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ROOM FOR GROWTH IN A TIME OF UNCERTAINTY: THE UK LUXURY AUTOMOTIVE INDUSTRY AND BREXIT

Gustavo Grinsteins



The UK has been a dominant hub for the production of luxury consumer vehicles for the past couple of decades. Yet this dominance is likely to wither with the new challenges facing the industry due to Brexit. This article examines how automotive supply chain globalization and foreign direct investment aided the development of the luxury automotive industry in the UK. The article considers the consequences that will result from industry isolation from the EU caused by Brexit.

Introduction

The automotive industry accounts for more than 800,000 jobs in the UK and 13% of UK total export goods (*SMMT Motor Industry Facts 2017*, pp. 6–7). One of the UK’s competitive advantages is its ability to create quality products. Premium car companies have been able to develop in the UK because of infrastructure and environment that foster creating high-quality automotive products brands, including Land Rover, Jaguar, Aston Martin, Rolls-Royce, Bentley, and McLaren—all based in the UK. Experts inside and outside the UK fear, however, that this sector will forfeit its competitive qualities after Brexit. Foreign direct investment (FDI) that brought capital to the automotive industry has started to slow, and long-term investments are uncertain. Furthermore, most of the parts suppliers to these UK brands are based in the EU thanks to pricing advantages within the single market. To understand the effect of Brexit, it is important

to analyze the dynamics of the UK automotive sector and key success factors that make it a leader in the luxury automotive market.

The following analysis focuses on the potential impact of Brexit on the UK luxury car sector. UK automotive manufacturing encompasses large multinational companies that have globalized sales and supply chains in addition to smaller companies that are more localized in the UK. Both types of companies target luxury niche markets. This analysis provides insight into how the two types of companies are approaching Brexit in an age where globalization dominates the automotive market. To make the analysis tangible, one large multinational company, Jaguar Land Rover (JLR), and one smaller national company, McLaren, are examined to understand their contrasting reaction to Brexit.

There are two paths the UK can take during Brexit negotiations: a “hard Brexit,” quitting the EU without a deal in place, means the UK would trade with the EU under World Trade

Table 1
UK Automotive Industry at a Glance

Workforce	814,000 of 32 million working people
Total revenue	£77.5 billion
Exports revenue	£40.1 billion
GDP contribution	13%
UK suppliers	2,500

Organization rules; a “soft Brexit” could keep close ties with the EU, possibly through some form of membership in the EU single market, in return for a degree of free movement of people and products. This analysis includes how UK competitiveness might be affected depending on Brexit negotiations. Combining elements of globalized and localized automakers with assessing possible results of Brexit can provide insight into what might happen to the UK auto industry in the near future.

Background of UK Automotive Industry

During the 1950s, the UK was the second-largest manufacturer of cars in the world (after the United States) and the largest exporter. After World War II, the government controlled the supply of steel and was interested in exporting steel to raise foreign income. This decision, mixed with a high demand for motor vehicles in neighboring countries, enabled the UK to become the largest motor vehicle exporter. In 1972, the UK produced a record 1.92 million cars thanks to British industries ramping up their presence in overseas markets by introducing new car models. The UK was producing large quantities, yet many of the cars were notorious for their low quality (Weldon). In 1973, the UK joined the European Economic Community, which later merged with the EU’s framework. Access to the single market made the UK a more attractive investment candidate to foreign industries. As a result, the auto industry changed in the 1980s as foreign car firms began to produce vehicles in the UK (Weldon). Foreign cars sold in the British market increased in popularity. For example, German Volkswagen

models gained momentum and Japanese cars started to appear on British highways, with Toyota one of the first Japanese carmakers to import cars to Britain. The introduction of new technology and management techniques from foreign businesses helped the UK develop a global manufacturing infrastructure. With these enhancements, the UK automotive industry continued to grow, improve its product reliability, and remain a leader in the global market.

UK Automotive Industry Today

The UK automotive industry has evolved into a globalized industry. UK original brands have been bought by foreign companies, including BMW, Tata Motors, and Volkswagen Group. Current statistics demonstrating the industry relevance to the UK economy are presented in Table 1 (*SMMT...*, pp. 5–7).

