

## ALTERNATIVES RESEARCH

# Brexit: New Beginnings

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On January 1, 2021, the United Kingdom (UK) left the single market and customs union after agreeing a trade deal with the European Union (EU). The deal allows for tariff- and quota-free trade between the UK and EU but creates significantly more barriers to trade in goods and services. Nevertheless, the deal has put an end to a long period of uncertainty and constitutes a base on which to build further agreements. The deal does not address financial services, but a memorandum on such regulation will be issued by March 2021.

The Brexit deal together with the COVID-19 related lockdowns have a negative impact on the UK economy in general, but its private markets seem to be able to hold the lead as far as investment activity is concerned. Wilshire's discretionary portfolios have very limited exposure to UK-companies vulnerable to the Brexit deal and we remain generally more concerned with the consequences of the global pandemic than this new trade deal. In this article, we seek to discern how COVID-19 is spurring on several trends, magnifying some obstacles, but also creating new opportunities.

## The Brexit Deal

More than four years after the 2016 Brexit referendum, on December 24, 2020, leaders of the EU and the UK announced a deal called the Trade and Cooperation Agreement ('TCA'). The agreement took effect provisionally on January 1, 2021, until the EU Parliament has ratified it and covers a wide range of issues from transport to law enforcement. We have summarized the key aspects below:

- 1) Trade in Goods; The deal provides that trade between the UK and EU will not be subject to tariffs or quotas. However, custom checks and procedures will be required on goods moving between the UK and the EU for the first time since 1973. This will add to the border disruptions and delays already caused by the COVID-19 crisis and entail additional costs. These non-tariff barriers are estimated to increase costs for UK businesses by £17 billion and for EU businesses by about £14 billion per year .

- 2) Level Playing Field; The EU insisted upon the adoption of common standards for goods and services to ensure a level playing field for fair competition. These standards involve regulations concerning workers' rights, social and environmental protection, taxation, and state business subsidies. Also, an arbitration panel will be established to resolve any divergences.
- 3) Fishing Rights; Despite accounting for just 0.1% of the UK's gross domestic product (GDP), fishing rights have been a big point of contention between the EU and UK. In the end, the deal reduced EU fishing rights in UK waters by 25% which will be implemented over a five-and-a-half-year period, with an allowance for annual negotiations thereafter.
- 4) Professional and Financial Services; The agreement fails to address the UK services sector, which accounts for more than 80% of the UK's GDP. This means that professional service providers will no longer be able to cross between EU countries and the UK. In addition, UK-based financial services firms have immediately lost their "passporting" rights which enabled them to conduct business in the EU without registering in each country individually. The relevant parties are however, working on a memorandum of understanding on such regulation and which is to be issued by March 2021.
- 5) Impact on Individuals; The loss of automatic professional access and free movement throughout the EU and UK will complicate individuals' professional licensing, add visa requirements for some and impose new obligations for travel and relocation between the UK and EU member states.

## UK Economic Impact

The combination of the continuing COVID-19 related lockdowns together with the Brexit deal is expected to have a negative impact on UK's GDP growth, unemployment rate and the valuation of the pound against other currencies.

The UK economy has suffered a severe economic contraction due to the spread of the (novel) coronavirus which is likely to persist through at least the first quarter of 2021, although a recovery is anticipated as vaccines are being rolled out. According to KPMG, the ongoing lockdown and elevated restrictions across the UK would result in total GDP shrinking by over 11% in 2020, nearly three times as much as the fall during the recession in 2009. Nevertheless, while KPMG estimates that Brexit could cost the UK economy 3% in 2021, GDP growth is forecasted to recover at 7% versus the previous year. With time, companies should become familiar with the new customs procedures and moreover, the UK can now negotiate deals with other countries, including with the US, Australia and New Zealand, possibly adding to future GDP growth.

### EXHIBIT 1 – KPMG Forecasts (average % change on previous calendar year) <sup>1</sup>

	2019	2020	2021	2022
GDP	1.3	-11.2	7.2	4.9
Consumer spending	0.8	-14.4	7.3	5.6
Investment	1.5	-12.6	5.4	5.8
Unemployment rate	3.8	4.7	7.3	6.8
Inflation	1.8	0.9	1.4	1.9

<sup>1</sup> ONS, KPMG forecasts. Scenario assumes a vaccine is approved in Jan 2021 and the UK agrees a deal with the EU. Average % change on previous calendar year, except for unemployment rate, which is average annual rate. Investment represents Gross Fixed Capital Formation, inflation measure used is the CPI and unemployment measure are LFS. Interest rate represents level at the end of calendar year.

