S&P Global
Ratings

The Top Brexit Risks For Rated Corporates Explained

December 14, 2017

Key Takeaways

– Brexit remains one of the top risks in Europe--a unique event with no precedents and an enormous level of uncertainty. As such, the impact on our rated U.K. and European corporates is hard to predict.

– We see the key risks for non-financial corporates in a downside scenario of a harder Brexit as:

  - Economic headwinds, notably from any further sterling depreciation;
  - A changing regulatory environment;
  - Restrictions on free movement of labor;
  - Introduction of trade barriers and dislocation in well-established supply chains; and
  - Lower near term capital investment.

– The complexity and associated risks attached to negotiating transition and trade in phase two of Brexit negotiations should not be underestimated. Delays in agreeing the transition will start to have a more tangible negative economic impact as U.K. and foreign companies adjust their longer-term business plans, including capital investment.

– Across our publicly rated non-financial corporate universe, we have so far detected only a cautious approach to implementing management and operational strategies to manage the risks attached to a disruptive exit from the EU. However, the majority of our rated companies are large and diversified businesses with less reliance on the U.K. for revenues or operations.

Between Rocks And Hard Places

After some last-minute finagling, sufficient progress has now been made in the eyes of the EU to allow phase two of the Brexit negotiations to begin. These will focus on transitional arrangements and agreeing upon a framework for a future relationship. However, determining the U.K.'s future trading relationship with the EU is a huge and complex task and will take months if not years to resolve with many bumps along the way.

Standard & Poor's Global Ratings' base case scenario has always been that the U.K. would avoid a "hard" Brexit—falling out of the single market and customs union and trading with the EU under World Trade Organization (WTO) rules. Moving negotiations to the next stage has reduced the risks of this potentially very disruptive outcome. Still, a high degree of uncertainty remains, political approval processes are unlikely to be straightforward, and the negotiations could yet run aground.

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This report highlights our views on the top three Brexit-related risks on a sector-by-sector basis in a downside scenario where, for example, the U.K. leaves the single market and customs union and trading reverts to WTO rules.

Chart 1

Brexit Sensitivities: The Top Three Risks For Each Corporate Sector

		Goods							Economic			
	EU labor	Trade flows	Trade barriers	Supply chain	Investment	Regulation	EU subsidies	Political risk	FX weakness	Lower conf/ demand	Cost pressures	Financing dislocation
Aero. & Defense												
Agriculture												
Airlines												
Autos												
Business Servs.												
Capital Goods												
Chemicals												
Commodities												
Construction												
Leisure (incl. hotels)												
Pharmaceuticals												
Real Estate												
Retail & Consumer												
Telcoms												
Transport Infra.												
Utilities (incl. nuclear)												

Negative impact	Probability						Positive impact
	high	medium	low	high	medium	low	
high							low
medium							medium
low							high

Source: S&P Global Ratings.

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Due to the complexities and considerable uncertainties which inherently surround this unique situation, we have not covered all of our potential concerns. However, our aim is to outline the most pressing issues that companies will face, as they make contingency plans to mitigate any fallout that could materialize in the absence of any collaborative withdrawal agreement.

The Ticking Clock

A key issue from a corporate perspective is whether a definitive agreement will be reached on a transition period early in the new year or whether that will be discussed in parallel with the future relationship as is reported to be the EU's intention. The earliest possible clarification will be critical to prevent both U.K. and European corporates from needing to implement their contingency plans. Any delays would likely cause companies to become more vocal about the risks of potential post-Brexit disruption to the labor force, supply chain, and regulation.

The hurdle of phase one discussions appears to have been surmounted for now; however specifics on certain issues still need to be resolved. Moreover the complexity and associated risks attached to negotiating transition and a framework for a future relationship, including trade, in phase two should not be underestimated. We consider transition to be a "wasting asset" and that extended delays in delivering an agreement will start to have a more tangible negative economic impact as U.K. and foreign companies adjust their longer-term business plans, including capital investment.

We consider transition to be a "wasting asset"

The U.K. economy has slowed markedly since the vote to leave the EU in June 2016. While it has performed better than initially forecast, we are certainly not in a "business as usual" situation. We may yet see further depreciation of the pound, which is still about 12% weaker against the euro since the Brexit vote. So far, the weaker pound has not appeared to have offered much benefit for the competitiveness of U.K. exports, while higher import prices have stoked inflation. We may also see a contraction in consumption, which, despite the negative growth in real incomes, has been sustained by a surge in consumer credit and lower household saving rates. A decrease in foreign and local capital investment in the U.K. also remains a key risk; a clear trend here has so far been hard to discern. It's clear though that private sector business investment has stalled since the start of 2016.

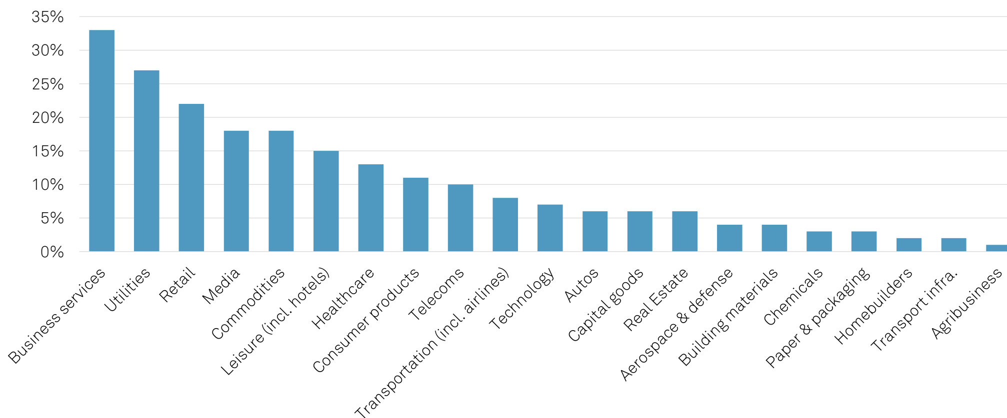
A decrease in foreign and local capital investment in the U.K. also remains a key risk.

The U.K. exported £145 billion worth of goods to the EU in 2016 and in turn imported £242 billion from the EU, according to Office of National Statistics data. We understand that the U.K. government is currently lobbying for zero tariffs on trade in goods post-Brexit and is aiming to maximize regulatory alignment and minimize market access barriers for both goods and services. However, there is still a risk that a deal will not be agreed by March 2019 or even early 2021 (when we anticipate the transition arrangement to end), which would trigger a fall back to WTO rules and could mean substantial tariff and administrative costs across many sectors. Such increased costs for U.K. businesses and consumers would likely have a damaging effect on both the U.K. and EU economies. It must also be noted that the U.K. will not be able to conclude trade deals with third countries, i.e. non-EU countries, while it is still a member of the EU.

Across our publicly rated non-financial corporate universe, we have so far detected only a cautious approach to implementing the management and operational strategies that would be needed to manage the risks of a disruptive exit from the EU. This is to be expected as the majority of our rated companies are large and diversified businesses with less reliance on the U.K. for revenues or operations. That said, given the uncertainties, we believe it's important to evaluate the risks of a hard Brexit to the corporate sectors that are most affected.

Chart 2

Sector Distribution Of S&P Global Rated U.K.-Based Companies



Data as of Nov. 30, 2017. Source: S&P Global Ratings.

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At S&P Global Ratings, we note that U.K.-based rated non-financial corporates are more concentrated in sectors such as Business Services, Utilities, Retail, Media, Commodities, Leisure and Healthcare, and less so in sectors such as Agriculture, Homebuilders, Paper and Packaging, Chemicals, Building Materials and Aerospace & Defense. Therefore, in a downside scenario we may expect rating actions to be more focused in the former sectors, depending on contingency plans companies put in place to negate Brexit-related risks. EU-based companies with material operating exposure to the U.K. would of course also be vulnerable to any deterioration in this post-Brexit environment.

Aerospace & Defense

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As one of the U.K.'s key growth engines, with an annual turnover of £72 billion, the Aerospace & Defense sector is heavily exposed to Brexit. The U.K. accounts for more than 20% of the global defence export market and a little less of the global aerospace market in terms of both manufacturing and research & development. A Brexit deal that would allow the U.K. to maintain a role in, and participate in the projects of, the main EU aviation and space agencies will be key in maintaining the U.K. industry's long-term competitiveness. These are: the European Aviation Safety Agency (EASA, an EU agency with regulatory responsibilities focused on safety and environmental protection for EU citizens), the European Space Agency (not directly an EU organisation, but we understand that about 20% of its funds originate from the EU), and EU space programs.

Risk 1: Introduction of trade tariffs and shifting regulatory standards (high impact, medium probability)

The introduction of trade tariffs would elevate the costs of doing business across the sector, and represents a key risk for the more than £30 billion of annual U.K. exports. If the U.K. leaves the EASA, it would trigger the need to develop new U.K.-specific safety and environmental standards. In a hard Brexit scenario, the reintroduction of customs and border controls would most likely mean additional costs, especially if associated with changes in industry regulations and standards. Any added red tape, for example whereby companies are required to identify the origin of all product components, will add unnecessary time and costs to doing business in the U.K., and have negative consequences for the U.K.'s competitiveness abroad.

