BREXIT:
A GUIDE FOR SMALL BUSINESSES

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Background

As readers are no doubt aware the UK voted to leave the EU in June 2016.

The long lasting effects are unknown and much will depend on the negotiation of trade agreements with the EU. Some commentators have suggested that the UK could be in recession for many months whilst others have suggested that this will all blow over and the UK will rapidly recover.

We have attempted to evaluate the worst case scenarios and impact on our small business clients.

We all need to be aware of the potential threats to the UK economy and our clients/customers and take appropriate steps in order to survive and to thrive.

Summary

The Bank Of England is likely to cut interest rates and provide liquidity facilities to banks in order to prevent another credit crisis and to calm the markets. Financial markets could be due to political or financial/economic reasons and its too early to predict what could happen in the future.

However, there is a potential risk of recession due to the fall in exchange rates, inflationary pressure and uncertainties affecting business and consumer confidence. Foreign investment may also fall.

The full impact of Brexit is not yet known and one of the key factors will be the negotiations of a new trade agreement with the EU. If the Norway/Swiss models are followed and UK businesses can access the Single Market for imports/exports and financial passporting then the impact of Brexit may be limited.

However, we have considered the worst case scenarios for our core sectors:

Financial services: In the short term, FCA firms should re-check financial forecasts, risk assessments and capital adequacy requirements. In the medium/long term they will need to consider whether they will need to migrate to the EU or setup a subsidiary to ensure passporting.

Tech startups: In the short term, cash burn and forecasts should be re-assessed as it could potentially become more difficult to raise finance if investors are nervous about the UK economy. In the long term, restrictions on movement of labour could reduce the talent pool and some of the infrastructure and benefits of operating in the UK.

Fintech: Could suffer the same problems as tech startups but could also be affected by lack of passporting or reduced demand from the financial services sector if they are suffering from Brexit.

Import / Export: Amazon sellers could suffer from double layers of taxation and tariffs if they'll now have to export goods to both the UK and EU separately, depending on how trade agreements are negotiated. Foreign goods could also become more expensive to UK customers, reducing to demand.

Contractors: Economic uncertainty could increase demand for temporary contracts if businesses are adverse to hiring new permanent staff. However, financial services could potentially suffer from job losses and temporary staff could also be affected. EU citizens need to check if they can stay in the UK and may be able to apply for permanent residence.

AIM/ISDX plcs: Equity markets have suffered and existing plcs may find it difficult to raise new capital. If the credit crisis of 2007-08 can be used as a guide then it may be difficult for new firms to list or to reverse in the near future, as many deals collapsed after the credit crisis.

Section 1) What happens now?

New Trade Agreements

It is not yet clear if the UK will lose access to the Single Market and the financial passport scheme, and this will be one of the key areas that the government will need to negotiate with the EU.

The UK government published a report on the possible models for the UK outside of the EU and this mentioned the following alternatives:

1) The Norway model: the UK stays in the EEA which would give them considerable but not complete access to the EU Single Market and financial passporting. Customs checks are still required on goods crossing into the EU but many goods traded are free from tariffs. Some goods, such as agricultural, may still be subject to tariffs.

   But this would require the UK to continue to implement any EU rules that form part of the EEA Agreement and contribute the EU's programmes and budget. The UK may also have to accept the free movement of people. As many of these requirements are precisely the "problems" that the Leave Campaign had issue with, they may be unwilling to comply with the EU's requirements.

2) The Swiss/Canada model: Bilateral agreements whereby the UK leaves the EEA but stays in the European Free Trade Agreement ("EFTA") or creates a new EU-UK Trade Agreement. This would require the UK to enter into lengthy negotiations to reach a settlement about higher levels of access to the Single Market, but it may not be full access. The UK would need to maintain "equivalent" legislation in certain areas and accepting free movement if following the Swiss model.

3) The WTO model: This would involve following WTO rules in no trading agreement with the EU can be reached. This would involve a complete break with the EU with no free movement, budgetary contributions or implementing EU rules. However if would lead to trade tariffs on imports/exports.