Automotive manufacturing in the UK stands at thirteenth globally and fourth among the European automotive manufacturers. In 2016, the UK car production reached its highest level in 17 years, getting closer to the all-time high in 1972. The UK automotive industry is not only a mature and beneficial sector for the UK economy but also a possible area where the UK economy can grow and become stronger.

Since the UK joined the European Economic Community in 1973, its automotive industry has been deeply rooted within the EU. For example, currently about 69% of total UK car imports come from the EU and 56% of car exports go to the EU. Additionally, the shares of outsourced components from the EU and UK-built components sent to the EU are 79% and 65%, respectively (*SMMT...*, p. 32).

Globalization of the Automotive Industry

In today's automotive industry, high levels of trade between international suppliers serve as a reminder of the worldwide reality of more global interconnections than ever. The assembly lines of UK auto manufacturers have benefited from outsourcing car components. Specifically, in the UK luxury car sector, BMW's Mini plant at Oxford, for example, outsources 60% of their components from the EU and across the globe. So too, Morgan Motor Company, a privately owned company in the UK, sources engines from BMW for several brands. Similarly, of a sample of 18 parts of the JLR Discovery, only 7 are made in UK and the rest are from various EU countries (Campbell and Pooler). In short, companies and suppliers are benefiting each other across many levels in the single market by exchanging parts and technology.

Because the UK serves as a platform for developing luxury vehicles that have brand value, multinational corporations like BMW and Tata Motors have decided to invest in the UK luxury automotive sector while importing major car components from other countries. Furthermore, the UK attracted these multinational companies because it had a robust but underperforming automotive infrastructure. Companies saw this as a business opportunity where they could buy the infrastructure and the name of the British brand and then improve the manufacturing operations to create the quality products of today. For these reasons, most car companies in the UK are now subsidiaries of foreign manufacturers or investors. Companies like JLR, Mini, and Rolls-Royce were born as UK companies but later bought by other multinational companies.

Foreign Direct Investment

FDI has been the main driver behind the UK luxury auto sector resurgence. According to a report from the Centre of Economic Performance, the UK is a major recipient of FDI in the manufacturing industry. Half of these contributions come from the EU. More specifically, the British automotive industry

has attracted record investments, including more than £3 billion in 2015 alone. Professor David Bailey, a UK automotive industry expert at Aston University, maintains that foreign automotive owners are keen in investing in the UK car industry, especially the luxury sector (Tovey, "The Fall..."). For example, Rolls-Royce, now owned by BMW, recently invested millions of pounds in its new plant in Goodwood (Tovey, "Rolls-Royce..."). The continuing stream of investments suggests that foreign investors are confident of the returns the luxury market can bring.

Some of the benefits to the UK from FDI are increased productivity, wages, and competitive pressure. FDI also gives UK subsidiaries access to technologies of the foreign parent company. Therefore, the substantial FDI into the UK's luxury automotive sector fosters the industry's hegemony in world markets. In 2016, the industry produced more than 1.7 million cars, approaching its all-time high, 1.9 million cars produced. FDI, much of it from the EU, has been one of the main drivers of the steady production increase through the last decade.

Implications of Brexit

Globalized Manufacturing

With Brexit on the horizon, many automotive experts are concerned about its impact on the UK's car production. Mark Hawes, head of Britain's Society of Motor Manufacturers and Traders, emphasizes that the current progress and health of Britain's automotive industry is due to the single market membership (Katz and Charlton). Furthermore, Simon Sproule, marketing director for Aston Martin, warns that Brexit can have some positive short-term results yet the industry should be focusing on long-term global growth (Katz and Charlton). Experts and specialists in the UK automotive industry are aware of the global nature of the automotive industry and the negative effects that isolation from the EU market would create. Therefore, multinational companies likely will start looking at strategic production alternatives to mitigate problems that might surge with Brexit.

