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Business yet to get a true fix on Brexit consequences

But for clear-eyed investors there are chances to pick and choose likely winners

By Charlie Geffen and Hardeep Plahe

Brexit is generating a lot of noise and heat ... but not a lot of light. Most of the debate has been speculation about the future relationship between the UK and Europe and the best that has emerged is the thoroughly uninformative "Brexit means Brexit".

But what does it all mean for businesses in the Gulf? What are the opportunities and where are the challenges?

First — and most obviously — has been the drop in the value of the sterling by around 15 per cent against the US dollar since the referendum. It is important to understand that the implications of this varies considerably by sector and business.

The fact that both the FTSE 100 and FTSE 250 have strengthened by about 15 per cent and 5 per cent, respectively, reflects the extent of overseas earnings for the companies in those indexes. In pure sterling terms they have received a significant FX boost to their revenue and profits, with FTSE 250 companies having a higher proportion of sterling income.

Despite this, the weakness of sterling and the relative strength of the US dollar cannot be underestimated. Gulf investors generally report their financial results in US dollars or in Gulf currencies that are pegged to the dollar. Furthermore, Gulf investors are not only holders of listed stock but have been keen investors in private companies and real estate assets in the UK and Europe.

The value of sterling-denominated investments has tumbled in dollar terms even if the sterling price has held steady or shown an increase. There is also growing strength in the US dollar. The US Commerce Department reported on October 28 that US GDP had grown at a higher than expected annualised pace of 2.9 per cent in the third quarter, which may increase calls for a US interest rate rise in December and thus further strengthening the dollar.

So for Gulf investors looking at UK businesses and assets it will be important to not only understand how the relative strengths of the dollar and sterling affect their internal financial reporting but also how the fundamentals of the UK investment will be affected. For example, when looking at a UK business, an investor should consider how much it sells domestically, how much overseas and the extent to which the supply chain is dependent on imports.

Many exporters in the UK are still dependent on, now more expensive, imports for their products. Sales may be up in sterling terms but margins are squeezed.

There are three other obvious known risks of Brexit. First, the extent to which restrictions on immigration will impact the labour force. Second, where there are significant sales into the EU, or supplies coming from the EU, whether there will be new tariffs either reducing margin or rendering the product uncompetitive.

And, third, the impact on the regulatory environment — many businesses benefit from simplified approvals processes from EU-wide exemptions.

Finally, it remains unclear how the broader UK economy will respond to Brexit. The devalued sterling has already led to a rise in fuel prices which is bound to feed through to most consumer goods as well as the day-to-day running costs for families. Food inflation is expected with many suggesting 5 per cent increases over the coming months as hedging arrangements expire and price increases are shared between wholesalers and retailers.

We have already seen "Marmitegate" between Unilever and Tesco and that is likely to be a foretaste of what is to come.

Nevertheless, the UK economy is growing more strongly than expected and although there appears to be consensus that there will be bumps in the road as the Brexit discussions continue the much forecasted recession has not (yet?) arrived.

At one level therefore it comes down to individual appetite for risk. Private equity investors and tightly controlled Gulf companies with a lengthy multi-year investment strategy may well see opportunities to acquire businesses that face increased risk today with commensurate lower valuations.

These businesses may present consolidation plays, buy-and-build strategies or other medium term chances to add value. It is also the case that a number of IPOs in London have struggled where the business has been more domestic.

The owners of these companies would clearly like to realise value — but the public markets are against them.

Whilst this sentiment cannot be ignored, it does reflect the pressures as listed companies try to produce short term results. This may therefore provide opportunities for those able to invest with longer term horizons.

Notwithstanding any of this, and whether Brexit is "soft", "hard" or more likely "fudgy", the UK's deep infrastructure, human capital, culture, geography, language and rule of law will continue to ensure that London remains one of the three most important global centres alongside New York and Hong Kong.

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