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Impacts of Brexit on Global Sourcing of Technology & Business Services

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Brexit, the shorthand notation for Britain's exit from the European Union, may have long-standing repercussions on the global economy, particularly on the technology services market.

Upholding the electoral manifesto of Britain's Conservative Party, the then Prime Minister David Cameron, scheduled an advisory referendum on June 23, 2016 where Britain voted to leave the European Union ("EU"). Immediate reactions that followed the voting were a mixed series of tears and cheers from across the global financial and business markets.

Britain, of course, experienced the maximum heat from the global markets. Immediately following the vote, the UK Stock Exchange plunged and the pound plummeted to a 31-year low. £120 billion were wiped off the value of Britain's leading shares and over $2 trillion from markets around the world. The pound was down 10% against the dollar and more than 7% against the Euro. In total, the combined FTSE 350 index surrendered £140 billion in the Brexit aftermath, (-14.2%) in 2 days. The yield on 10-year Government bonds dipped below 1% for the first time ever, as investors sought safety and bet that the Bank of England (BoE) would cut interest rates to zero.

Leading credit rating agencies have since downgraded UK's credit rating as well. Standard & Poor's (S&P) and Fitch's rating for UK is at AA with negative outlook. Moody's credit rating is at Aa1 with negative outlook. A summarized view from the credit rating agencies indicates that UK's economy will face less favorable terms for exports to the EU, lower immigration and a reduction in foreign direct investments that will impact medium-term growth, along with a recalibration in the value of the pound and softness in the business environment.

Implementation Timeline

Beyond the hysterical reaction of the global markets, the question to ask is whether the Brexit phenomenon is over? The factual position of the situation is that Brexit has not happened yet! Uncertainties shroud the actual execution of Britain's lawful exit from the EU. Technically, "Brexit" will start only when the UK Government/Parliament ratifies the Referendum result and formally notifies the European Council of its decision to leave the European Union, as requested by article 50 of the Treaty of the European Union (a.k.a. the Lisbon Treaty). Few proponents of Brexit (including Cabinet Ministers) are pushing the Government to trigger Article 50 as soon as possible. However, the new Prime Minister has recently committed to triggering Article 50 by the end of March 2017.

Future Scenarios for the UK

The only clearly defined scenario is that, without a new formal agreement, the UK will cease to be part of the EU and will fall back to a WTO position, with barriers and tariffs of up to 25% imposed on goods. In this case, most analysts have predicted that the UK will enter a recession.

Four possible post Brexit scenarios are being discussed as alternatives for Britain: the "Norway model", the "Switzerland model", the "Turkey model" and the "Canada model".

I. The Norway model: Britain has membership of the European Economic Area ("EEA") and the European Free Trade Association ("EFTA"), with full access to the single EU market, but is obliged to make a financial contribution and accepts a majority of EU laws, including free movement of people.

II. The Switzerland model: Britain has membership of the EFTA, but not the EEA. Its access to EU market is governed by a series of bilateral agreements (which cover some but not all areas of trade). It would make a financial contribution, but a smaller contribution than the Norway model. It does need to implement some EU regulations to enable trade and free movement. However, it does not have full access to the single market for its banking sector and other services (which incidentally make up 80% of the UK economy).

III. The Turkey model: Britain does not have membership of both the EEA or the EFTA, but does have a customs union with the EU, which imposes no tariffs or quotas on industrial goods exported to EU countries. Britain has to apply EU's external tariff on goods imported from outside the EU. The customs union, however, would not apply to agricultural goods or services.

IV. The Canada model: Similar to the Comprehensive Economic and Trade Agreement ("CETA") model that has been proposed between Canada and EU, where almost 98% of the tariffs would be eliminated, Britain can take the route to negotiate a similar deal. Such a deal would not guarantee "passporting" rights to London-based banks. It would also require UK exporters to prove that their goods are entirely "made in the UK" and comply with EU product standards and technical requirements.

Analysts estimates for the UK economy get progressively worse from the Norway to the Canada model, Norway being the option that may bring the economic situation to pre-referendum levels.

Sectoral Impacts

Britain is an open economy. So, the impact of Brexit will be felt not just in the domestic-focused industries and sectors, but also in all industries that have import or export concerns with Britain. It is expected that the ongoing uncertainties related to the Referendum and the ensuing negotiations with the EU will continue to impact all sectors until the end of the two-year negotiating period. Sectors that see the most trade done between UK and EU will be the most vulnerable. The table below highlights UK's five highest exporting sectors to EU.