	2019	2020	2021	2022
Base interest rate	0.75	0.1	0	0.25

As changing relations with the EU are expected to lead to a loss of output in the manufacturing sector, this is likely to generate job losses over the course of 2021. Further losses in employment in financial services and some other professional services linked to EU clients may also occur, making a recovery in overall UK employment levels somewhat weaker. As shown in Exhibit 1, KPMG forecasts show an average employment rate of 7.3% for 2021 and to slightly come down to 6.8% the year thereafter.

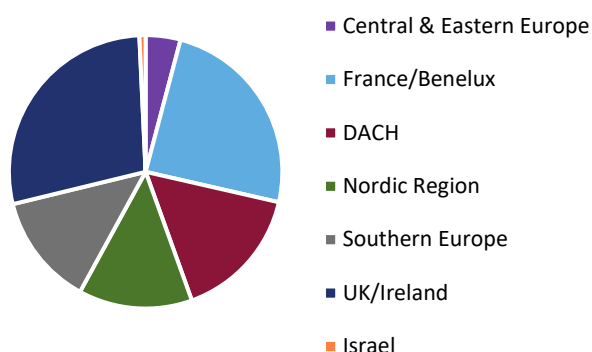
Furthermore, because of the unfavorable impact of shutting sizeable parts of the UK, the Bank of England may decide to cut interest rates to provide additional support to the economy and financial system. Interest rates are currently set at 0.10% and the pound is expected by foreign exchange analysts to fall, should market expectations for negative interest rates increase further.

## Private Markets Effects

The impact of Brexit does not seem to be on the forefront of private markets investors' minds. Only 3% of respondents to a questionnaire led by Dechert, the global law firm, said the UK's departure from the EU would have the biggest effect on the deal environment. A further 20% picked it as the second most important factor, but behind the potential for a downturn/recession (26%) and the impact of the COVID-19 crisis (23%)<sup>2</sup>. In fact, more confidence has likely returned to investing in the UK now it is certain that it has left Europe with a deal. Questions remain over the long-term impact that Brexit could have, in particular with the TCA not offering details on how financial services, let alone private markets, will be affected. Instead, the UK and the EU have given themselves until the end of March to set out a framework on how they will cooperate on financial services. In the meantime, Financial Conduct Authority (FCA) has put in place a temporary permissions regime to allow EU-based firms to continue to access UK markets.

### Exhibit 2 – Volume of PE Deals by Region

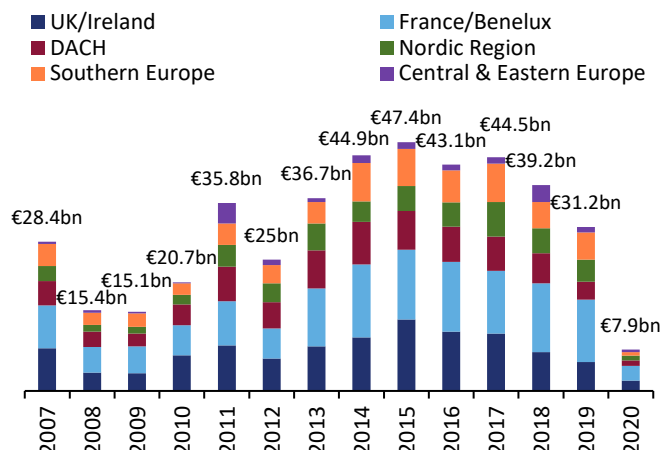
3Q 2020<sup>3</sup>



<sup>2</sup> Dechert LLC, Merger Market; 2021 Global Private Equity Outlook.

