

A Work Project presented as part of the requirements for the Award of a Master Degree in Finance from NOVA – School of Business and Economics.

**Potential Impact of Brexit in Marks
and Spencer**

Bernardo Ventura Inácio Ribeiro de
Faria

A Project carried out on the Master in Finance Program, under the supervision of
Filipa Castro

3rd January 2020

Abstract

Brexit still did not happen, but its consequences already came up: consumer confidence index (CCI) in UK has been decreasing since the election, the housing market has been softening and there are signs of a step-down in transactions. The future consequences can be severe for M&S and to the UK retail segment in general: (1) CCI decrease, (2) GBP devaluation, (3) less immigration and (4) more operational complexity in selling products outside the UK can be relevant for M&S and affect FCF for investors. The company should make effort to hedge these risks.

Keywords

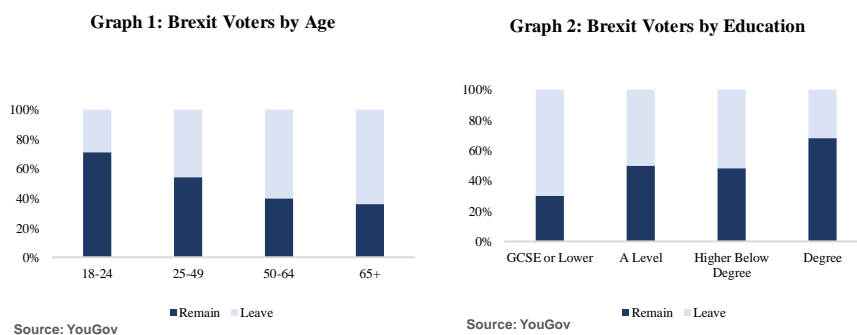
Brexit, Marks and Spencer, Retailer, Grocer

This work used infrastructure and resources funded by Fundação para a Ciência e a Tecnologia (UID/ECO/00124/2013, UID/ECO/00124/2019 and Social Sciences DataLab, Project 22209), POR Lisboa (LISBOA-01-0145-FEDER-007722 and Social Sciences DataLab, Project 22209) and POR Norte (Social Sciences DataLab, Project 22209).

Political Context

On 23rd June 2016, the most fearful happened: 51.89% of the British decided to leave EU. David Cameron, the prime minister at the time, made effort to stop the referendum trying to negotiate with EU the main issues identified by the conservative parties. These parties claimed additional immigration controls and tougher rules for EU citizens living in the UK, reduction of bureaucracy for business and less centralized power for the EU. As a response for UK's requests, EU offered to UK the so-called "emergency brake", this is, the possibility to withhold social benefits to new immigrants for the first 4 years they live in the UK. This negotiation did not end up in an agreement, so the referendum was scheduled to the 23rd of June 2016.

Voters who desired to leave were mainly older people with lower level of education, as seen in Graphs 1 and 2. This was motive for many protests across the country, since people argued that it was not fair that older people decided the future of the younger generations.



On 31st October 2019, the date of Brexit was rescheduled for the second time, for the 31st January 2020. In the meanwhile, Boris Johnson, one of the most important supporters of leaving EU in the time of the referendum, became prime minister.

Implications so Far

Consumer confidence in the UK has been decreasing for the last months (-10 in Jan'19 vs -14 in Oct'19), the housing market has been softening and there are signs of a step-down in transactions.

M&S wishes to have a “no-promotional” strategy in its food segment, decreasing prices and reducing temporary promotions. However, the signs above mentioned can result in a “last minute” approach to spending by the costumers thus, this strategy might not be the most appropriate at this time, since we forecast that, in this context, the promotional activity to be severe by the competitors.

Future Implications

1. Consumer confidence

As we can see in Graph 3, the consumer confidence is strongly correlated with the retail industry sales. In my opinion, M&S does not have a dynamic supply chain, capable of adjusting its needs to the current level of sales, so I think that a decrease in sales will struggle the company. As we mention in the equity research report, the logistics of M&S are not sufficiently innovated to rapidly adapt the demand of the company to quick shocks in sales volumes.

Thus, at the time of Brexit, I believe that M&S will be negatively affected in two manners: 1) the level of sales will decrease; 2) its logistics are not advanced enough to adapt its demand for products, so the operational margin of the company will decrease, resulting in less net income, and consequently less FCF for the investors (see Table 1).

Graph 3: Change in Retail Sales vs Change in CCI Index in UK

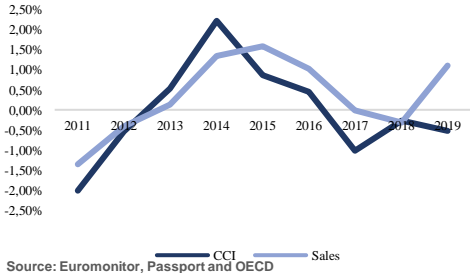


Table 1: Impact of Reducing Operational Result

UK Core Operating Result Change	Price per Share (£) ¹
-3%	140,55
-4%	139,73
-5%	138,90

Note: 2019 Sales: Forecasted value for Dec'19. 2019 CCI: Actual value for Oct'19. Thus, the CCI dos not consider the Christmas eve, where the CCI usually increases.

¹ Price calculated based on the ER model, base scenario.