The U.K. accounts for more than 20% of the global defence export market

Risk 2: Exclusion from EU research & development projects (high impact, medium probability)

One of the more significant risks for the U.K. could be diminished cooperation or even exclusion from EU Research & Development projects with continental scope. The loss of U.K. influence would likely result in reduced opportunities to cooperate on projects that would be too sizeable, ambitious, and financially unsustainable for a single economy (such as the Galileo satellite program). In addition, participation in EU research & development projects has supported partnerships between the industry and U.K. universities. While U.K. universities have benefitted from EU funding and academic links, they have also invested in the creation of intellectual property that helps to safeguard the competitive advantages of U.K. aerospace and defence companies. A Brexit deal that fails to secure the U.K. industry with access to EU projects and funding would reduce crucial research & development efforts and damage the overall industry's competitiveness over the long-term.

Risk 3: Rising costs of importing labor and reduced labor mobility (medium impact, medium probability)

Access to a skilled workforce, specifically essential researchers and engineers, has helped to keep the industry at the forefront of innovation in recent years. The U.K. Aerospace & Defense industry employs over 350,000 employees directly, which in turn indirectly generates thousands more jobs. Any restriction to the accessibility of the U.K. labor market could be an unnecessary constraint for an industry faced with the need for ongoing innovation and a dynamic international workforce. Retention of a skilled workforce could also be a risk in a market where industry growth is perceived to be constrained in the long-term. A reduced role for U.K. universities in cutting-edge projects could at the same time weigh on the offer of a highly skilled domestic labor force.

Agriculture

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The agricultural sector is very much exposed to the U.K.'s decision to leave the EU. The U.K. is an overall net importer of agricultural commodities with a large trade flow coming from the EU. Agricultural policies that impact the U.K.'s farmers and food supply are currently set by the EU through the Common Agricultural Policy (CAP). Post-Brexit, the UK will need a new agricultural policy and form new trading relationships with the EU and other countries, including establishing free trade, the level of import tariffs, and the level of support for U.K. farmers.

Risk 1: Changes in legislation and trade agreements will hit trade flows (high impact, medium probability)

Reaching a trade agreement with the EU regarding agricultural products will be an important element for commodity food importers and exporters. Although agricultural products can be bought and sold on international markets, the U.K.'s obvious trading partner remains the EU--the nearest market to transport products to and one of the largest agricultural producers globally. If effective bilateral agreements are not put in place, then trade flows (especially U.K. agricultural exports to the EU) are likely to be disrupted by higher regulatory barriers (such as food safety standards) and higher tariffs. What's more, signing new agricultural trade deals with other countries is a long process, complicated by contentious issues such as food safety standards (such as Genetically Modified Organisms and hormone-treated beef).

The U.K. government has highlighted the need to give particular consideration to the implications of tariffs on the U.K. agricultural sector. There is a fine balance to be struck, as high tariff barriers on imports would lead to cost inflation for U.K. customers, whereas lower (or zero) tariffs might undermine the domestic agricultural sector's competitiveness. That said, many EU agricultural tariffs are high, particularly for livestock products (12.8% for beef and veal plus a fixed tariff for instance), and there are opportunities to reduce the burden of stringent EU legislation.

The U.K. government has highlighted the need to give particular consideration to the implications of tariffs on the U.K.

Risk 2: Likely input cost inflation, especially if sterling remains weak (high impact, medium probability)

New trade barriers could lead to higher costs for U.K. agricultural producers in terms of their inputs (such as commodity food products, fertilizers, and seeds), especially if sterling remains weak against the euro. Although the U.K. would remain a large destination market for EU producers, the cost of distribution would increase and thus product prices would likely rise.

The industry employs a large seasonal workforce from the EU (many from the Central and Eastern European region) on land farms and processing factories, which benefit from the free movement of workers. It is unclear whether many workers would be able to stay in the U.K. post-Brexit, but if there are labor shortages or if they are replaced by the local workforce this could push wages up. This is likely to hit operating margins severely for small producers, which may not be able to pass on the full price increases to U.K. food and beverages companies and retailers.

Risk 3: Loss of income for producers from lower subsidies (high impact, medium probability)

Many British farmers receive subsidies from the EU through the Common Agricultural Policy (CAP) which support their viability. The aims of CAP are to support production levels and maintain high food quality standards. After Brexit the U.K. Government has only committed to matching these subsidies until 2020. If subsidies were to decline significantly afterward, farmers would be faced with a loss of income unless they can drastically reposition their products, reduce operating costs, or consolidate with other players to gain economies of scale.

Airlines

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Brexit is extremely important for European airlines, as the U.K. is the leading aviation market in Europe. As per Eurostat data, the U.K. represented about one-fifth of intra-European air transport passengers in 2016. Moreover, the airline industry operates on a global stage and the rise of more open-sky deals and low-cost carriers has buoyed globalisation and supported the growth of many other industries. We understand that the aviation sector is not covered by World Trade Organisation rules and it is therefore particularly important that agreements are secured soon, as customers may choose to book trips a year or so in advance.

Risk 1: Regulatory changes impact flight schedules (high impact, medium probability)

It is crucial that U.K. airlines retain access to EU airspace and airports post Brexit, and vice versa. Key agreements that will need to be renegotiated or paralleled to prevent obstacles are the European Common Aviation Area (ECAA) and the EU-U.S. Open Skies agreement--the latter we consider to be the most important out of the few external EU aviation agreements with countries outside of the EU today. If the U.K. does not remain in these agreements, it will need to negotiate other (e.g. bilateral) agreements ahead of Brexit and safeguard traffic rights.

In the worst case, flights could even be grounded if timely agreements are not secured--although we don't see this universally unfavourable outcome as likely. However, if uncertainty continues then U.K.-exposed airlines may choose to take pre-emptive measures to reduce regulatory risk, such as cancelling flights to and from the U.K. and moving aircraft to continental Europe. Some airlines have indeed already taken anticipatory actions (for example, easyJet PLC has established an Air Operator Certificate in Austria, as well as re-registering a number of aircraft). EU regulations also currently require registered airlines to be majority-owned and effectively controlled by EU nations, in order to retain an operating license in the EU.

U.K. passengers also currently benefit from consumer protections under EU law, such as the right to compensation if flights are heavily delayed or cancelled. Some U.K. airlines are reportedly drafting contingency plans to account for potential changes to U.K. consumer rights, with some already updating the terms and conditions on their websites to say they will not offer refunds for cancelled flights post-Brexit.

Risk 2: Sterling weakness to drive higher costs (medium impact, high probability)

A weak pound sterling causes U.S. dollar-denominated costs such as fuel and aircraft to rise for U.K.-based airlines over the medium-term (depending on hedges in place). Already, the effects of Brexit may have contributed to the collapse of Monarch Airlines in Oct. 2017, as the sharp and sudden drop in the sterling pushed up its U.S. dollar-denominated costs. About one-quarter of easyJet's costs are denominated in US dollar, which are partly hedged. The average 10% decline of the pound versus the US dollar in the year to Sept. 30, 2017, had a 20% impact on easyJet's headline profits before tax.

The U.K. represented just under one-fifth of intra-European air transport passengers in 2016.

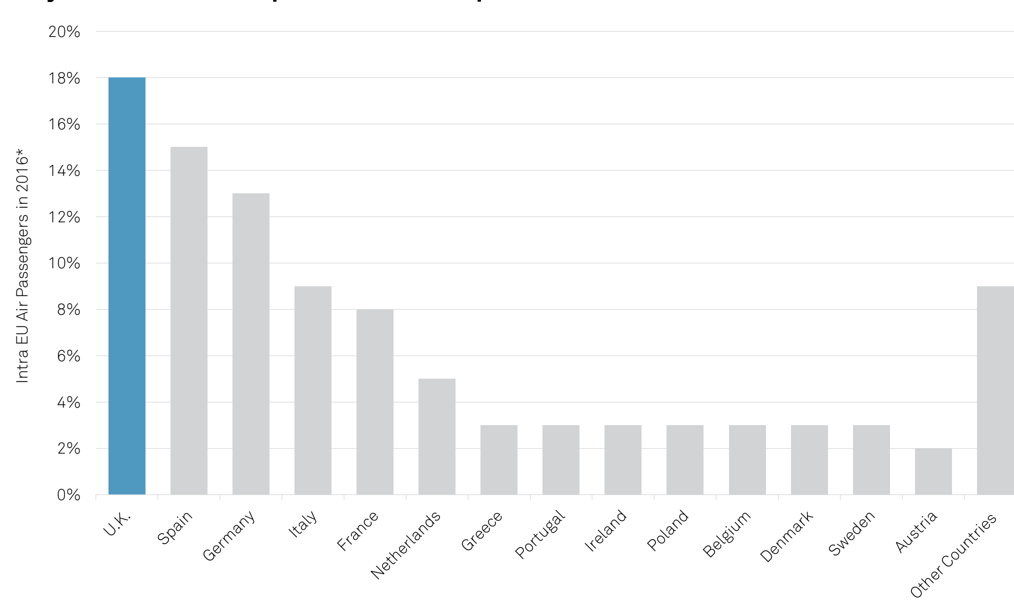
Risk 3: Deterioration in U.K. business sentiment (medium impact, medium probability)

A deterioration in U.K. business sentiment would hurt airlines such as British Airways, which is heavily exposed to the transatlantic premium market. Although there was a dip in demand for both

business and consumer travel in the months after the Brexit vote, traffic has held up surprisingly well this year. Pressures in the extremely competitive European short-haul market are expected to ease, following the recent administrations at Monarch Airlines, Air Berlin, and Alitalia (all unrated).