Changes in legislation

UK laws are currently intertwined with EU laws and directives. Our understanding is that the Justice Secretary is going to have to review all UK law and decide which parts they want to keep. This may need to be done by executive order with little or no parliamentary oversight. Any EU directive which is not specifically put into UK law directly could potentially become unenforceable. The nature of the EU-UK trade agreements will be important as the Norway/Swiss models, for example, would require that the UK still has to comply large parts of EU legislation.

Changes in taxation

VAT

Although VAT is largely a European tax it has been implemented in the UK under the VAT Act 1994. It is also popular with politicians due to the fact that it taxes people on their consumption even if their original income avoided or evaded taxation and raises a significant amount of revenue. Brexit could potentially make it easier for the UK to change the VAT rate or certain aspects of it. The UK may potentially no longer need to comply the rulings of the European Courts of Justice for VAT cases.

Other taxes

George Osborne previously stated that taxes would need to increase in case of Brexit. It is not clear whether he will remain as Chancellor of the Exchequer, but the next budget could potentially lead to higher taxes in the short term.

Section 2) Could there be a recession?

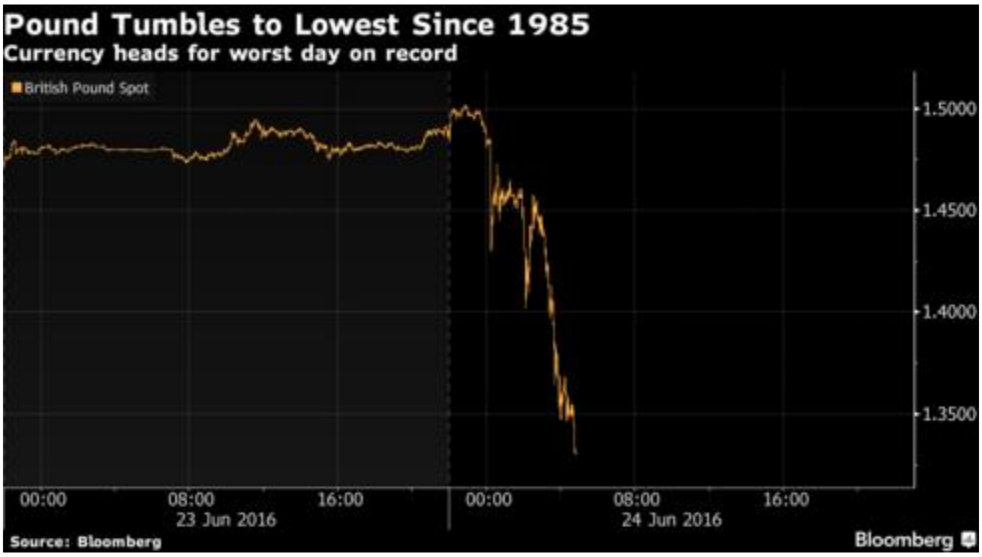
The Bank of England ("BoE") has sought to calm financial markets and the UK economy by stating that there won't be a financial crisis. They have also mentioned that UK banks are in much better health compared to the credit crisis of 2007-08 due to the new FCA/PRA regulations and increased capital and liquidity requirements. The BoE has also committed to providing £250bn liquidity (possibly supported by the ECB) to banks who require facilities to cope with foreign exchange liquidity, to continue providing credit *(unlike in the credit crisis)* and to supply other financial services to the real economy.

In the worst case scenario a number of commentators are predicting that the volatility in markets could potentially last for years whilst new trade agreements are drawn up and that there could be a lasting recession.

However, others consider Brexit to be a political event and the market volatility due to uncertainty rather than underlying economic reasons such as in the credit crisis of 2007-08.

Foreign exchange rates

GBP has depreciated significantly against foreign currencies. It was down by 8% against US$, which is double the loss of 4% during the ERM exit in 1992.



It is not clear whether or not this is a temporary fall or the start of a permanent devaluation, but the fall could potentially have the following significant effects in the short term:

1) The cost of imports could increase due to the higher cost of goods and also energy prices if the reductions in the US$ price of oil are less than the GBP depreciation. This could then put pressure on inflation.

2) Although the UK's exports would become cheaper and more competitive, the UK already has a significant current account deficit and this could worsen due to an unbalanced company relying on consumer spending, funded by debt. Many of the UK's exports are also made up by services which may not necessarily benefit from a fall in GBP.

