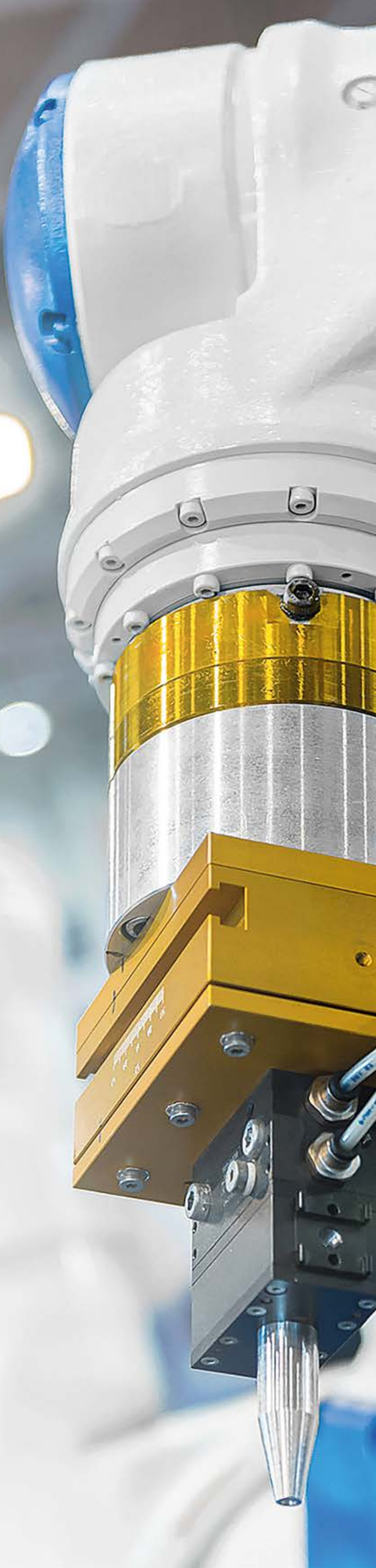
Rethink manufacturing

Mitigate risk and plan for opportunities - Brexit briefing



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Mitigate risk and plan for opportunities

Disruption is growing exponentially in the world of manufacturing. From talent and technology, including Industry 4.0, to Brexit and latterly the Trump election, there are many risks and opportunities ahead.

It's time for a rethink.

Stephen Cooper
Head of Industrial Manufacturing, KPMG in the UK

Uncertainty and loss of business confidence are major issues currently facing UK manufacturers. But businesses can best focus by framing their scenario planning around the likely paths that the UK will follow as we work through Brexit.

"We do know that the 'worst case scenario' for companies operating across international borders will be that defined by WTO (World Trade Organisation) rules," says Justin Benson, Director in KPMG in the UK's Industrial Manufacturing practice. "This could involve an increase in cost of around 10% for finished vehicle manufacturers exporting to the EU."

However, a significant proportion of the UK supply chain is localised within the UK. The local content of UK manufactured vehicles is approximately 41%, according to SMMT's Motor Industry Facts 2016. Increasing local sourcing may be a strategy worth considering as an alternative to opening up a plant in the EU, depending on what trade deal the UK strikes with the EU.

In this respect, Brexit is an opportunity for manufacturing executives to sharpen their thinking, mitigating future cost increases by building greater efficiency and appropriate structures into their business models.

Currency gains and losses

The fall in the value of the pound since 23 June, and indeed since the referendum was announced in November 2015, has meant UK costs – including wages – have fallen by around 20% relative to overseas competitors. Profitability of exports has soared too, once converted back into pounds. But many manufacturers have yet to feel these benefits. Hedges in place before the Brexit vote are still unravelling and the full impact of price rises in energy, steel and other imported supplies will emerge over the coming months. Currency markets remain volatile, particularly in light of the upcoming Trump presidency.

Sterling's fall does open the door to new export opportunities as well as the chance to generate increased profitability to drive capital investment and further engineering innovation and development.

"The UK aerospace supply chain has been traditionally focused around Airbus, BAE Systems and Rolls-Royce, says Glynn Bellamy, Head of Aerospace at KPMG in the UK. "But even before the EU referendum there was a trend emerging for companies to target General Electric, Pratt & Whitney, AVIC, Comac and other enterprises outside the EU.