Chart 3

Why Is The U.K. So Important For European Aviation?



*Percentages are an approximate representation, as the totals include double counting as e.g. a person flying from Paris to London will be counted in France and the U.K. Source: Eurostat.

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Autos

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Brexit is a key concern for the £76 billion U.K. car manufacturing industry (measured in 2016 sales). Almost 80% of U.K.-made vehicles are exported, with the EU the destination for about 56% of U.K. exports. The U.K. automotive industry covers a wide spectrum of companies, including nine major premium and sports car manufacturers, six mainstream car and commercial vehicle manufacturers, nine bus and coach manufacturers, nine engine manufacturers and around 2,500 suppliers.

Risk 1: Supply chain management disruption (high impact, high probability)

About two-thirds of components used in the U.K. manufacturing industry are imported from the EU. Under EU rules, car parts can move freely between the U.K. and the EU in various stages of the vehicle assembly process. This global supply chain--once celebrated for reducing costs and increasing efficiency--may cause problems post-Brexit when the U.K. must secure free trade agreements to avoid tariffs (see risk 3). However, under "rules of origin" regulations, FTAs usually state that cars must include a certain percentage of components from the country of manufacture. This could clearly lead to complexities for many manufacturers in the absence of agreement to being treated as EU components.

Chart 4

UK Passenger Car Production - Export Volume

Source: Source: SMMT, Thomson Reuters Datastream.

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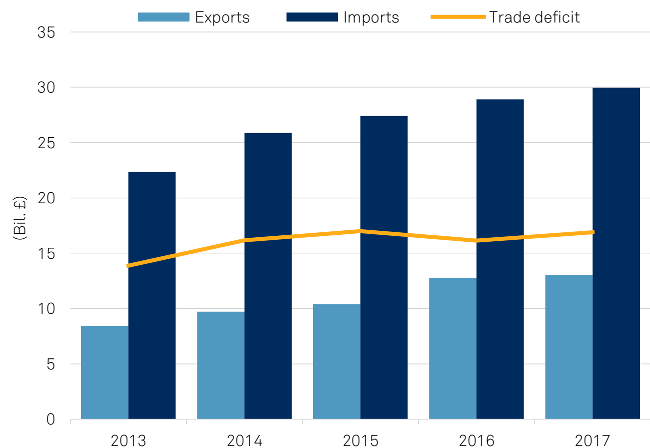
Chart 5

UK Passenger Car Imports and Exports to EU by Value



Source: ONS.

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Risk 2: Relocation of production facilities to the EU and reduction of investments into the U.K. (high impact, high probability)

The risk of an unfavourable Brexit agreement could lead global car manufacturers over time to relocate production capacity out of the U.K. and into the EU. This would have far-reaching consequences for the currently U.K.-based labor force (of some 800,000 people), assuming that only some local employees would be relocated. Crucial research & development centres may also be transferred. According to the Society of Motor Manufacturers and Traders (SMMT, a UK trade association), investment in the auto sector was just £322 million in the first six months of 2017, versus £1.7 billion in 2016. The SMMT has also said that U.K. car production could fall 10% if the

U.K. does not secure a free trade agreement with the rest of Europe post-Brexit. Global automotive companies such as Ford have recently warned that a hard Brexit could force them to reconsider investments in the U.K., while Honda and others have asked for clarity on transition plans by March 2018 to give them the necessary lead time to prepare. Failure to obtain U.K. type approval equivalence with the EU could also exacerbate this process.

Risk 3: Tariffs and trade barriers (high impact, medium probability)

The introduction of trade tariffs would increase production costs for an industry already suffering from pressures on profit margins from ever-tightening environmental regulations and intensified competition. If the U.K. reverted to WTO rules, the SMMT estimates that applying 10% tariffs to completed cars and 4.5% to EU sourced components would add about £4.5 billion to the industry's annual costs.

Applying 10% tariffs to completed cars and 4.5% to EU sourced components would add about £4.5 billion to the industry's annual costs.

Any restriction to trade flows that resulted in manufacturing delays would jeopardize just-in-time production processes and require U.K.-based car manufacturers to go back to managing car part inventories costing the industry time and money. However, Brexit could also present an opportunity for U.K. car parts manufacturers, who could become more competitive post-Brexit. That said, it would not be competitive to make all car parts in the U.K., particularly complex components where economies of scale are crucial.

Business Services

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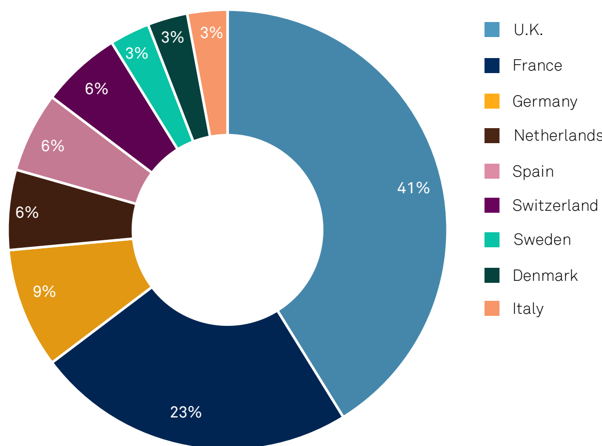
A high proportion (about 40%) of our publicly rated EMEA-based Business Services companies are U.K.-headquartered (see chart 6), mostly operating local business models, employing locally supplied labor, and lacking meaningful geographic diversification outside the U.K. For example, engineering and support services provider Babcock International Group plc generates about 75% of its revenues from the U.K., and warranty service provider Domestic & General (Galaxy Finco Limited) as much as 80%. As such, operating prospects in the sector remain closely tied to business conditions in the U.K., with slower economic growth typically dampening demand across a diverse range of services such as food catering, staffing, distributors, business processing outsourcers, and general facilities management. Any slowdown in the U.K. population growth may also be detrimental for hygiene companies, security firms, and testing and inspection companies.

Chart 6

EMEA Business And Consumer Services Ratings (Publicly Rated Issuers)



Source: S&P Global Ratings.

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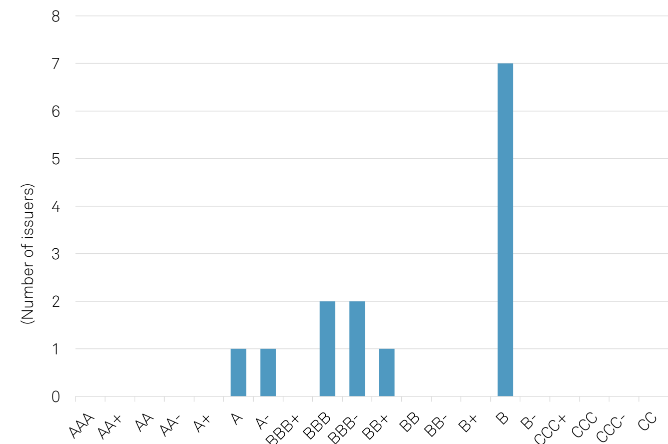
Chart 7

Rating Distribution - UK-Based Business And Consumer Services (Publicly Rated Issuers)



Source: S&P Global Ratings.

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Risk 1: Labor market supply and demand balance (high impact, high probability)

Labor costs are typically about half to two-thirds of Business Service companies' cost bases. Securing the status of EU citizens currently working in the U.K. therefore will be essential, as a lack of suitable labor supply would cause wage inflation to quickly escalate. If global corporates choose to relocate some staff out of the U.K. (to reduce current uncertainty) many jobs could be relocated to the continent, and European cities such as Paris, Frankfurt and Dublin could benefit. Sterling depreciation and uncertainty surrounding Brexit has already reduced the attractiveness of the U.K. as a place to work for many. The U.K. minimum wage continues to rise, which will also put upward pressure on costs. The staffing sector, which does not tend to benefit from the security of longer-term contracts, will likely see the most significant impact from shifts in labor markets. Staffing companies tend to be hit early on in any economic cycle with demand for staffing services highly correlated with unemployment levels. U.K.-based staffing operations felt an impact immediately after the Brexit referendum when many companies implemented a hiring freeze due to increased economic uncertainty.

Labor costs are typically about half to two-thirds of Business Service companies' cost bases.

Risk 2: Slower outsourcing decisions by the U.K. Government (high impact, high probability)

Outsourcing companies have benefited historically from winning large contracts from the U.K. government. For example, leading global provider of security solutions G4S plc--which generates about 20% of its revenues in the U.K--with a significant proportion derived from public contracts. With the government preoccupied with Brexit negotiations for the next few years, we believe that a slowing in outsourcing decisions is extremely likely. A number of unrated U.K.-based outsourcing companies already are reporting a marked decline in new order intake and a slow bidding pipeline. We expect this to result in increased competition for these contracts and more competitive pricing. The U.K. government is also likely to be increasingly cost conscious and have less flexibility or appetite to adapt existing contracts, particularly for valuable contract protection mechanisms such as cost-pass through (for example for input cost inflation). However, longer-term, increased cost consciousness and budgetary constraints will likely fuel a continuation of a general outsourcing trend.

Risk 3: Sterling depreciation (medium impact, medium probability)

As Business Services companies' business models tend to be locally focused, most do not import or export many products. However, there are certain sub-sectors which may be exposed to euro denominated costs; for example some distribution companies' profit margins have been hit by higher operating costs following the devaluation of the sterling post the Brexit vote. Other implications could arise for companies operating regulated businesses, such as those with insurance underwriting activities that may need to set up European branches for their operations on the continent to comply with regulatory requirements.