<u>Interest rates (See also Appendix)</u>

Whilst many commentators suggested pre-Brexit that interest rates could rise, early indications are that the Bank of England will either hold interest rates at 0.5% or reduce them to 0.25% in an effort to stimulate the economy.

Government bonds could potentially suffer from a cut in credit ratings in future, however yields have fallen due to increased demand.

<u>Investment</u>

Foreign investment in the UK could fall. We have already seen a fall in the UK stock market, and whilst the FTSE 100 has partially recovered, the FTSE 250 has fallen significantly. This could indicate a flight of capital from UK stock markets (as well as global stock markets). This would make it much more difficult for firms looking to raise equity.

UK companies may also find it difficult to issue corporate bonds to borrow from foreign investors due to the economic uncertainty.

Businesses are also likely to avoid making significant investment decisions until the situation clears.

<u>Consumption</u>

The increase in prices from a weaker GBP could reduce consumption. However, the psychology and sentiment of consumers may be the most important factor in avoiding recession. It is clear that Brexit is a completely different scenario to the credit crisis when there were bank runs and financial meltdown appeared to be imminent. However, if consumers are worried (rightly or wrongly) about job security or believe their mortgage interest payments could increase this will weaken private UK demand.

<u>Global economy</u>

Global stock markets have suffered with European indices falling more than in the UK and there could potentially be risks of global contagion. Although the UK's GDP was only 4% of the world GDP and imports in 2015 the UK is a major global financial hub with the UK financial sector assets accounting for more than 8 times its GDP. This means that the rest of the EU is much more exposed to the UK due to financial and investment linkages.

<u>Conclusion: Recession?</u>

The uncertainty could reduce consumption and investment. Although BoE could cut base rates and provide liquidity to banks this doesn't necessarily mean that banks will lend to businesses and consumers, and could hold onto capital to boost their own balance sheets. This could result in falls in the growth rate, which was only 0.4% in Q1 2016 so a contraction in GDP could be possible.

Although, it is too early to say with any uncertainty but businesses should definitely consider the possibility that the UK could be in a recession in the near future. Important business decisions may need to be delayed in the near future until there is further clarity for example, hiring staff, moving premises or committing to large R&D projects or capital expenditure.

Unemployment?

A number of UK employers have made statements that they could have to cut staff levels whilst others have stated that they won't need to. Historically, however, a recession is normally followed by increases in unemployment. We could also be in the unusual situation of low/negative growth and inflation at the same time.

Section 3) Potential impact of Brexit on our clients

A) IMPACT ON FINANCIAL SERVICES FIRMS

Short term:

FCA firms will often have access to the best information available on the economy and markets, however we would still advise that if they haven't done so already, they should re-check their financial forecasts and risk assessments, especially capital adequacy (eg ICAAP). Whilst some firms may gain from turmoil in financial markets, others may lose out. Trades may not work out as planned or funds may perform badly leading to a reduction in profits or even losses. Counterparties or clients could potentially redeem their funds or redirect their capital to other markets or financial products.

Firms should check that they will have sufficient liquidity to continue operating and to maintain capital adequacy in the worst case scenario. It may also be worth considering what happened to similar small FCA firms after the credit crisis of 2007-08 and whether your firm could suffer in a similar fashion?

Medium/Long term

Passporting scheme

Currently, due to EU wide legislation such as MiFID, AIFMD and PSD under the EU passporting scheme, UK FCA authorised firms can operate in other EEA states via cross border services or establishing a local branch without having to:

- obtain local authorisation
- meet differing local prudential requirements
- hold local capital

The process mainly involves providing notifications to the FCA/PRA about which countries and permitted services will be provided and the regulator will then inform the host state.

Although there will be some fees involved and same EEA states have some impediments in certain situations, this process is much quicker, cheaper and easier than having to be regulated in each host state.

Worst case scenario

In the worst case scenario that the UK will have no access to the Single Market and passporting, small FCA firms will need to evaluate whether they will need to obtain local authorisation in the EU and what the impact on capital requirements could be.