2. Currency

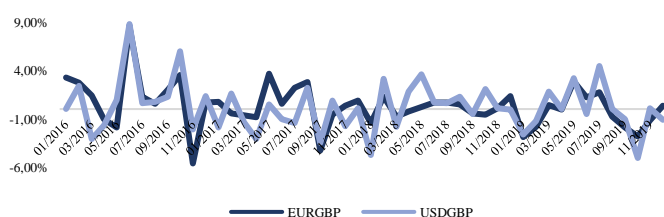
GBP started devaluating immediately after the referendum results were publicly announced. As we can see in Graph 4, in the day after of the referendum, GBP devaluated c.15% in relation to EUR and USD.

M&S has an international supply chain. In the C&H segment, most items are exposed to FX risk, since the key suppliers are in Asia. However, currency used to these transactions is USD. The Trump's administration strategy of devaluating USD made the GBP/USD rate to increase specially in the end of 2018 thus offsetting the devaluation of GBP caused by Brexit.

However, if Brexit really happens, I expect a significant loss of value from the GBP. M&S hedges its FX exposure through forward foreign exchange contracts, and it will certainly try to hedge this exposure at the time when Brexit occurs. It is impossible to perform an accurate and exact forecast about the impact of Brexit in GBP rates, but it will certainly be very difficult to M&S to completely hedge its FX exposure.

On the other hand, a devaluation of GBP could benefit the British exporters. Although M&S wants to increase its number of international stores, its products are produced overseas, so this effect will not offset the devaluation of GBP.

Graph 4: EURGBP and USDGBP



Source: Investina.com

Table 2: Impact of Increasing C&H COGS

C&H COGS Change	Price per Share (£) ¹
+5%	142,53
+6%	142,29
+7%	141,97

3. Labor force

M&S employs 78,000 people worldwide, 90% of them in the UK. It operates in an intensive-labor industry, so changes in the British labor market can possibly affect the performance of the company. Store staffing expenses account for 10.1% of revenues in FY'19.

Studies show that immigration, in the UK, has a considerable impact on the intermediate-qualified labor market. In the UK, 60% of the immigrants come from EU countries in 2018 (see Graph 5). UK immigrants have mostly intermediate or low qualifications. Studies show that a negative shock in the number of immigrants can lead to a negative impact on the job market, since the immigrants coming to the UK are replacing UK-born workers, the supply increases and the price of labor decrease. In the unskilled and semi-skilled service sector, a 1 percentage point rise in the share of migrants reduced average wages by about 0.2% (Nickell and Salaheen, 2015).

Shocks in the supply/demand take some time to adjust. As we can see in Graph 5, the number of immigrants in the UK already stabilized since 2016 (year of Brexit election), whereas the price of labor seems to be still adjusting. In FY'19, number of M&S employees decreased 2.42% and store staffing expenses decreased 2.71%. Thus, we can conclude that price of labor for M&S still did not increase due to the decrease in supply. However, it is expectable that it can happen in near future. M&S should be prepared to pay more for its employee's work, resulting in higher operating costs, less profitability and consequently less FCF to the investors (see Table 3).

Graph 5: Estimates of the non-British resident population of the UK by nationality

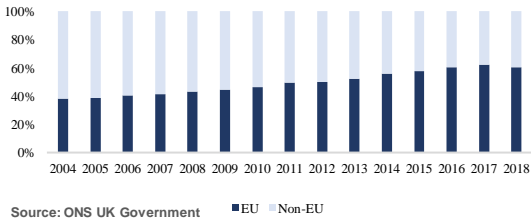


Table 3: Impact of Increasing Labor Costs

Labor Costs Change	Price per Share (£) ¹
+5%	142,71
+6%	142,50
+7%	142,09

4. Relocation/Access to EU markets

Currently, all the online sales of C&H segment for other EU countries come from British warehouses. M&S made effort in centralizing its logistics in Bradford Distribution Center, through its recent expansion, located in England. If the UK leaves EU as a third-party country, all the online sales to EU countries will be taxed. Thus, M&S has 2 alternatives: 1) continue to

operate from England; 2) decentralize its operations for another EU country. If M&S continues to operate from England, customers will have to pay an import tax for its products, thus increasing price and reducing demand for them. Most likely, EU costumers will move to other competitors, such as Primark or H&M. On the other hand, the company should incur in a significant CAPEX investment to decentralize its operations to another EU country.

Moreover, most online sales rely on data flows about potential customers. The uncertainty over UK-EU data flows if UK is classified as third-party country after Brexit should be considered. EU recently published a new Data Protection Normative that is very stiff about the transactions of data between non-EU countries.

In sum, the multi-channel retail strategy adopted by M&S, and its competitors in general, can be treated by the Brexit, especially if the UK leaves as a third-party country. We expect the online sales for other EU countries decrease, due to the more restrictive data flows normatives and the imposition of import taxes, which result in a worst performance and consequently less FCF to investors. M&S is aware of the challenges it will have to face, so it was decided to build a warehouse outside Paris, to supply all the Western Europe region.

Conclusion

In sum, I think Brexit will result in negative consequences for M&S. Decreasing consumer confidence, the devaluation of GBP, a negative shock in the labor supply and the more limited access to EU markets will, most likely, negatively impact the revenues of the company, decreasing margins and consequently FCF for investors. Each one of these factors, separately, seems to not have significant impact in the target price of share, however, if combined, the impact can substantial. M&S should make effort to hedge some of these aspects. Overall, the uncertainty that Brexit brings to markets, will certainly decline the business confidence as well, leading to delays in investment decisions and, consequently, more uncertainty and short-term volatility.