"The existing currency tailwind provides even greater opportunities, although the biggest risk to the supply chain is complacency arising from improved competitiveness caused by sterling devaluation. I believe that the pound's exchange rate is towards the bottom of its current range, and the UK aerospace industry needs to have its future based on technical innovation and value added engineering rather than a 'low cost' solution. It is therefore important that the industry uses the current currency benefit on margins to invest further in R&D and innovation."

Energy costs, capacity and demand

The fall in the pound will mean prices rise for oil, gas and electricity. Manufacturers should continue to enhance their drives to improve energy efficiency – not least because the UK has a potential problem with energy supply capacity.

The buffer between typical supply and demand in UK energy used to be between 15% and 20%. This winter, National Grid predict it to be 6.6%. Consumption – especially for industrial users – has become more efficient. But that wafer-thin buffer could see energy prices soar if this winter is more severe than in recent years. Spot price contracts will add to uncertainty in the short term – so supply contracts should be firmed up.

Over the longer term, the announced approval of fracking in Lancashire may lead to improved energy security in the UK (as well as more work for manufacturers and service companies in the energy supply industry).

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> Director, KPMG in the UK

Capital investment

Positive numbers from the Purchasing Managers' Index (PMI) and announcements like that from Nissan on making the next-generation Qashqai at its plant in Sunderland, paint a more positive picture for manufacturing investment, especially in the auto industry.

"The changes in tariffs and currency should prompt manufacturers to reassess their own value chain, looking to re-shore and focus on new markets," says John Leech, Head of Automotive at KPMG in the UK. "The key decisions relate to new model investments – things look bright following the Qashqai decision but suppliers will be wary of other mass-market models currently made in the UK which could be made instead at another EU plant."

There are other disruptive forces at work. Drivetrains in the automotive sector will start to move from internal combustion engines to hybrid or electric during the next twenty years. Traditional powertrain suppliers will come under pressure as volumes start to fall during the next decade.

"Of course this opens new opportunities too, particularly new battery production facilities required by the industry," Leech says. Investment in new skills and digital technology, and familiarity with new materials, will all be essential over the next 10 years.

People power

"I don't believe that any major manufacturer knows how many EU nationals are on their UK payroll or, in the case of the automotive sector, in the wider supply chain and dealer network," says John Leech. "Gather information now on employees and imports/exports that will be necessary once we exit the EU." If companies are to avoid running the risk of finding themselves in the middle of a staffing crisis, they should be certain of what their situation is. While the current likelihood is that existing EU nationals will not be required to leave the country, this has not yet been set in stone and it is almost certain that new documentation will need to be attained.