Capital Goods

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The capital goods sector is extremely diversified in terms of company size, in service-product offering, and end markets (oil and gas, infrastructure, metals & mining), so the likely impact of Brexit is variable and wide-ranging. Most rated capital goods companies do not identify Brexit as a major long-term disrupting factor. Larger rated players tend to be well diversified geographically, and are increasingly focused on either sizeable mature markets, or emerging markets due to their higher growth potential. Key concerns focus on the short to medium-term uncertainties regarding the final separation arrangements.

Risk 1: Lack of visibility delays investment decisions by U.K. clients (low impact, high probability)

Political uncertainties tend to have a dampening effect on investment decisions and U.K. capital goods customers could hold back capital spending plans until more visibility is available around the final Brexit deal with the EU. This is already reflected in the expectations of some large global capital goods companies for the period spanning 2017-2018. We understand that the short-term impact of Brexit on the performance of the U.K. market is perceived as temporary. As a consequence, the most relevant risk for the capital goods sector is the lack of visibility in the future relations and exchanges between the U.K. and EU.

The most relevant risk for the capital goods sector is the lack of visibility in the future relations

Risk 2: Propensity of large global capital goods players to invest in the U.K. (low impact, high probability)

Depending on the portfolio of activities--whether more product or serviced focused--Brexit could have very different impacts on companies producing goods in the U.K. that are earmarked for export rather than on companies focused on offering services to the domestic market. The risk of trade restrictions would more likely hit the former set of capital goods companies, triggering a potential loss of investments, but not necessarily penalizing capital goods companies eyeing high value services.

Chemicals

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Brexit is very important for the U.K. chemical industry, which is the sixth largest in the EU and accounted for 7% of EU chemicals sales in 2016 valued at €35 billion. There are around 2,500 non-pharmaceutical companies active in the U.K. chemicals sector. According to the U.K.'s Chemical Industries Association (CIA), the chemical a nd pharmaceutical industry is the second-largest manufacturing sector in the U.K., behind the food industry. It is one of the few U.K. industries, which are net exporters. The majority of the U.K.'s chemical trade is with the EU, representing 60% of chemicals exports and 75% of chemicals imports, including many critical raw materials. The U.K. chemical industry is therefore one of the sectors that could be most affected by a "hard" Brexit, alongside the automotive and machinery sectors.

Risk 1: Tariffs and trade barriers (high impact, medium probability)

A fall back to WTO rules and Most Favoured Nation (MFN) tariffs will negatively particularly affect exports but also imports of chemicals goods in the U.K., as most specialty chemicals and higher value-added activities are subject to higher MFN tariffs than raw materials. Some petrochemicals carry a 0% tariff, while intermediate and higher value-added specialty chemicals carry up to 6.5% tariffs. The majority of U.K. chemical company's exports are intermediate and higher value-added specialty chemicals, while bulk commodity chemicals are produced mainly for the domestic market. In the competitive global environment, it could prove difficult to pass on these additional costs to specialty customers and hence could result in lower profitability, reduced investments and hence lower growth prospects for U.K.-based producers.

The majority of the U.K.'s chemical trade is with the EU, representing 60% of chemicals exports and 75% of chemicals imports.

More generally, as one of the leading foundational industries in the U.K., it relies heavily on international scientific and engineering skills and a research network that receives substantial funding from the EU under the Horizon 2020 programme. These are all important elements for maintaining the attractiveness of the U.K. as a location for chemical investment.

Risk 2: Regulatory changes (high impact, medium probability)

The key risk for the chemical industry in the U.K. is the fact that the EU's REACH regulation, which applies to each member state, could no longer apply to U.K. chemical manufacturers or EU exporters into the U.K. after Brexit. As chemicals is such a heavily regulated industry, an important uncertainty is the new chemical regulatory framework that the U.K. will adopt, including whether the EU will permit U.K. regulatory equivalence after REACH regulations are translated into U.K. national legislation. If the event is disruptive, more than 6,000 current registrations filed by U.K. companies under REACH will lapse meaning that, without mutual recognition of standards, the related substances will not be able to be exported to the EU from that date. We currently believe that the impact on rated issuers with operations in the U.K. will be relatively limited, mainly because of diversity in their operations with exposure to many other countries globally.

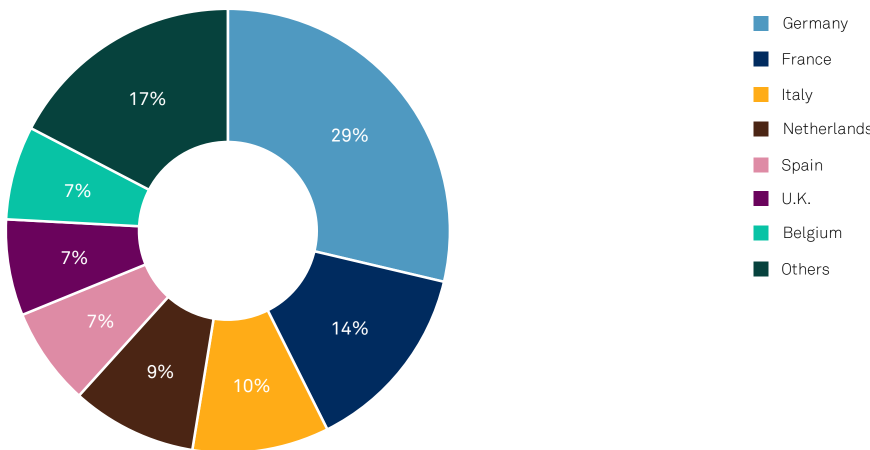
Other potential compromise solutions could involve the U.K. being accorded associate status within the European Chemicals Agency. This would require adherence to REACH regulations with limited ability to influence them as well as potentially remaining subject to legal due process in the EU. And, while trading under WTO rules is possible, the associated tariffs would apply and more significant costs might arise from non-tariff barriers, especially greater customs checks and potential delays in transporting across the English Channel.

Risk 3: Sterling depreciation (medium impact, high probability)

A weak pound sterling in the short-term benefits the competitiveness of U.K. based chemical companies on the global market and supports the export of chemical products produced in the U.K. Since the Brexit vote, chemical companies in the U.K. have experienced a positive impact from the currency drop. However, a weaker pound also makes imports of raw materials more expensive. Naphtha, a key feedstock for steam crackers, is mainly priced in US dollars, and its increasing cost in the U.K. affects the competitive position of some U.K. chemical companies compared to other European producers. Many imports cannot simply be substituted for U.K. products (the U.K. government gives an example of the three major feedstock required for the chemicals industry). A weaker pound also decreases the purchasing power of British consumers and reduces demand for chemical products directly and indirectly due to weaker demand in other sectors e.g. automotive.

Chart 8

EU Chemical Industry Sales By Geographic Breakdown



Source: Cefic Chemdata International.

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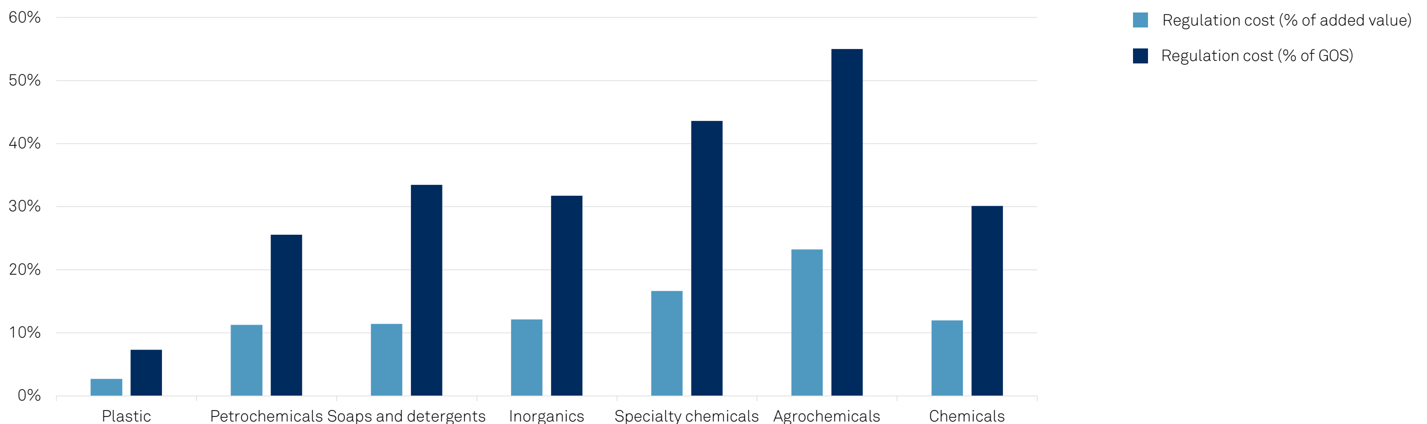
Chart 9

Impact Of Regulatory Cost* On The Chemical Sector



*Average cost per year (2004-2014). GOS--gross operating surplus. Source: EU Commission Report, "Cumulative Cost Assessment (CCA) for the EU Chemical Industry" (11 July 2016).

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Commodities

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Domestic mineral extraction especially for oil and gas contributes significantly to the U.K. economy. The U.K. is well-known for its concentration of global headquarters or listings of some of the largest international oil and gas and mining corporations. This in part reflects the availability and depth of legal, financial, accounting and other professional services. Similarly, U.K. service providers to the oil & gas industry in particular are numerous, and many boast global operations and activities.