Currently, trade between the UK and other EU countries is flowing without problems, but Brexit will bring complications. Arndt Ellinghorst, an analyst with the Evercore international and strategy investment group in London, predicts that as soon as the UK leaves, EU trade will become more complicated given new trade rules will have to be implemented. Ellinghorst further explains that, after Brexit, each UK car with an EU component will need its own trade agreement for that car to leave the country (Katz and Charlton). Given the intricate EU supplier involvement with UK automotive manufacturers, a possible disruption that new trade rules could have in the industry can be anticipated. In the case of a hard Brexit, the UK will most likely have to write their own trade agreements to substitute the ones established by the EU. It will mean negotiation rounds with each country to generate trade deals to benefit the UK automotive industry and its trade of parts and final products. In a highly dynamic industry where quick and effective turnovers are crucial for product development to satisfy customers and other stakeholders, rounds of trade deal negotiations might slow down these processes and become catastrophic.

Foreign Direct Investment

Beyond supply chain challenges, Brexit has also brought possible threats to FDI, which might decrease when the UK leaves the EU. As long as the UK remains in the single market, the UK serves as an export platform for countries seeking to avoid large tariff costs when exporting to the rest of the EU. Other EU countries will likely be able to compete away such FDI. To illustrate a case of a multinational taking action due to Brexit, Peter Campbell of the *Financial Times* recently reported that the BMW electric Mini, an iconic British brand dating to the 1950s, will be produced outside the UK, with BMW explaining that “the result of the EU referendum creates uncertainty for the automotive sector in general and for overseas investors in particular...Uncertainty is not helpful when it comes to making long-term business decisions” (Campbell, “Investment...”). Multinationals cannot afford to wait until the final Brexit deal is signed; they will start implementing contingency plans beforehand.

Tariffs and Parts Localization

Problematic as well is that when the UK leaves the single market, tariff barriers might be imposed on UK car exports to and imports from the EU. There is also a concern about tariffs imposed on imported parts from the EU. Possibly defaulting to higher World Trade Organization tariffs after Brexit negotiations is unsettling both to companies in the UK auto industry and to companies from the EU with manufacturing facilities in the UK. The immediate consequence could be a tariff increase of more than 10%. In addition, UK car companies have a comparatively low fraction of parts made in the UK, making the financial impact of tariffs more adverse. Multinationals that have low sourcing of parts from the UK are considering moving their manufacturing sites to other countries in the EU. For example, the General Motors Ellesmere Port facility is at risk because it has the lowest parts localization of any high-volume automaker in the UK, around 25%. Experts believe that General Motors is the most likely manufacturer to shift operations to mainland Europe if costs rise due to the country’s decision to leave the EU (“GM Most Likely to...”). Because multinationals have complex supply chains, supplying of parts would become harder to manage when the UK leaves the EU. In the worst-case scenario, a hard Brexit with imposed tariffs at UK borders will make imports and exports for car manufacturing significantly more expensive and less competitive.

Company Analyses

Case studies of two luxury automotive manufacturers in the UK with contrasting production volumes provide insight into how automotive globalization, FDI, and Brexit influence the decisions of major UK luxury automotive manufacturers.

Jaguar Land Rover and Brexit

JLR started as two separate car companies in the 1930s (Jaguar) and 1940s (Land Rover). They merged when Ford acquired both companies (Jaguar in 1989 and then Land Rover in 2000), although the brands were

kept distinct. Finally, the two brands were combined in 2013, when India's Tata Motors bought the UK manufacturers from Ford. Since the acquisition by Tata Motors, JLR has been able to ramp up its production, double annual sales, and nearly triple its revenue (Tovey, "The Fall..."). According to the JLR "Annual Report 2016/2017" (p. 57), 521,571 vehicles and a revenue of £22.2 billion were produced in fiscal year 2015/2016. By comparison, in 2011, the company was producing only 250,000 vehicles, with a revenue of £9.9 billion. It is clear that JLR is looking to increase these numbers even further.