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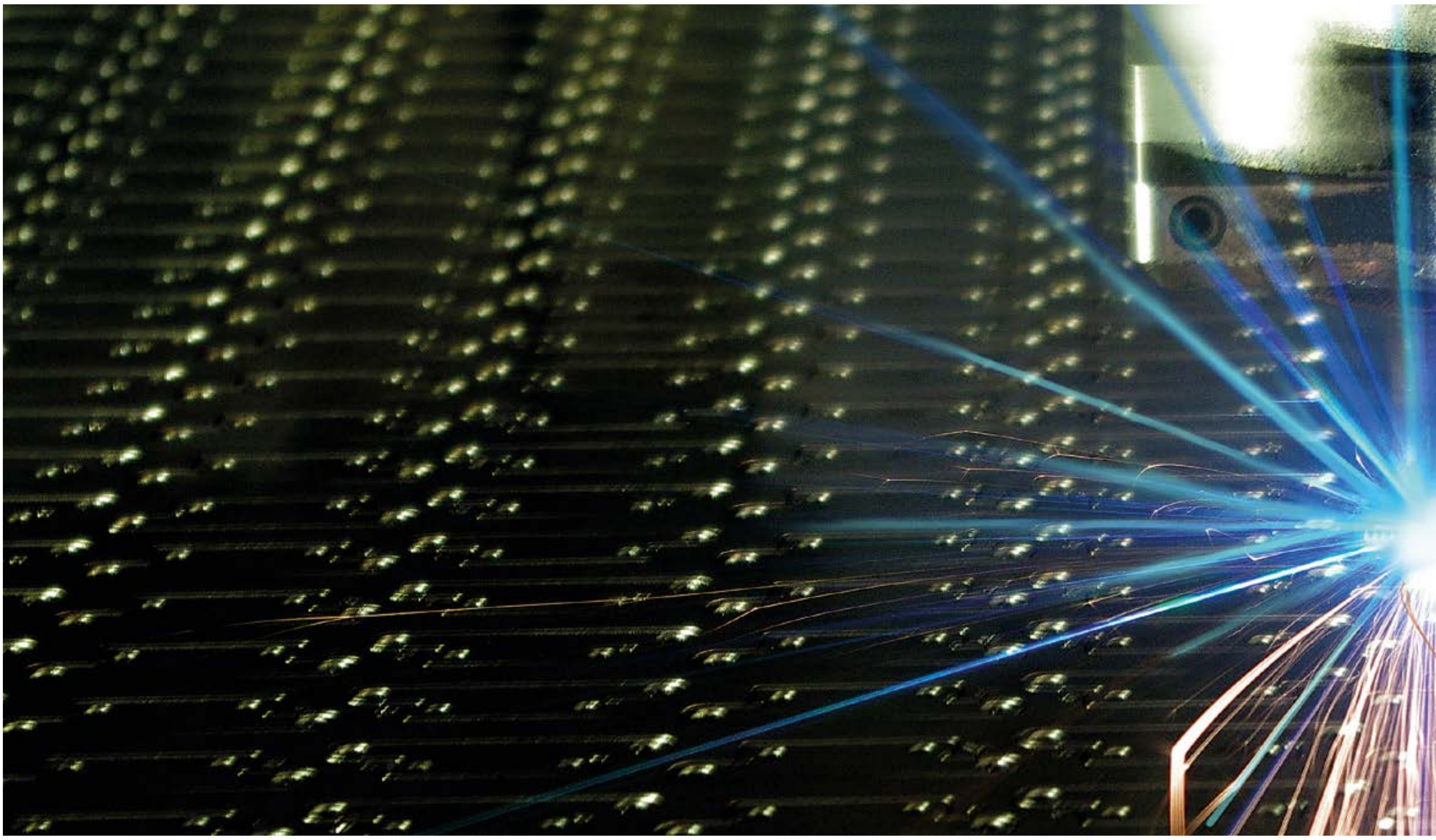

Flex the footprint

"Manufacturers operating across borders have an attractive opportunity to optimise their production footprint," says Justin Benson. For example, GKN has recently opened a second plant in Oleśnica, Poland. Jaguar Land Rover can exploit its factory in Slovakia to cater for EU markets.

"Companies with similar footprints can increase capacity for opportunities to grow. Consider gearing those plants towards supplying the EU and orientate their British plants towards the rest of the world," adds Benson. "That way, sales in Europe will not be affected by the introduction of tariffs and sales to the rest of the world will gain from the lower British cost base. If the UK is able to negotiate trade deals with countries like India, China and even the US, those factors will make it a very good place from which to do business."

Advanced technology and IT systems

Brexit presents the country with an additional driver to become the location for more cutting-edge technology, including in the auto supply chain. Research bases such as the Warwick Manufacturing Group and the Institute for Advanced Manufacturing are keen to innovate with manufacturers. The MTC at Coventry and Factory 2050 in Sheffield are inspirational demonstrators of the factory of the future where SMEs can experience the transformative power of exploiting data in a manufacturing context.

However, as companies continue to digitalise – with increased emphasis on cloud-based systems, for example, or exploiting data across geographies – they should also ensure that they build out capacity for dealing with complex paperwork and regulations on movements into and out of the EU (see tax column for further information).

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Manufacturing Brexit: tax matters

With Simon Jonsson, Partner, Tax, specialising in industrial manufacturing, KPMG in the UK.

What should manufacturers be doing to prepare their tax arrangements for Brexit?