If UK firms will have third country status and no passporting rights, they may need to establish a subsidiary in 1 EEA state and then passport from there into the rest of the EEA.

We have currently found that some firms have established themselves in the UK due to the relative ease of obtaining an FCA licence compared to other EEA countries. However, if they don't have many UK counterparties or clients then it may not make economic sense for small firms to be regulated in two countries and they could potentially be better off by migrating to an EEA state and ceasing to be authorised in the UK.

Although under AIFMD and MiFID2/MiFIR, there is potential for third countries to obtain some passporting rights, the new proposals/legislation may still require UK firms to register with an EU member state regime or directly with ESMA. Therefore, it may not be feasible or economic for small UK firms to comply with both sets of regulations due to duplicated legal/compliance costs as well as potentially having to maintain local capital.

PSD firms are likely to be in a similar situation in respect of licencing and passporting. Emoney and payment services firms may have to seek new EU regulatory approval to operate across the EU and to sign new merchant contracts.

Steps to take:

1) Short term: Re-check financial forecasts, risk assessments and capital adequacy requirements. Can your FCA firm continue to operate if it (or the clients it manages) suffers losses or capital/fund withdrawals/redemptions?
2) Medium/long term: Check with your compliance consultant whether you will be able to continue operating with a UK licence or whether you will have to obtain EU/ESMA regulatory approval?

B) IMPACT ON TECH STARTUPS // FINTECH

In the short term, founders should re-check their cash burn rates and plans to raise funds. The capital and equity markets have already suffered and investors could potentially be jittery about investing funds in private UK companies and may seek "safer" investments in other countries or even asset classes. Although Twilio recently helped to validate tech valuations with its US IPO, the same investor sentiments may not apply to UK companies in the short term.

Investors such as EIS and SEIS investment/VC funds and angels could potentially choose to wait till the dust settles or invest in startups outside of the UK in the short term until there is more certainty about the UK's future.

In the medium to long term, one of the key issues will be the availability of talent to drive startups forward. One of the key factors that encourages startups to incorporate in the UK is the large talent pool available compared to other EU countries, although we have heard that there are still shortages of good developers and designers in the UK. If EU workers are restricted from the UK this could exacerbate the problem. Although many tech startups do also outsource development to foreign/remote freelancers at the early stages, bringing talent in-house is often seen as key to growing significantly and seeking an exit.

Many tech startup founders themselves have emigrated to the UK from the EU and new startups could be discouraged from setting up in the UK due to the uncertainty, especially when there are tech hubs within the EU, such as in Berlin for example. This could lead to a reduction in the UK tech community/infrastructure and the synergies that it produces.

Fintech companies would be subject to all of the above but there is a potential cause for concern if the UK's financial services sector suffers in the future due to a lack of access to the Single Market and passporting as discussed above. However, for companies who are working on technology/platforms only and are not providing regulated services themselves, if they have a solution which makes life easier or cheaper for banks and financial services then Brexit could potentially create new opportunities.

C) **IMPORT / EXPORT**

Once again, the impact on import/export firms will largely depend on the trade agreement negotiations with the EU.The Norway or Swiss models may not have too much negative impact on UK firms.

However, non-EU firms who currently export to the UK and then subsequently send or sell them on to customers in EU Member States (eg via Amazon) would potentially suffer due to double layers of import duties, tariffs and VAT.

These non-EU firms may need to import goods into the UK and EU regions separately, which could duplicate legal costs such as applying for a VAT certificate in both regions as well as duplicating shipping costs.

Due to the depreciation of sterling, foreign goods may become more expensive and this could potentially reduce demand for non-essential imported goods for foreign businesses exporting to the UK. Although, during the last recession demand for certain goods increased as consumers sought higher quality or relief from tightened belts and austerity.

UK exporters could potentially benefit from more competitive sales prices to foreign customers, however many exporters have foreign cost bases as they need to import material or components, or have staff overseas, which could squeeze margins.

For both importers and exporters there will be volatility in foreign exchange rates. One potential business practice is to try and price goods in the same currency as the cost base to reduce uncertainty.