JLR CEO Ralf Speth quotes Adam Smith: "it is free and fair trade, access to the collective knowledge of the best talents globally and removing red tape that lead to greater national prosperity," emphasizing the contrast between the trajectory JLR sees as the most beneficial for the UK and the trajectory Brexit is taking the country. Speth maintains further that the EU is a business opportunity and there is no credible alternative. He preaches that in the case of a hard Brexit, the export industry will be hit and lose profitability ("Annual Report 2016/2017," p. 5). Furthermore, Hanno Kirner, the company's strategy director, fears that trade barriers would "not only affect what we sell, but what we buy and it will ultimately damage our business and British jobs" (Campbell, "Hard Brexit..."). Kirner said JLR supports some 300,000 jobs in the UK through its plants and suppliers and that these are dependent on exports. "Europe has emerged as our biggest market...It is incredibly important to us," he said, adding that sales of Jaguars to the EU more than doubled last year, while Land Rover sales rose 20%. Parts of the company's supply chain are in Europe, with 40% of JLR's purchasing budget spent on the continent. If tariffs are imposed, JLR would be penalized for buying from the EU as well as selling into it (Campbell, "Hard Brexit..."). JLR will become less competitive if the UK leaves the EU and tariff deals will give the upper hand to German car producers.

JLR has initiated a plan for a worst-case scenario in deciding to develop a new plant in Slovakia, a member of the EU. This plant is being built to have capacity for producing 150,000 cars a year. The project is predicted

to cost approximately \$1.6 billion and the main goal is to start producing Land Rovers in Slovakia by 2018. The plant will employ about 3,000 people when fully functional. This action will also assure that JLR will have at least one car manufacturing facility inside the EU when the UK officially exits the EU. Another sign that the company is looking for certainty is the production of its new electric car, E-Pace, which will be developed and produced in Austria, another member state of the EU. One of the reasons why JLR moved the production of this car outside the UK was that their plants were running at almost full capacity. In addition, another clear reason is that JLR wants to start moving the production of new vehicles outside the UK to mitigate the risk of imposed tariffs (Campbell, "Jaguar..."). General Motors, which owns Vauxhall, and BMW are also following in JLR's footsteps; they are detaching from the UK to remain within the single market. The partial exodus of these large multinationals will cause jobs to move outside the UK and create jobs and revenue for other countries. Reports say Vauxhall has already announced cutting 650 jobs at its Ellesmere Port car plant in 2018 ("Vauxhall..."). Similarly, JLR announced trimming 1,000 jobs at its UK plant in Solihull in 2018 (Farrell), and BMW has not announced official figures but is threatening to move its Mini production in case of a hard Brexit (Tovey, "BMW..."). In summary, even if the UK ends up with a soft Brexit, actions are already being taken by these multinationals to move work to EU locations with more certainty. The longer and more confusing this process becomes, the more companies will follow.

McLaren and Brexit

The second illustrative case is McLaren Automotive, a British manufacturer of sports and luxury cars. Originally called McLaren Cars, it was founded in 1985. In 2010, McLaren Automotive was formed when the founder of McLaren Cars sold his shares to the umbrella company McLaren Group. The firm is much smaller than JLR and focuses on even higher-end vehicles. In 2015, the company sold 1,654 cars, with prices ranging from about £120,000 (\$157,000) to more than £800,000 (\$1.04 million).

According to the *Financial Times*, McLaren might be one of the few UK brands that could benefit from Brexit (Ford). McLaren exports more than 90% of its sports cars; therefore, this article argues that the fall of the pound post-Brexit could possibly boost the production numbers for McLaren. In addition, the majority of McLaren's foreign customers are based in the United States rather than in Europe. According to Mike Flewitt, CEO of McLaren, "We sell about 70% of our cars into either dollar markets or dollar-denominated markets so that brings increased income" (Pitas). Of the ten different cars that McLaren produces, only two go to the EU; therefore, McLaren has limited exposure to the EU. "The US is a much more important market for us and tariffs on imported cars there are just 2.5 per cent," said Paul Buddin, the company's chief financial officer (Ford). Moreover, Flewitt said McLaren sources 50% of its parts in value from the UK, including engines, with another 20% to 30% imported from continental Europe (Pitas).

McLaren admits that it will be susceptible if tariffs appear on imported components. Yet it is confident that this would not be of great harm to the company. Regarding future uncertainty, Flewitt said, "The key thing is what happens next, and that's what nobody knows...We need open trade and we need free movement of people" (Ford).