Although we do not anticipate Brexit to have a large impact on the oil or mining industries, incremental bureaucratic or financial hurdles to the sale of oil and gas (through pipelines) to the EU and international markets would add friction costs. An inability to purchase equipment or trade crude – including the international Brent benchmark grade – would represent an effective embargo scenario.

The U.K. Oil & Gas Authority (OGA) has estimated U.K. proven and probable hydrocarbon reserves in place of 3.6 billion and 5.7 billion barrels of oil equivalent, respectively, the largest in the EU. In principle, these reserves could sustain production for another two decades without further successful exploration. Even as production moderates and declines from the U.K. Continental Shelf (U.K.CS) in the North Sea, decommissioning activities will require financial, operational and human resources for many years to come. The U.K. industry association, Oil & Gas U.K., estimates that the U.K.CS still employs or supports 300,000 jobs, many of which are well paid.

Risk 1: Scottish Independence (high impact, low probability).

A major uncertainty for the industry could arise as a result of the geographical location of most of the U.K. hydrocarbon reserves. The Scottish government has claimed about 90% of U.K. resources. This is broadly consistent with the territory under the jurisdiction of Scottish law, defined as the U.K. maritime area north of latitude 55o north. If Scotland gained independence from the rest of the U.K. post Brexit, even in a benign scenario of licences for fields being rolled over and the respective legal and fiscal frameworks remaining unchanged, it is hard not to imagine some hiatus in investment while the future institutions and frameworks were established and clarified, not least in respect of decommissioning.

A major uncertainty for the industry could arise as a result of the geographical location of most of the U.K. hydrocarbon reserves.

With the collapse in oil prices since the last Scottish referendum on independence in 2014, the economic uncertainties and financial resources of a self-sufficient Scotland were again highlighted. Nonetheless, Scottish independence is unlikely to disappear from political agendas, even if it appears a less insistent issue at present. The path and processes associated with negotiating a separation of U.K. hydrocarbon resources could be a prickly one. If this risk transpired, it would likely have a greater impact on the U.K. oil & gas sector than the other more direct effects of Brexit.

Risk 2: Tax or regulatory change (medium impact, medium probability).

The U.K. has a poor international reputation for fiscal stability in the oil & gas sector. Among other parameters companies consider before committing to invest capital, the certainty and visibility of the tax and royalty regime is a critical one. We see a potential risk that the existing, fairly complex tax rules could be changed again, even if the policy focus is on promoting and sustaining investment in the U.K.CS for cost effective recovery of resources. This could be compounded in the context of declining production and increasing decommissioning requirements.

Similarly, Brexit could engender further regulatory uncertainty and change. Although the U.K. licencing and regulatory regime was established before the first oil production in 1967, the

framework and practicalities have evolved and could develop further. For example, in April 2015, OGA replaced the Department for Energy and Climate Change (DECC) as the licensing and regulatory body.

Risk 3: Delays in investment (medium impact, medium probability).

Given the maturity of many fields, any direct or indirect Brexit-related delays in reinvestment or sustaining capex could have a disproportionate impact on production and field viability in the U.K. For a marginal field, when investment is postponed, we understand that the tendency is for greater subsequent costs and investments to “catch-up” all other things being equal. Such a field might become uneconomic without regular investment.

Construction

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Brexit is a very important topic for a few of our building materials and engineering & construction issuers that either operate solely, or have a high percentage of their overall operations, in the U.K. That said, most of the companies that we rate in the sector are large European-based multinationals with low level U.K. operations – so Brexit is far less of a concern for them. This industry is, by and large, a very local business where materials--especially for heavy side products like cement and aggregates--and contractors tend to be sourced locally and therefore very few of our issuers are reporting concerns over cross border servicing or logistics.

Risk 1: Severe contraction in the U.K. for new construction and RMI (high impact, medium probability).

A hard Brexit would undoubtedly have a damaging impact on consumer sentiment and thus new construction activity in the U.K., at least in the short-term where projects would likely be postponed. Whereas repair, maintenance and improvement (RMI) activity usually adds an element of stability to issuer's volumes and overall performance, a sudden and pronounced dip in U.K. consumer confidence and tighter household budgets could also result in a swift drop in demand for RMI-related products and services, as households postpone repairs and refurbishment, at least in the short-term. Rated corporates operating mainly in the U.K., such as HSS Hire, which operates primarily in the London and south east of the U.K., are considered to be most exposed to a hard Brexit.

A hard Brexit would undoubtedly have a damaging impact on consumer sentiment and thus new construction activity in the U.K.

Risk 2: FX volatility (medium impact, high probability).

Forex volatility is being created by political uncertainty (not just from Brexit but in countries where some of our issuers have material exposure, such as Algeria, Egypt, Turkey and Brazil). This continues to affect issuers' financial results.

Volatility has also started to affect rates between major currencies. This affects the stability of pricing for raw materials and energy inputs (which are often priced in major currencies). In the event of a hard Brexit, local players would likely face price inflation for raw materials and any imported manufacturing inputs and components (especially any priced in U.S. dollars or euros), compounded by a weaker ability to pass through the extra cost to financially-stretched end customers.

Risk 3: Rising interest rates and choppy debt markets (high impact, medium probability).

Virtually all of our sub-investment grade building materials and engineering and construction issuers have refinanced in 2017 at historically low rates and now have fairly aggressive "cov-lite" debt structures in place. Debt leverage is gradually rising across this segment, particularly for some private equity-owned issuers, which could result in weakening credit metrics and rating revisions. Building materials and engineering and construction issuers have in the past exhibited significant and rapid EBITDA declines when the market has taken a downturn, meaning that high leverage leaves less room for these issuers to react when under stress. In our opinion rates can and will only rise in the future and these issuers could face higher interest costs when they next look to tap the markets. It also slightly raises the refinancing risk four to five years out, as most of the structures put in place through 2017 mature in around 2022.

Leisure (including hotels)

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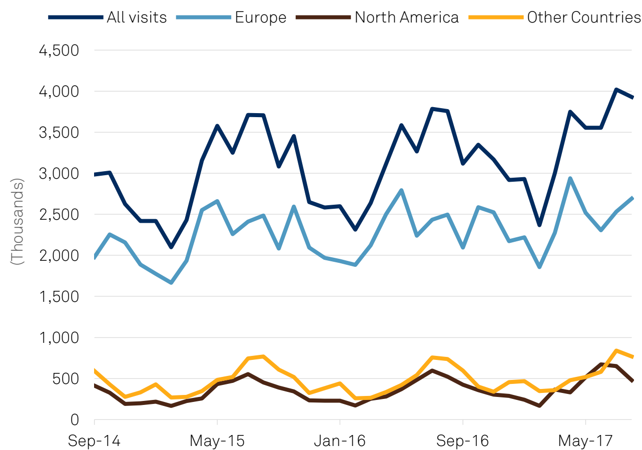
The leisure sector includes hotels, tour operators, gaming, sports, and theme parks. In our view, a disruptive Brexit, although not our base case scenario would have a different effect on each, with some correlation between the different areas. The operational and business impact would likely feed through various transmission channels; cross border immigration and visa regulations, transportation links and cost pressures being the main challenges for this industry. Certain segments such as gaming and sport would likely see less of an impact, while inbound tourism may see some benefit depending on the circumstances.

Chart 10

Overseas Residents' Visits To The U.K. By Month



Source: International Passenger Survey, ONS.

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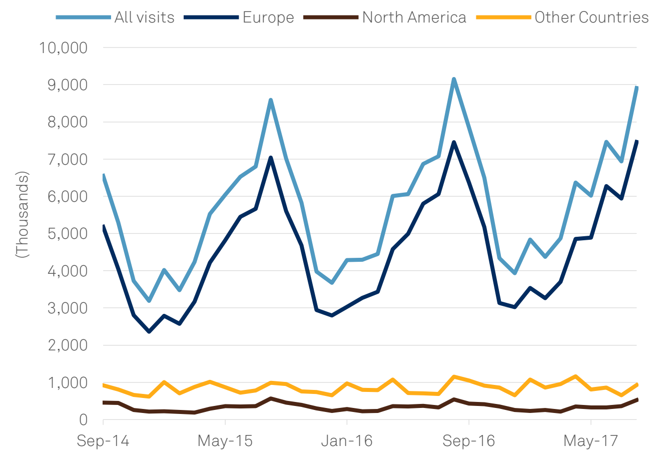
Chart 11

UK Resident Visits Abroad By Month



Source: International Passenger Survey, ONS.

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Risk 1: Labor cost increases if cheap labor becomes less available (medium impact, high probability)

The key challenge for the labor intensive leisure industry is to recruit the necessary staff. labor expenses are a significant part of the cost structure, particularly for businesses that require high volumes of low cost personnel. The U.K.'s hotel and hospitality sector is highly dependent on immigrant workers, of which a large proportion come from the EU. A recent report from KPMG highlights that the hotel and restaurant industry are the two sectors most reliant on EU migrant workers in the U.K. They estimate that between 22% and 34% of the hotel workforce and between 12% and 26% of the restaurant workforce are currently EU nationals.

Between 22% and 34% of the hotel workforce and between 12% and 26% of the restaurant workforce are currently EU nationals.

In addition, turnover in these industries is high and demand for seasonal workers acute. In a disruptive Brexit scenario, restrictions placed on EU migrant workers together with the perception that the U.K. might be less welcoming, could have serious business repercussions for many operators.