Sector	% of Exports to EU
Machinery and Transport Equipment	41.1%
Chemicals	57.2%
Mineral Fuels	77.3%
Insurance and Financial Services	33.8%
Manufactured Goods	53.1%

Source: HM Revenue & Customs, ONS, Atradius, Economic Research

In the immediate aftermath of the Brexit vote, the hardest hit sectors on the UK Stock Exchange were real estate, insurance and financial services, and airlines. Most firms in these sectors lost massive amounts of market value overnight following the voting. The quantum of such losses are depicted in the table below:

Sector	% Loss of Market Value
Real Estate	- 15 to 20%
Insurance and Financial Services	- 10 to 30%
Airlines	- 5 to 20%

The Brexit uncertainty has dampened demand and has forced slowed progress on planned developments of commercial property, and the number of transactions for residential property has also plummeted. Some Asian banks have suspended lending against London properties whilst others have locked their real estate investment funds.

The fate of the banking industry is almost entirely dependent on the Brexit negotiations regarding passporting rights, which grant the UK banks and financial services firms of European Economic Area ("EEA") the rights to provide a wide range of products and services, and open branches in member states of the EEA. It is reasonable to expect that key European regulatory and supervisory bodies might no longer be headquartered in London. Even though the French and the Germans are eager to promote Paris and Frankfurt, respectively, as the new European financial capital, moving the entire financial ecosystem to other locations would be an uphill task. Therefore, it is expected that there might not be such a large exodus of financial activity out of London and that a lot of London's thriving financial activity will still be retained.

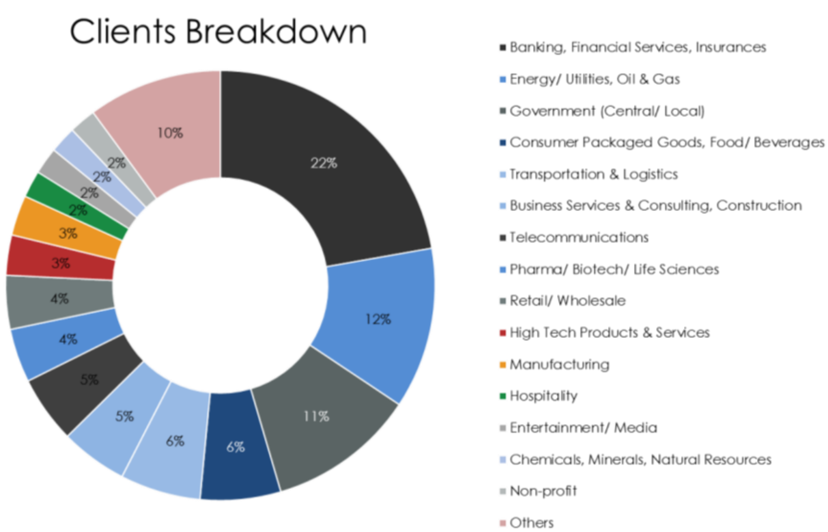
The airline industry is also facing uncertainty, as it will have to embrace an alternate business model post-Brexit, and uncertainty about the future business climate will hamper decision making. Any disruptions to trading volumes in the oil and gas sector, from UK to EU, will have immediate negative impact on the companies of UK.

It's not all grim, though. Certain export-oriented sectors stand to gain in the wake of a weaker pound. A weaker pound augurs well for Britain's exporters as it makes their goods more competitive; this is only partially hindered by more expensive imports, thus on-balance growth may be boosted. A weaker pound may also boost the economy through tourism. The hospitality and retail industries may partially benefit from the lower exchange rates, although this will be offset by lower consumer confidence in case of a possible UK recession.

The job market across sectors presents a flat outlook. A survey conducted by the Institute of Directors found that a quarter of the 1,000+ members, who were surveyed, expressed their plans to freeze hiring in their organizations, while 5% were planning job cuts.

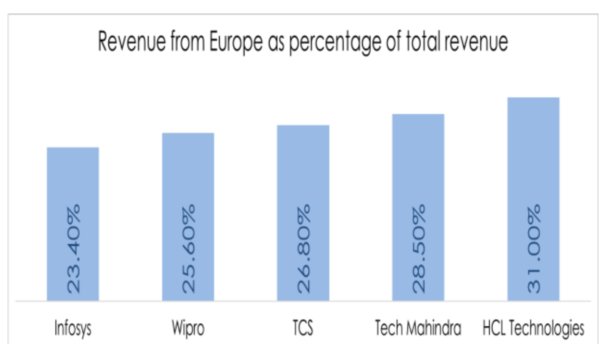
Impact on the IT Services Sector

IT Service Providers serve clients in a range of industries in the UK, most notably in banking, financial services and insurance (22%), energy/utilities, oil & gas (12%), and government (11%). UK is a critical market for many Service Provider ecosystems, so much so that, many large India-based Service Providers receive more than 25% of their revenue streams from UK. A number of IT Service Providers, including Indian and East European ones from Ukraine and Poland, have a large operational footprint in UK. Given the importance of the UK outsourcing market, the impending uncertainties in the business environment, post-Brexit, present a dampening effect on the global IT Service Provider market.



