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Brexit: The Bigger Picture

Rethinking supply chains in a time of uncertainty

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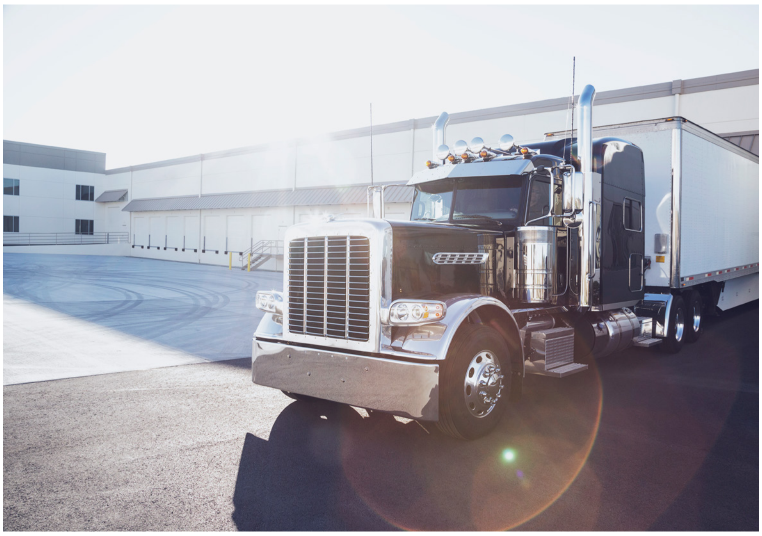
Many British businesses, along with the UK operations of multinationals, depend heavily on imports from the European Union (EU) and are closely integrated with EU-based suppliers. Indeed, the EU accounts for 54 percent of all goods imported into the UK. We interviewed executives at about 50 firms across the UK, who told us that Brexit has injected considerable uncertainty into their supply chains. The uncertainty will not be short-lived: it is likely to persist for a decade or more, and will add to existing volatility and vulnerability in the supply chains of many industries.

— by Wim Gysegom, Ruben Sabah, Maximiliano Schlichter, Christoph Schmitz, and Francois Soubien

In the first article in the 'Brexit: The Bigger Picture' series by McKinsey's UK and Ireland office, we emphasized that the EU is the UK's largest market, accounting for nearly half of all British goods exports. That makes Brexit a keen concern for companies with British operations – and a compelling reason for executives to revisit their export strategies. In this article, we spotlight the other side of the equation: imports from the EU into the UK. If anything, companies' Brexit-related challenges in this arena are even greater.

Whatever the eventual outcome of Brexit, companies can and should see the current high-uncertainty environment as a prompt to rethink their supply chains and so make them more resilient. For many firms there is a big need to update supply-chain strategies, bring greater flexibility to their operations, and build new structural agility into their organisations. Pioneering companies in the UK and internationally are already adopting those approaches to deliver real improvements – including revenue increases of at least 3 percent and capex reductions of around 5 percent.

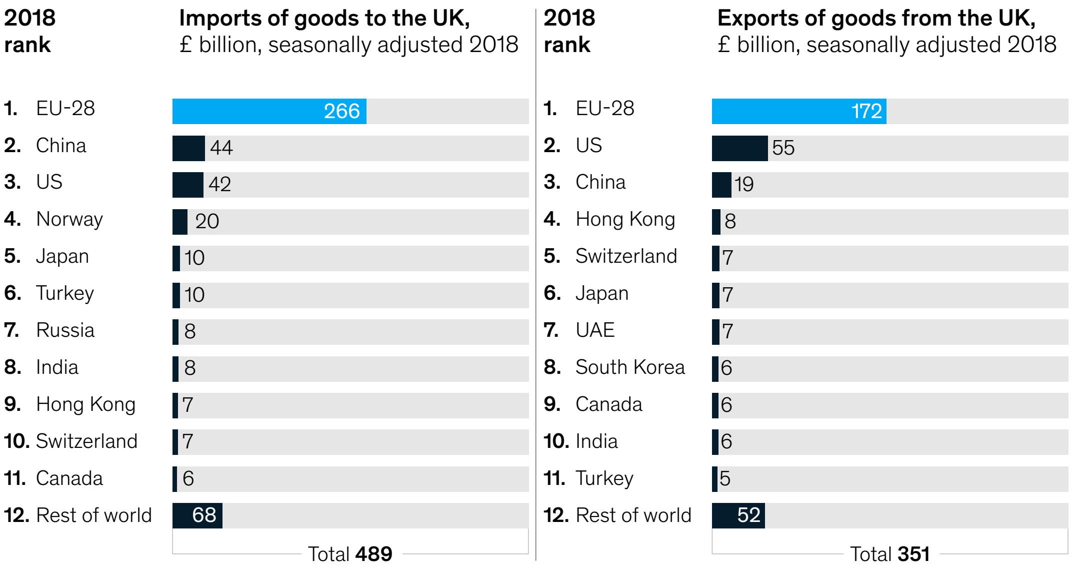


Why Europe is so critical in British supply chains

The EU is the UK's largest trading partner, accounting for approximately half of both imports and exports of goods (Exhibit 1). Moreover, a large proportion of the UK's imports from and exports to the EU are in the form of intermediary products – an indicator of the high degree of interconnectedness between UK and EU supply chains (Exhibit 2)