In fact, McLaren has moved part of its supply chain back to the UK. It is investing £50 million in a new technology facility, which, according to the *Financial Times*, will increase the share of McLaren parts made in the UK from 50% to 58% (Ford). Replacing euros with pounds will help McLaren benefit from the pound's weakness, thanks to its many overseas sales in US dollars. The government is also offering incentives to increase the domestic content. For McLaren, the biggest positive effect of Brexit is that it has focused the government on supporting the industry. Paul Buddin, the company's chief financial officer, cites the Faraday Challenge, a government-sponsored competition to support the development of a domestic battery supply industry, to explain how the UK government has collaborated with the company (Ford). McLaren is continuing to

push for sourcing more supplies within the UK to remain competitive after Brexit occurs.

Comparison of JLR and McLaren Reactions to Brexit

These case studies demonstrate how two different luxury car companies are reacting to Brexit according to their relative sizes, primary consumer markets, and supplier locations. On one hand, JLR produces 500,000 cars annually with a primary consumer market and supplier relations in the EU. With this volume and the involved supply relations within the EU, JLR will be deeply affected by a hard Brexit tariff policy. Profits will decline and costs will rise, making the company substantially less profitable. As a result, JLR is starting to move production to EU member state locations, thereby removing income and jobs from the UK economy. In addition, FDI, which has significantly helped the automotive industry in the UK, will decline and multinational companies similar to JLR in size and infrastructure will shrink their investments in the UK.

On the other hand, as of 2016, McLaren produces 3,000 cars annually, mainly for the US, with almost half of its suppliers in the UK (and an insignificant number in the EU). McLaren perceives Brexit in a more positive light than JLR. McLaren admits Brexit will have a negative impact on its business but not with the same repercussions as for JLR. McLaren has taken the approach of bringing technology back to the UK and opening new facilities to develop and produce more parts for its cars in country. This will benefit the UK economy by generating more jobs and income, the opposite of JLR's actions. McLaren has an easier time bringing its business back to the UK due to its production volume, non-EU customer base, and high percentage of UK suppliers. JLR might be able to learn from McLaren and try to mitigate the consequences of Brexit by not outsourcing jobs to other countries and instead increasing reliance on suppliers within the UK, thus generating more local jobs.

Brexit could have positive impacts on the UK economy if companies take McLaren's approach. However, these benefits that Brexit could bring might not be sufficient to balance the downsides.

The Future of the UK Luxury Automotive Sector

Globalization has changed the dynamics of how business works by providing more opportunities for collaboration within international industries. The UK automotive industry today benefits from this collaboration by outsourcing raw materials and subassemblies at competitive prices in order to put these components together within the UK. Given the amazing automotive infrastructure that has been developed over several decades in the UK, this collaboration continues to help bring multinational company investments into the UK to develop and manufacture quality products. By interconnecting international corporations, companies can increase efficiency and productivity, bringing in new sources of management and technology. In addition, as part of the EU single market, the UK has nurtured the global interdependencies of its automotive businesses. Yet, the globalization trend has had the downside of discouraging the sourcing of local raw materials or production of subassemblies in the UK due to the competitive prices that companies can find elsewhere in the EU.

Brexit has already had a colossal impact on the UK's globalization trajectory. With the UK divorcing the EU, the many benefits from this partnership could be nullified or completely reversed. Furthermore, the fact that the UK has been leveraging and building relationships in this partnership for 45 years will roughen the transition to an environment with an absent partnership. Longstanding supplier relations within the EU may be severed due to possible increases in tariffs. FDI could slow or come to a stop as multinational companies lose confidence in their investments in the UK. Production of cars might fall if new trade agreements need to be negotiated for UK-manufactured cars containing EU components. On the other hand, Brexit brings opportunities for the UK to develop in business areas previously neglected due to the comfort that comes from the single market. This can be an opportunity for UK companies to stop outsourcing and ramp up the percentage of materials acquired within the UK. In addition, smaller national car companies like McLaren can develop their business infrastructure within the UK, creating more jobs and income for the economy. Brexit undeniably has changed the UK luxury automotive industry and it will take a prolonged period of adjustment for it to throttle to full-speed again.

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