IT Service Providers in the UK market

Source: Consultancy.uk



(Source: Company financial reports)

The UK's National Outsourcing Association ("NOA") recently conducted a survey to solicit opinions of its members about Brexit. Globally, UK is currently the second largest outsourcer and its economy benefits tremendously from outsourcing. According to NOA's survey results, 73% of the UK outsourcing industry thought that the UK should stay in the EU, with the most important reason being to maintain valuable outsourcing and commerce relationships (35%) and to strengthen UK exports (15%). 34% stated that to the UK, the benefits of EU membership far outweighs its costs and that it is unwise and impulsive to leave the EU.

Brexit's Impact on the Sourcing Industry

Buyers Perspectives

Increasing use of IT services and automation, especially in banking and insurance: Brexit might bring in greater long-term transformation of the European financial markets. The possible loss of passporting rights would prevent UK-based financial services firms from providing their products and services directly to the EU. They might need to invest or acquire domestic EU companies. In addition, UK and European financial services companies will increasingly need IT services to comply with new compliance and regulatory requirements in both UK and EU financial markets. UK service providers might have neither the cost advantage, nor the capacity to handle necessary adaptations on time, creating an important market niche for non-UK IT service providers. Furthermore, UK's advanced outsourcing market is already active in adoption of and migration to cloud, automation and artificial intelligence applications. The escalating cost saving pressure post-Brexit would lead increasing momentum in automation, a more cost-effective alternative to labor cost-arbitrage outsourcing.

Decreasing offshoring activities and investments: The outlook for the outsourcing industry could be adversely impacted by a potential economic downturn. It is estimated that 5% of UK's GDP is going to evaporate during the exit process. The EU budget and EU member countries would suffer losses as the UK net contribution of 7-8 billion pound per year is wiped off and trade and ecocomic activity with the UK would diminish. As a result, the overall level of investments in innovations and new technologies will decline, creating negative impacts on the entire IT industry. Under uncertainty, companies may delay large outsourcing projects, slowding down order flows to big IT service providers. Brexit verdict signals anti-immigrant sentiment thus outsourcing service buyers all over Europe will be more cautious about offshore outsourcing.

Service Delivery to UK companies will suffer: Foreign IT service providers who use UK office as a gateway to serve Europe market will face uncertainty. They may have to downsize their operations or renegotiate contracts to get higher rates. UK-based outsourcing service buyers may find that smaller domestic IT service providers could be a more affordable option.

Data Privacy and Compliance will get more complicated: Despite Brexit, UK is trying to converge its Data Protection Act towards a more stringent EU's General Data Protection Requirements. UK's revised data privacy and compliance laws are likely to come into effect in 2018. At such point, it is expected that some service providers in the UK will become non-compliant. In addition, data exchanged with the UK would be under more vigilant governance as the UK would be considered a "third-party" non-EU country. With the current data protection and privacy handling being very complicated and time-consuming, Brexit would render the practice even more complex. However, this will present advanced opportunities for services providers of information security, data privacy and protection, cloud computing, and data storage services.

Seller Perspectives

Decreasing revenue due to depreciation of British pound: The British pound-denominated revenues make up for almost 10-15% of the overall revenues of a large number of IT service providers. A strong pound used to make IT outsourcing to IT outsourcing serivce providers from Asia and continental Europe, especially Central and Eastern Europe, more attractive for the UK. Post Brexit, a cheaper pound makes outsourcing more expensive, reduces the cost advantage of offshore IT service providers and holds up the decision to send work offshore to low cost locations.

The table below presents the relative attractiveness of outsourcing services of a country as measured by relative value of its currency to the pound. A cheaper currency allows Poland, Czech Republic and Hungary to remain competitive on the cost basis.