Risk 2: Sterling depreciation presents an upside for U.K. tourism (medium impact, medium probability)

The travel industry in the U.K. is mainly exposed to travel from Europe, although U.K. residents consistently make almost two times as many visits to European countries (predominantly Spain, France, and Germany) than European residents make to the U.K. This is reflected in the total amount spent by U.K. residents abroad compared to foreign residents visiting the U.K.

A disruptive Brexit could exacerbate the impact that the tourism industry has seen over the last year since the referendum. The depreciation in the pound has given a boost to inbound tourism (see chart 10) while dampening the time (if not the number of) U.K. visitors spend abroad (see chart 11).

However, while a hard Brexit could see sterling weaken markedly, the actual impact on visitor numbers travelling to and from the EU could be markedly different than seen recently. Indeed, it is not impossible to envisage a sharp fall in both inbound and outbound European visitors depending on factors such as ease of travel, visa requirements, as well as the extent of any general economic uncertainty. Inbound business travel would also likely be hit in the short term. Even so, we anticipate that long haul inbound tourists, often with more disposable income to spend in the U.K., would benefit.

Risk 3: Cost pressures hit profit margins (medium impact, high probability)

A disruptive Brexit would likely lead to rising cost pressures, putting downward pressure on margins. This would feed through from higher wages at a time when labor shortages in the leisure industry are already present and businesses are migrating their lower paid workers toward the higher National Living Wage. The higher cost of imported products following a further slide in sterling, including food, would need to be passed through to end customers. This may be difficult, particularly if it coincided with a reduction in occupancy rates for hotels for instance, especially outside London. The end result could be an unexpected and sharp downturn in overall earnings for certain leisure segments such as hotels.

Pharmaceutical

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The pharmaceutical industry is highly regulated and subject to more EU derived legislation than most other industries. In 2014, the pharmaceutical market value in Europe was approximately €267 billion (in retail prices). More than 700,000 people are employed in the industry, of which 10% are currently based in the U.K. According to the International Trade Council, U.K. pharmaceutical exports to other EU countries were valued at around £15 billion in 2015, with pharmaceutical products in the top five of products most imported and exported between the U.K. and the EU. In 2014, the pharmaceutical industry invested an estimated record €30 billion in research and development in Europe, €4.8 billion of which was spent in the U.K., making it the third most popular country to carry out research within the EU (after Germany with €6 billion and Switzerland with €5 billion).

Depending on any post-Brexit agreements, trade barriers (such as the introduction of tariffs), the relocation of research teams, or slower market authorization processes, may result in rising costs of medicines in the U.K.

Risk 1: Increase in operating expenses, primarily R&D costs (high impact, high probability)

Trade barriers, the relocation of research teams, or slower market authorization processes, may result in rising costs of medicines in the U.K.

The U.K. ranks amongst the largest pharmaceutical R&D platforms in Europe. It has enjoyed access to the EU's research and innovation programs, such as Horizon 2020, but automatic access would unlikely be granted post-Brexit. In addition, from 2018 the new EU Clinical Trails Regulation will come into practice, unifying the conditions for running clinical trials across Europe and their subsequent approval in the EU. If the U.K. sits outside this regulatory system, then pharmaceutical companies may need to set up separate trials for U.K. approvals leading to higher costs and a more time consuming processes. Furthermore, trials currently carried out in the U.K. may be allocated to EU member states to gain access to a larger market.

Pharmaceutical research is highly innovative, fast-moving, and reliant on attracting skilled labor. The U.K. has attracted a large number of skilled workers from abroad, most of which are EU citizens, but any restriction on the free movement of labor will make it more difficult to recruit. If the government fails to reach satisfactory regulatory agreements with the EU and to replace lost research grants, the U.K. could lose its competitive edge, and U.K. based multinationals may transfer key research initiatives to the EU.

Brexit could also affect companies' investment decisions, although it is just one factor to consider when deciding on new investments or cost cuts. Novo Nordisk plans to fund a new research centre in Oxford, saying that Brexit did not affect its decision, and GlaxoSmithKline is investing in U.K. manufacturing sites. Pfizer, meanwhile, is shutting three manufacturing plants in the U.K. in the next four years, but says that the Brexit vote did not contribute to this decision.

Risk 2: Increased regulatory burden, chiefly registering and authorizing drugs (high impact, medium probability)

Existing product standards in the European Economic Area (EEA) are authorized by the European Medicines Agency (EMA), currently based in London, and all drugs approved by the EMA are automatically granted access to the U.K. market. If the U.K.'s post-Brexit relationship with the EU does not include a shared regulatory framework, then the development and authorization of new medicine could take even longer and be even more costly. EU law currently requires that marketing authorization holders are established in the EU or EEA. Absent an adequate agreement, U.K.-based pharmaceutical companies will need to transfer U.K. product licenses to European-

based entities, including the potential need for retesting of U.K.-manufactured batches of medicines shipped to Europe.

The U.K. will also have to re-establish its own medicines approval and regulatory system. The two regulatory bodies--the EMA and the U.K.'s own regulator the Medicines and Healthcare Products Regulatory Agency (MHRA)--will have to find ways to cooperate post-Brexit. It's possible that authorizations to market medicines--granted by the European Commission on the recommendation of the EMA while the U.K. is still a member of the EU--could continue to apply to the sale of medicines in the U.K. and Europe post-Brexit.

Risk 3: Disruption to the free movement of goods (medium impact, medium probability)

The U.K. has a large pharmaceuticals sector and produces many medicines used in Europe and other countries, including large fast-growing markets like China, where shipments are currently also governed by EU trade arrangements. In the absence of a deal, the U.K.'s trade with the EU would revert to WTO rules, under which industrialized countries generally apply zero tariffs for medicines. However, the WTO's drugs list has not been updated since 2010, so newer medicines could still be hit. There is also a risk that all goods due to be moved between the U.K. and EU could be held either at border checks, in warehouses or manufacturing premises or be subject to extensive retesting requirements. Innovative medicines of the kind being produced today are often very complex to manufacture, involving multiple cross-border transfers before the final product is available for patients in the U.K. and elsewhere in Europe.

Real Estate

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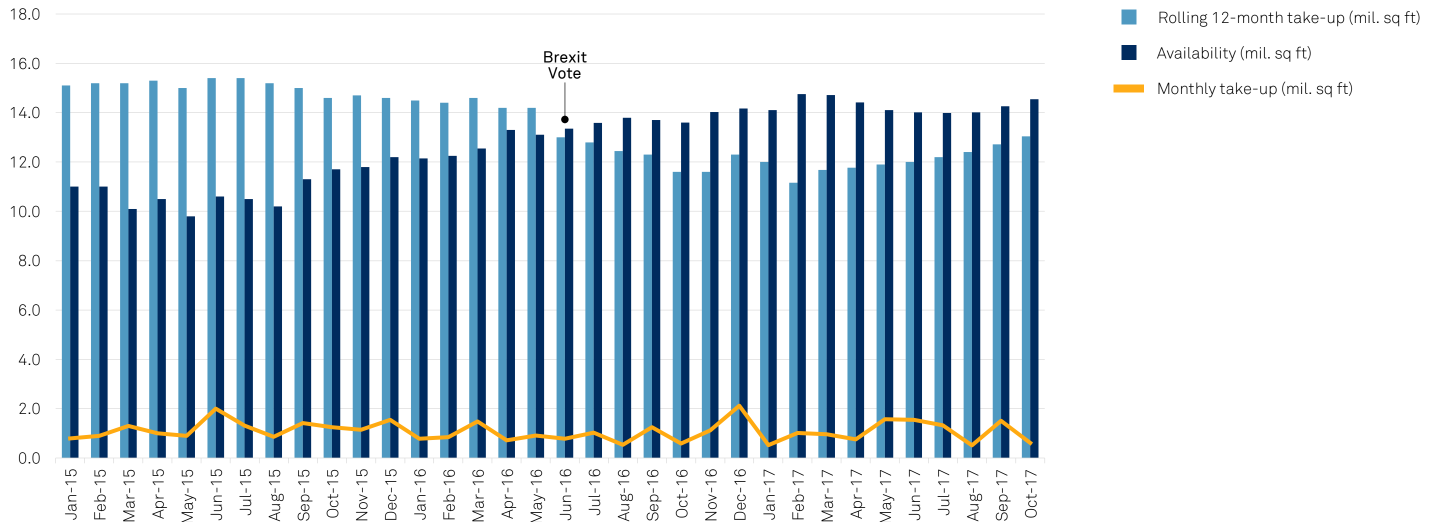
Although Brexit could weigh very heavily on valuations of commercial properties in London, it should prove beneficial for some other European cities. Locations like Frankfurt or Dublin, or to lesser degree Paris are set to benefit from the separation process.

Chart 12

Monthly Take-up and Availability in Central London Office Market



Source: CBRE.

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Risk 1: Decline in commercial property values, particularly office assets in central London (medium impact, high probability)

U.K. commercial real estate companies will likely be affected by stagnating valuations in some areas like central London as the implications of the Brexit process, especially for the financial industry, become clearer. We believe that Brexit will give financial services firms that are already under pressure to contain costs more reason to consider reducing their office space in London. We expect the pressure to be most acute for landlords with a large number of offices in the City of London, a market that is already cooling off in 2017. Even if a cheaper sterling has helped to attract new investors to the U.K., especially from the Far East, the process of leaving the EU will pressure valuations of commercial real estate assets in particular in London. For the London office market, under our base case, we see valuations falling by as much as 10% over a two-year period starting in 2018. Other regions and asset classes in the U.K. --retail, industrial, hotels, mixed use, and specialty--should show much better resilience.