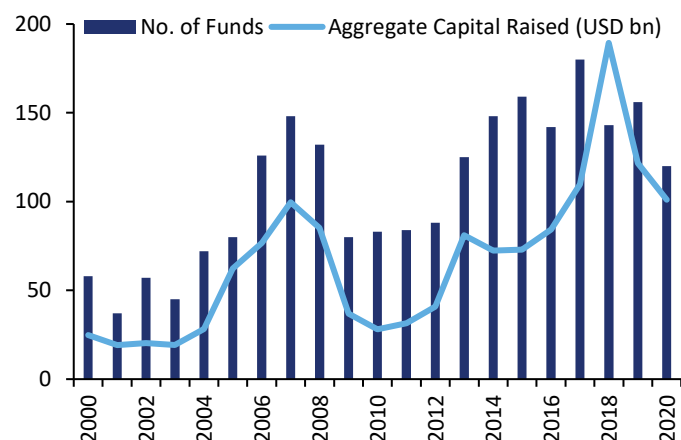
<sup>3</sup> PitchBook's Q3 European PE Breakdown, Oct. 14, 2020.

### EXHIBIT 3 – PE Divestments by Region at Cost 2007 – 1H 2020<sup>4</sup>



With the one-year transition period coinciding with the global pandemic, it is not exactly clear how much of an impact Brexit had on investment activity during 2020. What we do know is that European private equity firms invested over €316 billion in the region across 2,791 deals through September 30, 2020, with the UK still representing the largest chunk (around 30%) of those numbers<sup>5</sup>. In terms of divestments, however, Exhibit 3 shows that the UK/Ireland region has come down since 2016, with the first half of 2020 showing a low point since the 2009 recession. Notwithstanding the future fundraising rules, global private equity funds still have record levels of dry powder and largely managed to fundraise remotely during the pandemic and general lockdown. Nevertheless, 2020 fundraising of UK-based fund managers (which include managers with global and pan-European strategies), ended up below 2019 levels.

### EXHIBIT 4 – UK Manager Fundraising (\$bn)<sup>6</sup>

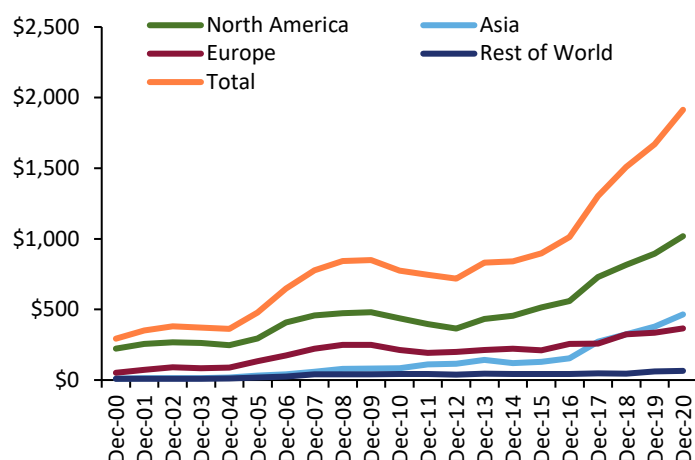


<sup>4</sup> InvestEurope/EDC; All Private Equity – Divestments at cost by region, Nov. 2020.

<sup>5</sup> PitchBook's Q3 European PE Breakdown, Oct. 14, 2020.

<sup>6</sup> Preqin, December 31, 2020

EXHIBIT 5 – Global PE Dry Powder (\$bn)<sup>7</sup>



## Wilshire's Assessment

The UK voted to leave the EU in 2016, triggering a long period of political uncertainty. When building our portfolios, we always have a focus on right-sizing commitments in “other client-based” denominated currencies, to allow for exchange rate volatilities. With the pending Brexit, however, we have been even more cautious committing to domestic investment opportunities, given the anticipated negative impact on the overall UK economy, including imports and exports and the possible risk of departing skilled workforce. In addition to some UK-based pan-European buyout and inherently global venture capital funds, Wilshire made just one UK-only focused commitment since 2016. Its strategy, however, has a focus on technology and services, with high recurring revenues and as such this investment continues to track well, albeit at a low valuation of the pound.

Overall, we believe that our portfolio companies are well-positioned to operate in the post-Brexit business environment. The discretionary private markets portfolios we manage on behalf of our clients have only a 6.6% NAV exposure to UK-based companies, of which over 60% are IT-related companies. In our view, technology remains one of the few secular growth opportunities with COVID-19 and we suspect also the Brexit, further accelerating tech adoption. To conclude, we are more concerned with the consequences of the global pandemic than the Brexit deal. While from a top-down review this trade deal puts some downward pressure on the UK economy and the pound, we expect that with diligent bottom-up analysis, we will see some compelling opportunities arise from the current market dislocation.

<sup>7</sup> Preqin, December 31, 2020

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