Country	Relative Value to the Pound	Attractiveness of Outsourcing Services
Chinese Yuan	More expensive	Less attractive
Indian Rupee	More expensive	Less attractive
Euro	More expensive	Less attractive
Swiss France	More expensive	Less attractive
Slovakia Koruna/Euro	More expensive	Less attractive
Slovenia Tolar/Euro	More expensive	Less attractive
Estonia Kroon/Euro	More expensive	Less attractive
Poland Zloty	Cheaper	More attractive
Czech Republic Koruna	Cheaper	More attractive
Hungary Forint	Cheaper	More attractive

Business cannibalization due to loss of client orders: Since the Brexit Referendum, the loss of business already happened to few select service providers. Post Brexit, the Royal Bank of ("RBS") held up its plans to establish a separate affiliate in the UK. The delay was a blow to Infosys, RBS's key technology partner. It could result in an annual loss of $50 million of revenue to Infosys and forced the IT service provider to reassign 3,000 staff to other clients.

Contract Renegotiation: The ongoing IT projects with UK clients need to be re-evaluated to compensate for increasing risk exposure due to Brexit. The question is how to account for all the existing and newly emergent uncertainties correctly. A decline in the value of the pound devalues many existing contracts. IT service providers who are paid fixed prices may find it impossible to honor contractual commitment unless contracts are renegotiated or contract risks are discounted appropriately. Those using time and materials pricing might see their profits less negatively impacted.

Increasing costs of outsourcing labor available in the UK market: The lack of IT manpower has been one of the biggest challenges for the British companies. Many foreign IT professionals are having difficulties in getting UK work visas. After Brexit, the situation will become even worse. Brexit undoubtedly closes the job opportunity for many talents and projects UK as a foreigner-unfriendly workplace. Due to immigration entry barriers and "red-tape" issues, many IT professionals might abandon plans to work in the UK, causing the domestic IT labor cost to spike.

Operations Disruption: Brexit would cause operational disruptions to IT service providers. UK has traditionally been the headquarters for foreign IT firms to serve Europe market. The free movement of skilled IT professionals in the Euro zone is an enabler. If a "hard Brexit" is implemented, IT service providers might need to set up separate headquarters or operations in Europe, leading to divestment and diversion of operations from the UK.

Ramping up IT security risks mitigation: Leaving the EU increases business IT security risks. Currently, EU legislation regarding data protection and cyber security requires the UK to be more vigilant at risk management. This would no longer be required once the UK leaves the EU. Outsourcing buyers and providers should identify and understand potential risks, prepare risk mitigation plans, and ensure that data and IT infrastructure are appropriately protected despite not being required to by EU law.

More legal complications: Some of the major advantages of outsourcing IT services to other countries of the European Union for British companies were the similarities in legal systems and the universality of EU standards. If the UK won't continue to have access to the EU single market, questions surrounding the form and extent of new legal barriers will need to be answered.

Opportunities in the Service Provider market: Brexit problems will not dissuade British companies from outsourcing, especially if the lack of competent IT professionals will further strangle the British economy. According London Technology Week, the demand for IT professionals in Europe is 850,000 by 2020, while the UK alone needs 180,000. This can push up the salaries of UK local IT professionals, forcing British companies to further leverage outsourcing. As the UK is no longer able to resort to intra-EU immigration, it could become more open to high-skilled immigrants from other non-EU countries.

CONCLUSION

Brexit and its consequences pose new risks, however, it also brings opportunities for those companies which can better adapt to new conditions.

Brexit brings in short and near-term risks to IT Services Providers including currency exchange risks, operation and labour market disruptions and to financial services firms, possible loss of business in the UK due to loss of passporting rights. However, in the medium to long run, Service Providers should be prepared to exploit new opportunities that were hitherto unheard of, such as automation services, increasing demand for IT services to deal with changing regulations, data protection and information security, as well as shifting demand from the UK to the EU or even outside the EU. It is important that IT Services Providers realize the risks and have corrective risk mitigation plans, and at the same time, leverage the opportunities by improving relevant competencies.

Sourcing service buyers, on the other hand, should evaluate possible scenarios and their impacts, thus be prepared to have investment plans accordingly, and become more flexible, efficient, and cost effective. Improving business process efficiency, automation, and sourcing etc. are solutions worth considering.

About the Author

Kevin S. Parikh is a noted expert and thought leader on digital and business transformation. He has published numerous widely distributed white papers, articles and texts on the subject and authored a book on digital enterprise transformation. Kevin also advises both private and public sector clients on risk management, corporate governance, and service and vendor negotiations. Prior to joining Avasant, Kevin led the Global Sourcing practice for Gartner Consulting. He has a bachelor's degree in Economics and Political Science from the University of California Davis and received his J.D. from American University.

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