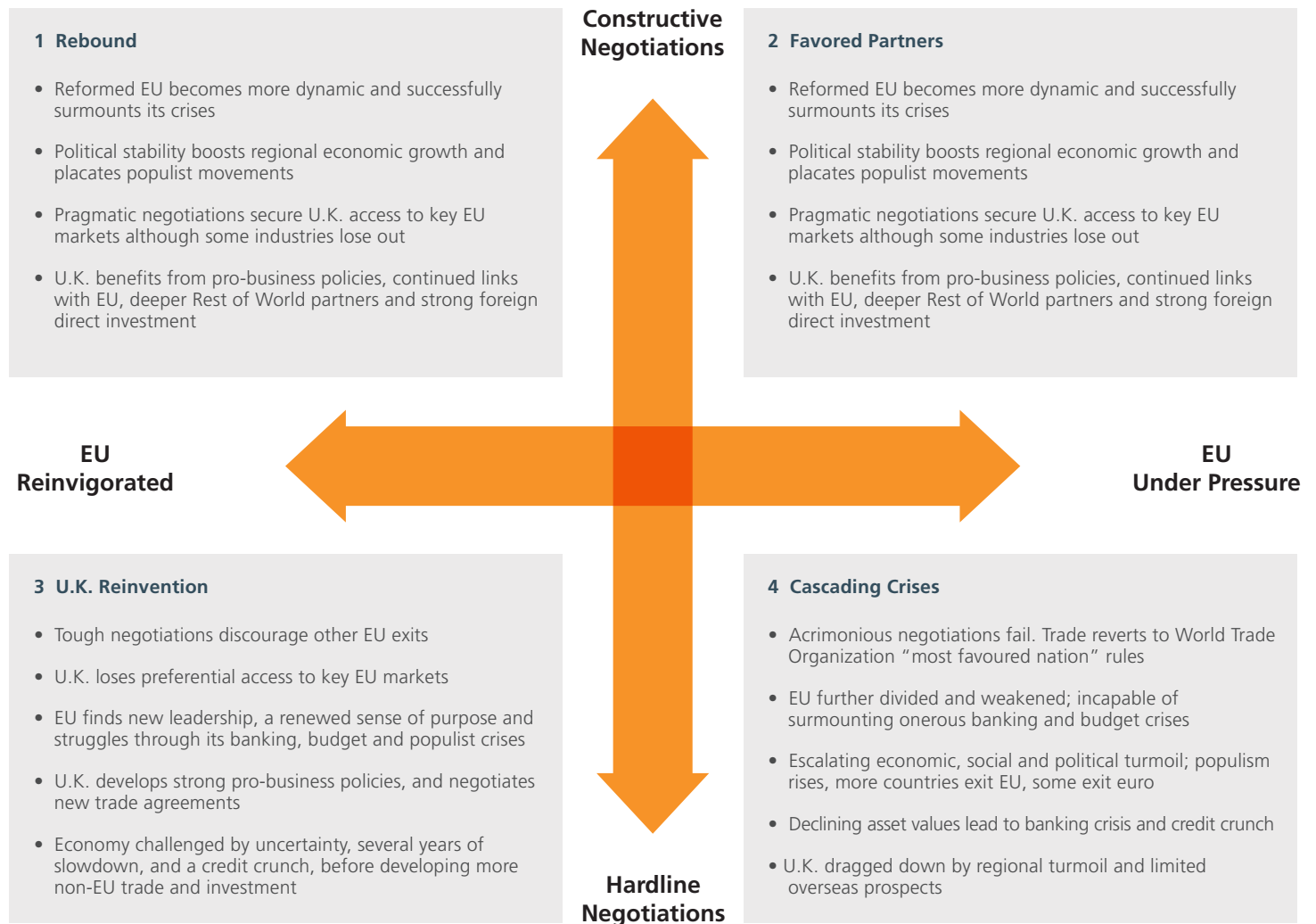
Brexit has upset global markets. Since the EU referendum on June 23, currency exchange rates have been especially volatile, with the GBP falling 10.7% against the USD and 8.5% against the EUR while the EUR-USD exchange rate has declined only 2.3%.

¹Schwartz, P. (1991) *The Art of the Long View*. New York: Doubleday Currency.

Brexit: Building a Strategic Response was written by Partners **Peter Debenham** and **Aubry Pierre**, and **Mark Boyd-Boland**, a Manager. Peter and Mark are based in London and Aubry divides his time between London and Paris.

For more information, please contact strategy@lek.com

Figure 1
Characteristics of Four Possible Brexit Scenarios



Source: L.E.K. analysis

Stock markets, which dropped immediately after the vote, have recovered good ground, but construction sentiment, banking stocks and consumer confidence have trended downwards amid fears of a U.K. downturn.

On the political front, Theresa May's rapid appointment as U.K. prime minister has restored some confidence in the government, but Brexit negotiations are likely to be long and complex. Concerns about the future will continue to trouble financial markets and businesses for a considerable amount of time.