Exhibit 1

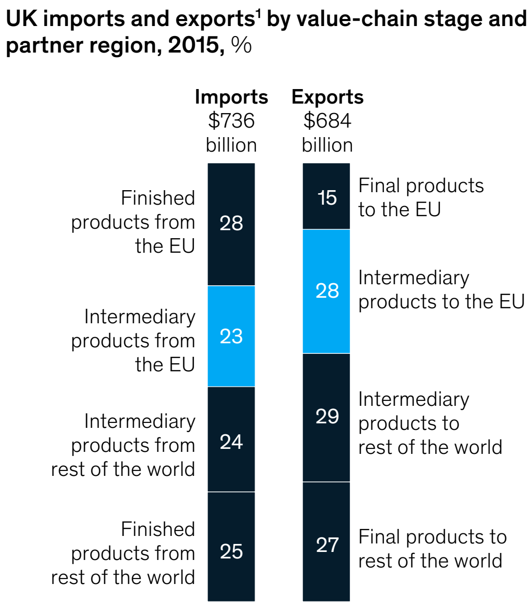
The European Union is the UK's number-one partner for trade in goods, comprising 54 percent of imports and 49 percent of exports



Note: Figures may not sum, because of rounding.
Source: ONS

Exhibit 2

A significant proportion of the UK's imports from and exports to the European Union are in the form of intermediary products



Note: Figures may not sum to 100%, because of rounding.
[1]Includes both goods and services.
Source: OECD Trade in Value Added database; McKinsey analysis

Trading ties with the EU are of particular importance to UK-based firms in the food and drink, chemicals and automotive sectors. The EU accounts for the great majority of the UK's trade in the crucial commodities in these sectors' supply chains (Exhibit 3). Trade in these inputs is vulnerable to disruption from Brexit, as they would all face relatively high duties in the event that UK trade with the EU reverted to World Trade Organisation (WTO) most-favoured nation status.

Brexit poses major uncertainty for supply chains – and this could persist for a decade or more

No-one knows today how Brexit will unfold. Given how closely British supply chains are integrated with the EU, companies need to prepare for any one of several scenarios. They also need to give thought to broader geopolitical uncertainties and the challenges that could arise if a future UK–EU trade agreement proves as difficult to negotiate and ratify as those Brussels reached with Switzerland and Canada.

Switzerland's negotiations with the EU continued for more than a decade, from 1992 to 2004, and resulted in about 20 separate treaties. In the case of Canada's Comprehensive Economic and Trade Agreement with the EU, negotiations began in 2009 and were concluded only in 2014 – and the agreement has yet to be ratified by all EU national legislatures. That is a stark reminder that, even if a firm decision is taken on Brexit in the next few months, uncertainty about the UK's trade regime could persist for a decade or more.

In our interviews with UK-based executives, we found deep concern about the near-term uncertainty and impact of Brexit, but limited preparedness for the ongoing ambiguity about UK–EU trade that could be with us for years to come. In total we interviewed about 50 executives in FTSE 100, FTSE 250 and other large UK-headquartered corporations, across key sectors including consumer goods, retail, pharmaceuticals, advanced industries and logistics.

Exhibit 3

In several major economic sectors, the European Union accounts for the great majority of the UK's trade

Commodity groups	% of total UK trade, 2018	% of which is trade with EU-27	EU MFN[1] average applied duties, %
Transport equipment	17	78	4.7
Chemicals	15	77	4.6
Non-electrical machinery	14	59	1.8
Minerals and metals	14	52	2.0
Agricultural products[2]	9	77	0.0–35.9
Other manufacturers	7	57	2.3
Electrical machinery	7	51	2.5
Clothing and textiles	6	49	11.5
Petroleum	5	50	2.5
Wood, paper, etc	4	61	0.9
Leather, footwear, etc	2	65	4.1
Fish and fish products	1	51	11.6

[1]Most-favoured nation.
[2]Includes animal products, dairy products, fruit, vegetables, plants, coffee, tea, cereals and preparations, oilseeds, fats and oils, sugars and confectionery, beverages and tobacco, cotton and other agricultural products.
Source: World Integrated Trade Solution; OFX; McKinsey analysis

Consumer-goods-manufacturing companies, for example, told us they were fundamentally concerned about the impact of tariffs and border friction on existing supply chains. Many food-manufacturing companies serve EU markets from UK manufacturing plants, and vice versa. Companies manufacturing products with short shelf-lives are particularly concerned about potential delays at ports. As one food-manufacturing executive said: “If Brexit goes badly, we could easily lose £100 million of business. Some of our products become immediately uncompetitive if we are hit with tariffs.”