The process of leaving the EU will pressure valuations of commercial real estate assets.

Downward pressure on valuations for Real Estate Investment Trusts (REITs) will come from the combined effect of a lower volume of foreign direct investments going into the market (down to around £50 billion this year, from an historical high of £66 billion two years ago), and appraisals having to reflect average transaction price per square meter on comparable assets.

Risk 2: Reduction in new housing starts for homebuilders (medium impact, low probability)

U.K. homebuilders could be affected by Brexit if demand for new homes starts falling and purchase decisions are delayed, which is not the situation observed in 2017, thanks to tight supply and resilient demand largely supported by demographics. The increase in mortgage rates initiated in November 2017 is likely to weigh on homebuilders' activity from 2018. For the U.K., we foresee a 1% drop, nationwide, in average house prices in 2018. Declines should be concentrated on the London prime residential segment for properties exceeding £1 million, which could see double-digit declines (to check).

Throughout Brexit, we expect the shortage of housing and the government's measures to provide a buffer for average selling prices nationally. Still, should household incomes drop sharply and property prices really decline, the banking sector may seek to cut its exposure to the development sector.

Risk 3: Reduced labor mobility (medium impact, medium probability)

As part of the Brexit discussions, any restriction on the ability of EU nationals to look for work in the U.K. could heavily impact the construction sector. In some regions in the U.K., EU workers represent as much as half of the sector's workforce. This could easily result in extra delays for new build deliveries or rising construction costs and contribute to a slowdown in development activity.

Retail & Consumer Goods

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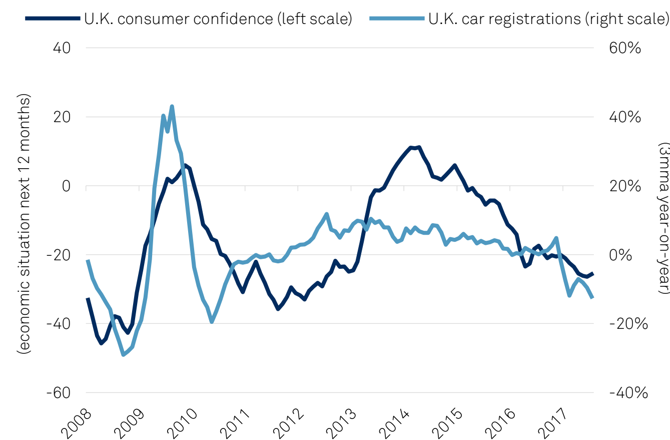
The immediate aftermath of the Brexit vote has been more like a slow puncture than a full-blown crash for the EMEA retail and consumer sectors. Nearly a year and a half later, most macroeconomic indicators affecting consumer-facing sectors are only slightly subdued. This is particularly the case for consumer durables and nondurables and grocery retailers, with somewhat weaker trends apparent for nonfood and apparel retailers that are more exposed to trends in discretionary spending. Note, U.K. retail can broadly be segregated as food retailers, apparel retailers, and departmental stores.

Chart 13

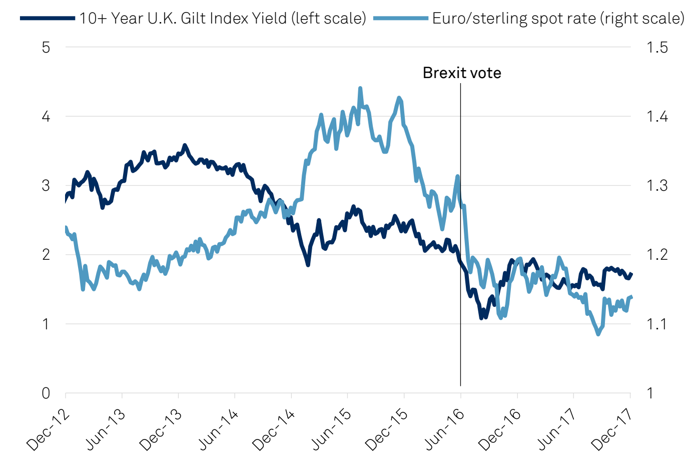
Consumer Confidence On The Wane



mma--month moving average. Sources: Eurostat, OECD, Thomson Reuters. Datastream.Copyright © by Standard & Poor's Financial Services LLC. All rights reserved.

Chart 14

Sterling Remains Vulnerable To Hard Brexit



Sources: BoA Merrill Lynch, Thomson Reuters Datastream.
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Risk 1: Inflationary pressure in food retail (medium impact, high probability)

As food retail is largely non-discretionary in nature, we do not expect demand to drop heavily post-Brexit. Furthermore, with the return of an inflationary environment--already as high as 3% for 2017--U.K. food retailers should be in a better position to pass on some increased costs to consumers through price increases. However, in the somewhat weakened macro-economic environment following the Brexit vote, U.K. consumers' wallets are already being squeezed. Inflationary price increases appear to be divided three ways: one-third is being absorbed by food manufacturers, one-third by food retailers, and the remaining third is being passed on to the end consumer.

In response, food retailers are realigning their portfolios by increasing focus on value added and premium private label products in efforts to stimulate demand. Branded consumer companies are under increased pressure to streamline their product offering and to continue to focus on innovation, as they now have to constantly innovate to preserve brand loyalty from the ever price savvy consumer.

Risk 2: FX volatility for apparel retail eroding profit margins (medium impact, medium probability)

U.K. non-food retail would be particularly vulnerable to a hard Brexit scenario due to a heavy reliance on imported goods and a consumer base that would be under material financial pressures. That is on top of an already challenging operating environment given the competitive nature of the industry – not least from fast fashion and the growing penetration of online retailers.

Most large apparel and home goods retailers are highly sensitive to the risk of sterling depreciating and hedge their transactional exposure to the U.S. dollar on a rolling 12-18 month basis. This provides some protection from currency volatility and delays the impact of rising costs but they eventually feed through. As companies invest in refocusing their merchandising and pricing strategies, improving logistics, and omnichannel platforms, we expect further erosion to profitability and falling EBITDA margins over the next 12 months. A hard Brexit with a further bout of sterling weakness would only compound the pressures.

Risk 3: Trade and tariff barriers and related costs (low impact, medium probability)

If WTO tariffs and trade barriers come into place, the average price of EU imported foods – constituting about 70% of U.K. gross food imports - would likely increase by about 22% according to the British Retail Consortium. Theoretically, being outside the EU customs union, the U.K. could mitigate most, or even all, the higher cost of food by unilaterally setting lower tariffs particularly on foods that are not produced in the U.K. They could also choose to import food that may not meet current EU regulatory food standards, at the risk of complicating any future potential free trade negotiation with the EU. However, under WTO rules these tariffs would need to be uniformly applied in the absence of a specific free trade agreement with any particular WTO member.

The average price of EU imported foods – constituting about 70% of U.K. gross food imports – would likely increase by about 22%.

Telecoms

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The national nature of most telecoms markets helps to insulate the sector from many direct Brexit-related risk factors. We expect that consumers will continue to demand and consume telecom products, a service that has many utility-like characteristics. Still, a hard-Brexit with higher unemployment or reduced discretionary spending among retail consumers could have an adverse effect if increased price sensitivity amplifies competition, or if consumers downgrade their consumption of telecom products to cheaper packages.

Risk 1: Increased regulatory uncertainty (medium impact, medium probability)

The most uncertain of the potential Brexit impacts on telecoms is regulation. Today's telecom regulation, including access regulation for fixed networks, roaming, and mobile termination rates, are based on EU directives (that were transposed into national laws), and measures taken by national regulators such as Ofcom are reviewed by the EU before implementation. As the U.K. exits the Brussels regulatory regime, existing telecom laws can be revisited, injecting uncertainty around a host of issues. For example, retail roaming charges were phased out in the EU through a two-step process completed in summer 2017, but these rules will no longer apply.

The most uncertain of the potential Brexit impacts on telecoms is regulation.

What this means to U.K. carriers and customers will depend upon whether similar roaming rules are incorporated into the Brexit agreement and future U.K. telecoms law. If not, continental carriers could increase their wholesale charges for roaming services, hitting UK telecom operators with higher costs. Wholesale access to fixed networks would also be governed by U.K. national rules, which could redefine regulatory principles for market analysis, availability of access products, and pricing. Additionally, the merger control would now be subject to UK rather than EU jurisdiction. In 2016, the European Commission blocked the Three-O2 merger on competition concerns. While we do not believe U.K. competition authorities and Ofcom policies would radically depart from Brussels (in fact Ofcom urged the EC to block the 2016 transaction), the jurisdictional reclassification would inject further uncertainty that will either require pre-emptive communications to clarify or time for a track record to develop.

Risk 2: Enterprise revenue headwinds (medium impact, medium probability)

In addition to retail consumers, a key segment for telcos is the enterprise customer, which comprises both public and private entities. We believe a hard-Brexit scenario could have a more disruptive impact on these customer bases. The primary causes would likely be reduced investment by private sector enterprise triggered by economic uncertainty, and for some segments like financial institutions, potential relocation to other European hubs. On the public sector side, if the U.K. cuts budgets to prepare for costs associated with a hard-Brexit, delays and disruptions to projects could occur as local governments and government agencies also scale back spending. We view these risks as more pronounced for telcos like British Telecommunications and Vodafone Group, given their exposure to larger enterprise consumers.