It's important to remember that until Brexit actually takes place – or until new legislation is introduced – nothing changes in law. But that doesn't mean businesses can't start preparing for what they know is coming. Indirect tax is likely to be the biggest practical concern for businesses. The majority of UK tax law will probably stay the same and the impact on direct taxation is unlikely to be huge.

What will be the impact on corporate and income taxes?

The EU Parent-Subsidiary Directive and the Interest and Royalties Directive currently provide a measure of relief on cross-border income streams. In post-Brexit UK these Directives will cease to apply.

Instead, UK businesses will rely on bilateral Double Taxation Agreements (DTAs). None of these were abolished when those directives came in, so they remain in place. But they are not all the same: different countries have different arrangements, formed at different times, and each DTA will have to be tested in practice. Comprehensive DTAs may never have been agreed with countries formerly part of the Soviet Union, or newly formed states.

The UK may have a high number of DTAs in place. But businesses will have to deal with the complexity of moving from a single, EU directive-based system to one where DTAs have to be tested each time they are used. This is likely to result in less advantageous terms for businesses and more administration around tax compliance in respect of cross-border transactions.

The EU Arbitration Convention on Transfer Pricing includes measures on the relief from double taxation of intra-group transactions. Critically, it includes dispute settlement processes, and acts as an incentive to both businesses and tax authorities to settle disputes. A post-Brexit UK will lose that resolution method; UK multinationals will no longer have recourse to the Convention if they aren't happy about how they are being treated.

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> Partner, KPMG in the UK

What are manufacturers' key concerns around indirect tax?

First is VAT: One of the requirements of being part of the EU Single Market is that the UK had to implement a VAT system which complies with the principles of the EU VAT Directives. As VAT is a major source of government revenue, it is expected that the UK will maintain the broad principles of the current EU VAT system.

Current EU principles regulate how VAT is applied on cross-border movements of goods, ensuring that VAT is applied once only on each transaction. In most cases, this VAT is self-accounted by the recipient of the goods or services under a reverse charge mechanism. There is also a pan-national agreement on how to treat imports/exports with third countries. Post Brexit, movements of goods between the UK and other Member States will become imports/exports and be subject to the payment of import VAT.

Second, customs duty rates in a worst case scenario would be set at a maximum of the UK's WTO bound rates. Post-Brexit, the UK will have the opportunity to set its own duty rates at or below these rates on individual product categories. In order to facilitate trade, the UK government may be able to sign its own Free Trade Agreements or make certain unilateral tariff reductions to a lower or nil rate, specific to industry sector.

If the UK fails to enact any trade agreements with the EU and the rest of the world, businesses may need to plan for a worst case scenario based on WTO bound rates as a baseline for current supply chain impacts.

Movements of goods between the UK and remaining EU will likely become imports and exports. This could lead to an significant increase in administrative costs and, potentially, in inventory costs and supply chain delays. These costs can often be mitigated through automation of declaration communications with HMRC and other EU authorities.

The aerospace and automotive sector currently has specific duty reliefs available for its goods and manufacturing activities regulated under EU law. Moving forward, we expect that the UK will retain or extend these duty reliefs. Consideration should be given to whether your supply chain could benefit from these reliefs and procedures (for example end use, customs warehousing, inward processing).

It is likely that as a starting point for day one, these reliefs and procedures will simply be replicated in the UK's own legislation, which usually involves obtaining authorisation from HMRC. As this can take some time, it may be prudent to start contingency planning immediately in spite of the continued lack of certainty of the ultimate outcome.

To-do list

- > Determine your supply chain tax exposure on day one of the UK's exit from the EU.
- > Analyse and collate movements and EU trading covering three, and ideally five, years, in order to identify trends.
- > Start contract negotiations with freight forwarders. Consolidate movements in order to drive down costs.
- > Prepare for Certificates of Origin being required for EU trades. Obtaining an approved exporter status could prove to be a significant benefit.
- > Consider authorised economic operator (AEO) status. A self assessment model would prove beneficial for just in time supply chain operations.
- > Reconfigure warehouse management systems in order to take into account customs and duty status.

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