Advanced manufacturing companies are worried about the impact of tariffs, warehousing and border friction on existing supply chains, particularly in the case of just-in-time manufacturing. Executives told us they were preparing for greater risk in their ability to meet existing contract obligations, as well as in the competitive positioning and profitability of their business models. As one executive at an automotive manufacturer said, “The operational costs alone of managing increased customs processes will be in excess of £7 million pounds a year for our company.”

In the pharmaceuticals and medical-technology sectors, most companies we spoke to were actively considering stockpiling key products. Some had already begun doing so, with significant implications for their working capital.

We encourage British companies across sectors to undertake a sober assessment of the full range of Brexit-related uncertainties, not just the potential short-term disruptions but also the possibility of having to manage their supply chains while multi-year trade negotiations proceed between the UK and the EU.

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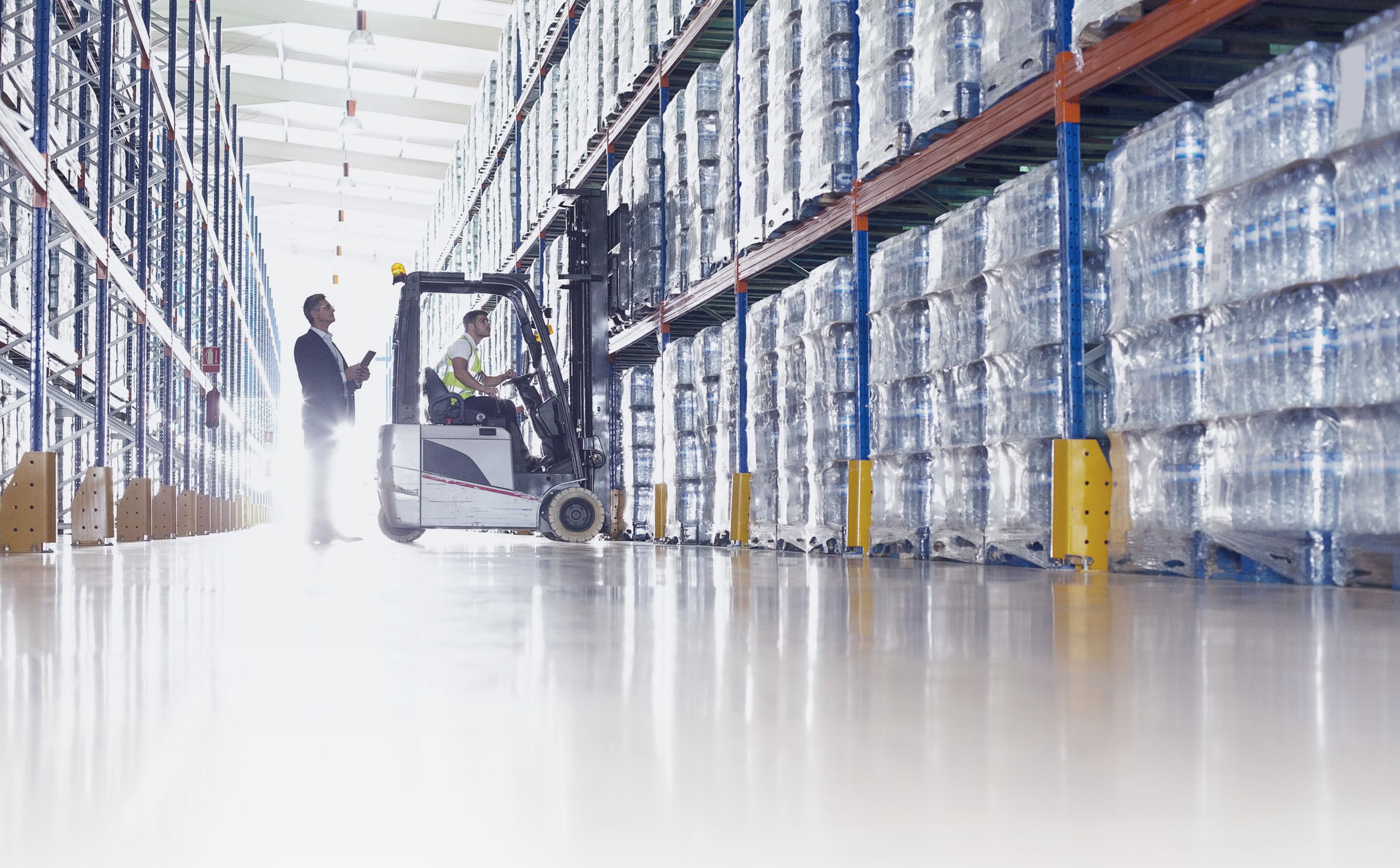