Some key questions include:

- How will EU-U.K. relations be structured?

- Will EU leaders play "hardball" with the U.K. to deter further exits from the EU?
- What EU regulations and policies will the U.K. be prepared to accept?
- What industries will the U.K. prioritize in negotiations (and which could be sacrificed)?
- Where will the U.K. government step in to replicate existing EU subsidies?
- Will Brexit lead to further changes in the composition of the EU and / or the U.K.?

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Clearly, the economic environment will differ in each scenario and will therefore impact the prospects of businesses differently. However, we have sought to highlight differential “winners and losers” in each scenario, rather than in absolute terms. In addition, given the broad range of current EU-related trade tariffs (for both imports and exports), there will be “natural” winners and losers as new trade deals are negotiated on more or less favorable terms than those in the EU, the U.K. included, currently face (as the Transatlantic Trade and Investment Partnership negotiation has hinted).

Scenario 1: Rebound

One benign scenario for Brexit is that the shock causes a rethink of EU priorities, leading to renewed dynamism in the EU institutions and European markets. Under this scenario, constructive negotiations preserve U.K. access to most elements of the single market, even if some industries inevitably lose out in the negotiations as a result of the U.K.’s insistence on some restriction of free movement of people within the EU. The attractiveness of the U.K. for trade and foreign direct investment increases with a revitalized EU and openness to the rest of the world. Economic optimism restores political stability across the region, including in the U.K., further boosting growth and placating populist movements.

Business implications of scenario 1:

- The winners have the strategic conviction to exploit short-term discontinuity and currency devaluation to invest, or to use M&A to consolidate relative underperformers as a platform for growth as European economies slowly recover. Businesses prosper that leverage the U.K.’s greater openness to the rest of the world, act as a strategic gateway to the EU, and integrate even more deeply into global supply chains, as do U.K. businesses that rapidly exploit new opportunities with non-EU economies.
- Industries that are sacrificed in the negotiations with the EU suffer from restrictions on ownership or trading rights. Depending on what immigration is permitted, businesses relying on large numbers of foreign staff stagnate. Companies struggle if they are unable to adapt to the increasingly dynamic EU-wide competitive market or fail to capitalize on new export opportunities.

Scenario 2: Favored Partners

A weakened EU fragments further into a multi-speed model. Larger EU economies take the lead in EU-U.K. negotiations to prioritize their own interests. Populism and nationalism rise and a few other countries exit the EU. Social turmoil in the EU creates political uncertainty, reducing economic growth across the region and a

disjointed EU struggles to coordinate and manage several major shocks (e.g., national budget crises, banking crises, new migration crises). The U.K. concludes favorable trading arrangements with most strategic EU partners in return for moderate contributions and some migration limits. The U.K. adapts to a significantly different landscape and experiences stronger economic growth than the EU, driven by acceptable deals with key EU countries, and new trade agreements with emerging markets and North America.

Business implications of scenario 2:

- Successful industries organize themselves to ensure their voice is heard at the negotiation table. Businesses with European interests insulate themselves from the adverse impact of the EU slowdown by emphasizing non-EU opportunities. Those offering products and services across Europe address the higher frictional costs of doing business: higher sales costs, pricing complexity, etc. They benefit if they move quickly to develop nimbler distribution and supply chain organizations. Low-cost operators capitalize on consumers and businesses trading down, especially those exposed to the euro depreciation caused by instability in the eurozone.
- Losing companies are those heavily exposed to weakening economies in a fragmenting EU, which are affected by the U.K.’s exclusion from key aspects of the EU single market or fail to exploit new global opportunities. Large multinationals operating complex supply chains across multiple EU geographies are forced to restructure as their cost to serve escalates. Companies unwilling to adapt rapidly lose share.

Scenario 3: U.K. Reinvention

The EU runs tough negotiations to discourage other countries from exiting, and the U.K. loses preferential access for a significant volume of services exports that go to the single market, as well as all EU / European Investment Bank funding. The EU embraces a renewed sense of purpose and successfully navigates Brexit, supported by a shift of key U.K. capabilities and foreign direct investment to strategic continental markets. In the U.K., renewed support for Scottish independence is quashed by a Spanish veto and low oil prices, as well as the absence of a suitable currency. The U.K. concludes trade agreements with former EU partners and new emerging markets, with which it can negotiate more freely and more rapidly. The U.K. economy is helped by pro-business policies and taxation, as well as domestic reinvestment of EU budget contributions and increasing trade with developing markets, but it goes through an important and painful transition with considerable uncertainty and a deep recession in the early years.

