Credit Thoughts

YCAP asset management

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*"…It is true that the past years have been the most difficult ones in history of our union, but I always remember what my father used to tell me: What does no kill you makes you stronger"*

**EU President, Donald Tusk**

# 3D of Brexit impact on the UK Retail Sector

A month after the shockwave sent through the financial markets by the UK vote in favor of the Brexit, it is time to take a swim back, breath and think. At YCAP Asset Management (Europe), we take our confidence from our resilient portfolios, which are based on sound and fundamental analysis of sectors and companies.

## *Defiance: Are consumers now tightening their belts?*

One impact of the Brexit will very likely be a slowdown in economic growth of the whole UK economy. GDP forecasts have been reduced after the referendum's result: OECD assesses GDP losses of 1.3% by 2018, of 3.3% by 2020 (equivalent to a cost per household of GBP 2200) and of 2.5% by 2030.

A second impact could be on employment levels. Barclay´s assesses employment growth to "turn negative in the second half of 2016 […] and unemployment rate to increase to 5.9% in 2017 from expected 5.2% in 2016." So far, UK unemployment figures were quite resilient. Rates released this month reveal that unemployment has fallen to its lowest level since July 2015, at 4.9% by end of June 2016.

Third, increasing unemployment could lead to a decrease in household consumption levels: from an increase of 2.9% in 2015, forecasts for 2016 are now at 2.5%, and 2.3% for both 2017 and 2018. A survey posted by the UK government revealed that following the results of the vote, confidence level fell to a three year low from 111.9 points (period 1-23 June) to 104.3 for the period after the vote. Until today, this development did not find its way to people´s mind, as a survey performed by Barclay´s in the week of July 5th showed that 52% of consumers do not expect any impact on their household finances post Brexit. Even more surprising, the same study revealed that during the week following the Brexit vote, consumer spending increased 2.14% compared to the prior week.

In general, the economic situation is the first factor of retailer consumption, and short to medium term forecasts are not very encouraging. However, some companies could limit the impact of Britain's gloomy mood by exporting more, by targeting less sensitive consumer groups or by using innovations to create new needs or lusts.

## *Depreciation: Will UK be left skinny?*

The UK remains a strong European economy, with different means at its disposal to mitigate the impacts of the "leave" vote - one being on the governmental side. Regarding fiscal policy an announcement of potential cuts of corporate tax rates have already been made. Another available resource is the monetary policy from the Bank of England (BoE). Directly after the results, the BoE mentioned that it would "take all necessary steps to meet its responsibilities for monetary and financial stability." In its June meeting the BoE has already taken steps to ensure sufficient liquidity is provided for the GBP. Additionally consensus expect the BoE to cut its Bank Rate by 50 bps to 0% in its August meeting.

Nevertheless, such BoE measures will most probably lead to further GBP depreciation. It´s least to say that GBP reaction to the Brexit decision was not small: since the 23rd of June, GBP has lost over 12% value versus USD. It now trades at USD 1.29 from USD 1.15. Bloomberg foresees the exchange rate to remain at this level until 2017. Depreciation of the Pound has multiple consequences that need to be assessed. This will probably lead to inflation for all imported goods into the UK. Bloomberg has assessed CPI to grow from 0.04% in 2015, to +0.4% in 2016 and finally up 0.86% in 2017.

On the one hand, inflation is good for retailers, especially for food retailers, as it will finally reverse the longer term deflationary trend observed in the UK, slightly relieving margin pressure and reported sales levels. Furthermore it might encourage immediate consumption, to benefit from "better" prices versus current attitude of delaying purchases. On the other hand, decreasing Pound value will lead to increased costs for retailers as in average 70 to 80% of the products/raw materials are sourced in USD. Barclay´s has calculated that a 10% depreciation of GBP would lead to approx. 100 to 150 bps less margin for retailers.

Another side effect of a weaker GBP is a probable increase in fashion tourism in the UK, especially in London or Edinburgh. And with their increased purchasing power, international tourists will probably visit some of the flagship stores of the main Apparel Retailers, such as NewLook, Next, Primark, Debenhams, House of Frasier.

## *Divestment: Who said Brexit would mean to exit?*

Even if the UK voters have chosen to leave the European Union, it does not mean that investors should exit their investment in the sector as some opportunities will definitely arise. Retailers are nowadays much more financially robust and flexible in terms of Supply Chains then they were back in 2009. Nevertheless, to reflect the complicated environment, we have downgraded our overall assessment on UK Retailers from Overweight to Marketweight.
Thus, a clear distinction shall be made between:

- Food retailers and Apparel retailers: Food retailers will profit from the rebound in inflation and are less sensitive to consumer´s state of mind than apparel retailer. Furthermore Food retailers are sourcing a bigger proportion of their goods from the UK and are therefore less sensitive to pound devaluation.

- Low value and high-end retailers: Low value retailers will be less impacted by the whole situation as they make their profit based on volumes, not on margins. Additionally their target customers are younger, less sensitive to general gloom then to their outlook and image. High-end retailers on the contrary will need to come up with incentives for customers to continue shopping with them and to not shift to lower value goods. Especially threatened are big ticket retailers such as those selling housing equipment.

- Geographical breakdown of sourcing and sales: Supply chain strength and flexibility will be the key criteria in this situation. Retailers counting on strong international sales (via online platforms for example) and those that can pass on price pressure to their supplier will be better equipped to face the UK´s internal situation.

It is clear that the above mentioned impacts, won´t certainly arise immediately but will start to materialize in the coming months, when the market will gain more insight of on the timing with regard to the triggering of Article 50, and of the probable outcomes from the negotiations. But what we certainly could expect is recurring volatility. In this environment, the deep understanding of each individual companies and of the sector, remains a strong protection as it helps to identify the impact of the described assumptions. Even though losses due to market events can never be excluded, the fundamental based investments have proven to suffer significantly less in difficult markets. We will therefore continue to monitor the Retail universe closely.

Based on the above mentioned criteria, we remain very positive on New Look as a lower end, geographically better diversified retailer. Tesco is also offering an attractive entry point, especially after the new management team has announced a turn in strategy, as the supply chain has been strongly improved over the past year and as Tesco is a food retailer sourcing significant part of its products in the UK.


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