It is also worth checking payment processes and seeking to streamline them and reduce unnecessary FX conversions if they can be avoided. For example, setup multi-currency bank accounts so that you can receive £, € and $, hold the funds in those currencies and then spend them accordingly on goods/services in the same currencies. If a US company only has a $ bank account, it could have sales denominated in £ and the payment processor or the bank would have to convert from £ into $, and they may not offer the best foreign exchange rates.

D) **CONTRACTORS / FREELANCERS**

In the short term, economic uncertainty could potentially increase the use of temporary staff if firms are hesitant to hire staff on a permanent basis. Prior to the vote, however, a number of banks and companies in the UK announced that they may need to make staff cuts in case of Brexit, which could potentially lead to temporary contracts not being renewed. At the time of writing several banks have mentioned that they will not yet be cutting jobs. Until the situation becomes clearer, contractors could potentially avoid taking big economic decisions such as buying a house/ increasing a mortgage or other large capital expenditure.

Permanent staff contracts could potentially increase job security however even this is uncertain.

In the long term, the worst case scenario would be under the WTO model with no free movement of labour as it is not clear whether EU citizens will be allowed to remain working in the UK. EU contractors living in the UK may need to seek legal advice about their status. They could also investigate whether or not they should obtain permission to remain in the UK. For example, it may be worth looking into whether the following application form could help:

https://www.gov.uk/government/publications/apply-for-a-document-certifying-permanent-residence-or-permanent-residence-card-form-eea-pr

E) AIM/ISDX PLCS

It may become difficult for firms to raise finance on equity markets due to the flight of capital from UK stock markets. This could make it difficult both for existing listed companies to issue new shares and also companies looking to list or reverse onto AIM/ISDX.

If we look back to the aftermath of the credit crisis of 2007-08 many listing/reverse deals collapsed.

Indeed, AIM lost 40% of its listed plcs – from 1,694 in 2007 down to 1,013 in April 2016. Moreover, it seems that international companies are more reluctant than UK companies. AIM lost 45% and 38% of them respectively.

However, Bacanora Minerals, the Mexico focused lithium group, revealed plans to list on London's small-cap exchange, Aim, despite the UK's vote to leave the EU. This could be an indicator of the future of AIM.

Appendix: Interest rates

1) **What could the negative impact on the UK economy be from an increase in interest rates?**

Prior to Brexit many commentators suggested that Brexit could potentially result in an increase in interest rates. The Treasury also forecasted a rise of between 0.7% and 1.1% in borrowing costs.

In theory, higher interest rates could lead to:

1. Increased costs of borrowing for businesses
2. Increased mortgage interest payments
3. Increased incentive to save rather than spend
4. Higher interest rates could reduce the devaluation of GBP
5. Reduced confidence and reduced pressure on inflation

Higher interest rates tend to reduce consumer spending and investment. This could lower growth, create higher unemployment but improve the current account because of reduced spending on imports.

2) **How likely is it that the BoE will increase interest rates, for example, in response to the £ depreciating?**

This doesn't appear to be likely in the short to medium term as markets expect Bank of England to cut interest rates to 0.25 in the coming months.

In the long run the BoE may need to consider the impact of an increase in interest rates on inflation as they have an obligation to keep inflation close to 2 per a year. If GBP continues to stay at low levels and prices rise substantially the BOE could consider raising interest rates. This could make GBP more attractive to savers, reduce demand by putting up the cost of borrowing and make it more expensive for business to borrow to expand output.

The BOE has to counter this against the possibility that the economy could enter a recession, if so the interest rates may not rise by much or could be held. For example, after the credit crisis, higher inflation was tolerated in order to help the UK recover from recession.

3) **What is the potential impact of cutting interest rates?**

Reducing interest rates could provide an economic stimulus to counter a potential recession by encouraging firms and consumers to spend as a result of reducing borrowing costs and incentives to save.

4) **Can mortgages still increase if base rates are unchanged?**

Mortgage rates are linked to base interest rates but the rate at which they are fixed are set are also related to the markets' long term projection of interest rates. Whilst a bank may reduce mortgage rates this may be offset by banks wanting to keep strong capital reserves in uncertain times, reducing their ability to lend.

In the short term, however, the fall in gilt yields could potentially lead to cheaper mortgages.