Risk 3: FX weakness (low impact, high probability)

A further weakening in sterling resulting from a hard-Brexit scenario would likely have two key negative impacts for the sector. For international telecoms that consolidate U.K. subsidiaries into non-sterling reporting, like Telefonica or Liberty Global, U.K. contributions would decline. Secondly, while domestic operations are generally insulated from currency movements, a significant component of capital spending is foreign currency-based, typically about 30%-40%, often in US dollars or euros. Therefore, a 10% devaluation in sterling could result in a 3%-4% increase in capex spending on a sterling-reported basis, reducing FOCF measures.

Transport Infrastructure

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European airports (including U.K. based airports) recorded an impressive (5-6%) increase in average passenger volumes in 2016. The trend has continued in 2017. In the U.K., despite a sharp weakening of the pound, we have observed no impact of the relatively higher cost of travelling on the number of passengers. Indeed, some airports reported that instead of cancelling flights, holidaymakers have been reducing the duration of their holiday, but still flying. Furthermore, a weak pound has attracted more discretionary travellers to the U.K. That said, out of all of the transport infrastructure sectors (including roads, rail, and car parks, which tend to be more influenced by local trends) the airports sector could be most affected by Brexit related risks.

Risk 1: Drop in passenger numbers at U.K. airports (high impact, medium probability)

A drop in passenger numbers at U.K. airports could result from any restrictions on the free movement of travellers between the U.K. and EU countries, or indeed any changes in the rights to live in the U.K. and other EU member states. A severe post-Brexit economic slowdown in the U.K. could also lead to a reduction in passenger numbers at U.K. airports, in particular, there could be a reduction in U.K. discretionary travellers due to a weak sterling (as consumer spending power is reduced abroad), although this could be somewhat offset by more tourists visiting the U.K.

As per the airlines section, a worst case scenario would be that flights could even be grounded if timely regulatory agreements are not secured. We view this as an extremely low risk but with an extremely high impact, given the U.K.'s high dependence on air traffic. However, a higher probability could be attached to changing cabotage rights (the right to operate within the domestic borders of another country), in particular the right of U.K. carriers to operate within the EU domestic area, and vice versa. The impact would depend on the type of traffic, and the carriers served by the airport. For Heathrow and Gatwick we view any likely impact as limited--for Gatwick only Ryanair's route from London to Belfast would likely be affected. Other non-U.K.-based airlines, such as Norwegian, already have a U.K. Air Operators Certificate so should be able to continue to operate in the U.K. like a U.K.-based airline.

Risk 2: Regulatory uncertainty for U.K. air traffic controller (medium impact, medium probability)

The Civil Aviation Authority (CAA), which is the economic regulator of NATS, the UK air traffic controller, operates within an overarching framework of economic regulation for air traffic management set by the European Commission. The current five-year regulatory period (Reference Period 2, RP2) under the Single European Sky II (SES II) framework started on Jan. 1, 2015. NATS En Route (NATS), which has been part of the Single European Sky initiative, has played a critical role in shaping the air traffic regulation in Europe and the region's efforts to boost the competitiveness of the industry. The influence of NATS within the sector could be under threat depending on the outcome of Brexit negotiations. Any uncertainty around the numerous agreements and regulations that underpin Single European Sky legislation could contribute to economic uncertainty and market volatility. This in turn could affect the demand for air travel and therefore introduce volatility in NATS future revenue, even if revenue declines can largely be mitigated by traffic volume risk sharing arrangements in place under its contractual framework.

Some airports reported that instead of cancelling flights, holidaymakers have been reducing the duration of their holiday

Risk 3: Workforce availability (medium impact, medium probability)

Reduced workforce availability would likely push up salaries and increase costs across the industry. Some companies are trying to mitigate this risk, including via apprentice schemes.

Utilities (including nuclear)

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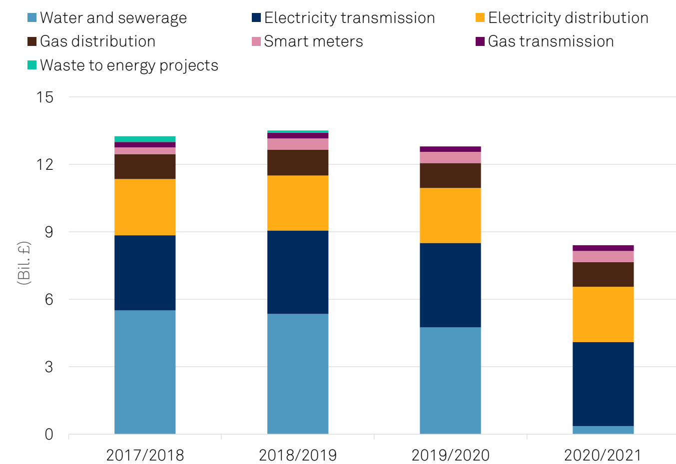
Regulated utilities in the U.K. benefit from a strong framework governed by independent regulators, with cost pass-through mechanisms (including inflation, cost of debt, and power price volatility). As a result, they are largely insulated from changing macroeconomic conditions. We do not, therefore, currently view the direct implications of Brexit as material for the standalone credit quality of rated utilities companies. However, for unregulated power and gas companies, we see more risks emerging, given a higher degree of sensitivity to market conditions, particularly via market prices and energy consumption.

Chart 15

Utilities Investment From 2017/18 To 2020/21 Split By Sub-Sector



Sources: UK government, S&P Global Ratings calculations.

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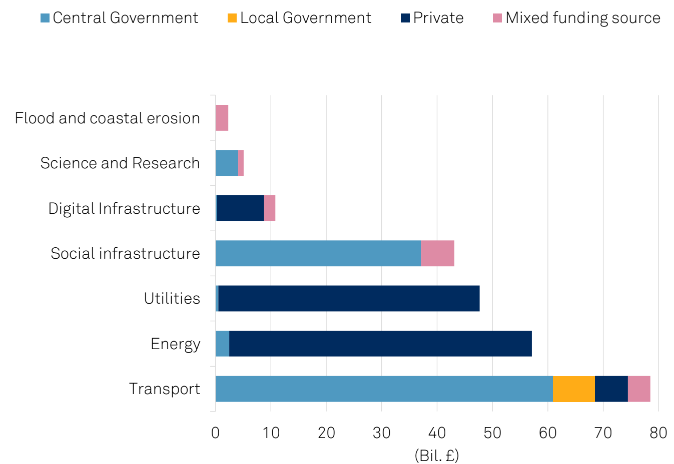
Chart 16

Funding Mix Of The Pipeline 2017/18 To 2020/21 By Sector



Sources: UK government, S&P Global Ratings calculations.

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Risk 1: Heightened political risk for U.K. utilities (high impact, medium probability)

Since the U.K.'s Brexit vote in June 2016, the two main political parties in the U.K. have focused attention on energy companies, and affordability issues appear to be an area where they could find some consensus. More recently, in her speech on Oct. 4, 2017, U.K. Prime Minister Theresa May announced that the government will try to push for a cap on gas prices for standard variable tariffs (SVTs), proposing to put a price cap on energy bills. SVTs, the default tariffs a consumer is charged for their gas or electricity if they do not actively search for a new tariff, are applied to approximately 14 million homes in the U.K. (the total figure for the top 10 suppliers). SVT consumers display a lower switching rate than consumers on other tariffs, which has been singled out as a potential cause of the inefficient functioning of the energy markets. Another indirect political risk is that the Labour Party has announced it intends to nationalise utilities, water companies being the priority.

Risk 2: Increased funding risk due to capital markets disruption and termination of EIB financing (medium impact, medium probability)

The utilities sector is extremely capital intensive and a disruption to the capital markets would impact their ability to finance themselves, although in the last financial crisis utilities companies were the most able to retain market access. Another key issue for the sector would be any loss of access to funding from the European Investment Bank (EIB). More than one-quarter of U.K. infrastructure investment comes from public sources, of which the EIB is a major conduit. The bank has invested more than €42 billion in the U.K. over the past eight years, with almost half (€19.1 billion) going to infrastructure. At this stage, the impact is mainly the cost of capital, and, given currently exceptionally low interest rates, it has not yet impacted utilities companies who still have access to the EIB.

A key issue for the sector would be any loss of access to funding from the European Investment Bank.

Risk 3: Lower long-term demand for energy (medium impact, medium probability)

Longer-term, unregulated utilities companies would be impacted if overall demand diminishes due to a reduction in the U.K.'s population. The existing large pipeline of new assets in the renewables space and the construction of the new Hinkley Point C nuclear plant could over time displace a larger part of thermal production than currently anticipated, which could lead to other plant closures. For the networks, since affordability remains a key focus of both the regulators and politicians, we could see higher pressure on credit quality if the cost of the networks and investments need to be shared among a smaller customer base.

Related Research

- Ratings And Negative Outlook On The U.K. Not Immediately Affected By EC Recommendation To Open Phase Two Talks, Dec. 8, 2017.
- Credit Conditions: Hope Overcomes Fears As The Fundamentals Propel Europe Forward, Dec. 5, 2017.
- Banking Industry Country Risk Assessment: United Kingdom, Nov. 15, 2017.
- Life After Article 50: Opportunities From Uncertainty For Corporates In The U.K., May 30, 2017.

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