Six steps to rethink supply-chain strategy, operations and organisation

Whatever the eventual outcome of Brexit, UK-based companies can and should see the current high-uncertainty environment as a prompt to rethink their supply-chain strategies and operations, so building greater flexibility into their investment and transition plans. We suggest six key topics that executives can focus on; some companies are already making progress on several of these priorities, but few firms have mastered all of them.
The six steps are as follows:

1. Redefine sourcing strategy.
Many companies might need to explore onshoring opportunities and develop local suppliers – or the local footprints of international suppliers – to ensure reliable supply at competitive cost even in a scenario of ongoing uncertainty over European trade. Companies can also hedge currency and commodity-price risks, and modify contract structures to protect against short- and medium-term risks.

2. Revisit footprint.
Companies will need to optimise their manufacturing and logistics footprints, reconsider the scope and timing of investments, and assess ways to re-allocate production. They can use digital technologies and advanced analytics tools to sift through reams of data, so identifying the trade-offs involved and making decisions that optimise end-to-end costs.[1]

3. Review inventory build-up strategy.
Many firms will need to adjust their inventory tactics for the short term to ensure business continuity and maintain service levels in any Brexit scenario. In the medium term, they will need to reassess their safety-stock levels in light of new operating conditions.

4. Prepare for changes in demand.
Companies can reinforce their forecasting capabilities so that they can predict and manage the impact of changes in demand on their volumes. A key focus should be on increasing flexibility – for example through greater use of outsourcing – to cope with greater volatility and uncertainty in demand.

[1] As our previous research emphasises, the use of digital tools will be critical in enabling successful supply-chain transformations. See "Supply Chain 4.0 – the next-generation digital supply chain", McKinsey & Company, October 2016. https://www.mckinsey.com/business-functions/operations/our-insights/supply-chain-40--the-next-generation-digital-supply-chain

5. Adjust product portfolio. Many firms will also need to adjust their R&D strategies to manage changes in product specifications. Those changes might be driven by Brexit-related regulatory changes or by shifting consumer needs.

6. Strengthen capabilities and talent. The changes set out above will require a suite of new capabilities to underpin a more agile, flexible organisation. These include forecasting and analytical capabilities, as well as capabilities to react quickly to shifts in the market, such as digitally powered control towers that reinforce real-time data visibility. This will require a new push to attract and retain talent.

Pioneering companies are already applying these steps to deliver real improvements in the resilience of their supply chains, as well as significant uplift in revenues as they reduce costs, write-downs, inventory and capital expenditure. We have observed companies increasing revenue by at least 3 percent through minimising stock-outs by holding the right amount of safety inventory (Exhibit 4).

Some firms have reduced write-downs by as much as 45 percent by placing the right inventory bets to minimise excess unwanted products. They have also reduced overall inventory by 10 percent or more by reducing year-over-year inventory carry-overs as a result of excess safety inventory. That has led to capex reductions in the region of 5 percent, as companies have eliminated the need for capacity expansion at plants to produce excess safety inventory.

Exhibit 4

Companies that master strategies for high-uncertainty supply chains achieve significant impact

Income statement			Balance sheet	
Revenue	Cost of goods sold	Write-downs	Stock	Capital expenditures
3+%	2–3%	30–45%	10+%	5+%
by minimising stock-outs through holding the right amount of safety stock	by reducing overtime production to make up for bad decisions	by placing the right stock bets to minimise excess unwanted products	by reducing year-over-year stock carry-overs as a result of excess safety stock	by eliminating the need for capacity expansion at plants to produce excess safety stock

Conclusion

Brexit poses major uncertainty for the supply chains of many companies operating in the UK, on top of already high levels of uncertainty caused by global geopolitical and economic trends. But we are convinced that companies can respond to the ongoing uncertainty by reinventing their supply chains – not just to protect against near-term disruption, but to deliver long-lasting improvements in resilience, flexibility and bottom-line performance.

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