Business implications of scenario 3:

- The U.K. market environment undergoes profound change, and the winners are the nimble players that adapt quickly and rebalance their corporate portfolios in favor of non-EU markets. They move assets and capabilities to adapt to the new order. Those strongly dependent on EU business move headquarters and key assets to the EU to preserve value, benefitting the destination countries from the relocation of business activities from the U.K. They not only capture the foreign direct investment of companies formerly investing in the U.K. as a means of entering the EU, they also capture all future flows. Successful British players also aggressively and rapidly develop new non-EU markets. The numerous U.K. businesses with limited EU trading exposure benefit from a lighter regulatory burden.
- Loss of key financial services activities weakens the City of London and the broader south-eastern U.K. economy, with commensurate impact on U.K. GDP creation. Companies with integrated supply chains or sales networks across the EU restructure. Leveraged players face substantial headwinds as capital becomes scarce and expensive. Reduced immigration requires less housebuilding activity. U.K. businesses relying on the free movement of people within the EU to rectify domestic labour shortages are put under severe cost pressure.

Scenario 4: Cascading Crises

Long-running, acrimonious Brexit negotiations destabilize the region, inducing recession and a euro crisis. EU-U.K. negotiations fail and regional trade reverts to World Trade Organization “most favored nation” status. A divided EU becomes incapable of managing banking and budget crises, leading to a domino effect of declining asset values, tighter lending criteria, liquidity crunch and banking crises. Sovereign credit ratings are downgraded. The EU retracts in scale and scope. National interests lead to a rise in protectionist policies and countries introduce restrictions on the movement of people, goods and services. Populist parties gain influence, leading to a succession of exits from the EU and the Euro. EU division weakens NATO and pan-European cooperation on foreign policy. The U.K. turns decisively towards the U.S. and Asia, but London’s position as a global center is diminished due to its weaker links with continental Europe. The EU regulatory burden is lifted, but budgetary issues reduce room to manoeuvre on taxation and significant government-led infrastructure spending seeks to mitigate recession. The U.K. avoids a constitutional crisis as the EU is no longer an attractive proposition for Scotland.

Business implications of scenario 4:

- There are some opportunities for companies that have — or can rapidly develop — strong ties and winning business propositions outside the EU. However, the global economy is likely to be weak and competitive, with all European companies on a major export drive. Public investment in infrastructure benefits transport, energy and construction, while well-established larger companies gain in the short term from protectionism and global diversification. Low-cost operators capitalize on consumers and businesses trading down during recession and gain share.
- In this environment, most businesses are negatively affected by low consumer and business confidence, weak demand, tightening capital markets and rising bankruptcies. Industries that depend on the structure of existing EU regulation and subsidies are hit particularly hard. Leveraged players and business models are seriously challenged. Losers don’t reduce costs sufficiently and fail to restructure on-the-ground operations in the EU. Public sector suppliers must adapt to increased pricing pressure as a result of constrained national budgets.

Developing a Winning Post-Brexit Strategy

Which of the four scenarios is the most likely? What other scenarios exist? These issues are not the key point. Everybody has a “favorite” scenario, and most companies have an implicit “official future” which may be adequate in times of relative normality. In periods of severe discontinuity, however, a more robust approach is needed. Scenario Planning helps executives broaden their thinking across a range of potential outcomes, considering the big strategic themes that could significantly impact their business.

The system dynamics that will unfold over the next five to 10 years will bring into play many of the components of each scenario we have considered and will massively impact the values of all businesses in ways that are currently hard to envisage.

As a result, senior executives have an imperative to review their “status quo” strategies in the light of true scenario thinking in order to:

- Identify the key uncertainties their own company faces
- Understand the possible scenarios that may unfold in their industry and markets
- Determine what winners will need to do to succeed in each scenario
- Examine how well their current strategy would perform in each scenario

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- Define a winning strategy for each of the scenarios and identify what organizational capability gaps need addressing to ensure effective delivery
- Put in place a series of “early warning indicators” to understand which scenario is unfolding and what actions need to be taken

The four scenarios outlined above are generic; to prepare for Brexit, companies must develop scenarios tailored to their own circumstances and fully flesh out the strategic implications sooner rather than later.

L.E.K. Consulting is a global strategy consulting firm with deep expertise in Scenario Planning. We can help businesses assess the uncertainties caused by Brexit and prepare scenario plans and strategies to both avoid the pitfalls and capitalize on the opportunities created by this unique event.

About the Authors



Peter Debenham is a Partner and Global Co-Head of L.E.K. Consulting's Industrials practice. He has been with L.E.K. since 1996 and is a member of L.E.K.'s European Regional Management Committee. Peter has over 20 years of experience assisting corporate clients in developing distinctive strategies and improving their bottom-line performance.



Aubry Pierre is a Partner in L.E.K.'s London office, with more than 22 years' experience of advising leading corporations across Europe, North America, the Middle East and Asia. He focuses on corporate and business unit strategy, organizational strategy and corporate transformation. Aubry's expertise covers a range of industry sectors, including banking, insurance, retail, consumer goods and industrial products.

About L.E.K. Consulting

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