With three weeks passed since the United Kingdom’s ("UK") historic “leave” vote, there are still many more questions than answers. Given the fluidity of the situation, bold predictions should be left to politicians, pundits, and futurists. That being said, private equity investors should have a point of view regarding the post-Brexit future, so as to position their portfolios for resilience in the face of multiple eventualities. To that end, what can we expect with some confidence?

**Impact on the UK: Rough Going Ahead, but no Collapse**

The UK looks to be in for a bumpy ride for at least the next year or two, and perhaps longer depending on how the exit talks proceed.

Â**Political instability:** With Theresa May now residing at 10 Downing Street, the Tory leadership succession is now resolved, but the party remains quite divided. Meanwhile, Labour leader Jeremy Corbyn faces open rebellion by his party’s Members of Parliament (“MPs”). Add in the possibility of an early election, and policy uncertainty in the near term (or longer) seems a good bet. The secession movements in both Scotland and Northern Ireland will be an ongoing challenge.

Â**Brexit likely to proceed:** A reset to something like the pre-referendum status quo is unlikely. The European Union (“EU”) is disinclined to make concessions to entice the UK back, while the UK’s return to the EU without a significant concession (e.g., immigration) would be dangerously unpopular and damaging to its credibility.

Â**Economic impact:** Brexit will be significant, but not devastating. The UK derives about 30% of its GDP from trade, less than half with the EU. The country is a net importer of goods, so more pain is likely to be felt by its key EU
trading partners. Services, the UK’s primary export, are likely to be reduced, probably significantly, once an agreement is reached with the EU. More important for the near term are foreign investment flows, domestic capital investment, and consumer spending, all widely expected to fall due to political and economic uncertainty. The developing consensus estimates flat to slightly negative GDP growth in the near term.

**Financial services:** The biggest loser from Brexit is the UK financial sector, which accounts for 10% to 12% of UK GDP. According to an April 2016 study by PwC¹, Leaving the EU: Implications for the UK financial services sector, points to a 5.7% to 9.5% reduction in growth and 70,000 to 100,000 lost jobs by 2020. However, these declines are expected to moderate significantly by 2030². These are tough numbers, but they do not spell doom for the sector (New York had similar losses after the financial crisis). The City still maintains significant advantages, including an educated professional base, reasonable regulatory and tax regimes, and its location within a world-class city. In spite of this, the threat of loss of its financial passport to the EU (Paris, Frankfurt, and Dublin are all vying to end London’s pre-eminence) means the City is likely to take a substantial hit.

**EU: Identity Crisis**

Somewhat lost in all of the talk of the impact of Brexit on the UK is the spillover to the other side of the Channel. Some thoughts on that below:

**Economic impact:** The EU has lost its second largest economy (about 15% of EU GDP) and an important trading partner. GDP estimates now suggest a knock of up to 50 bps due to Brexit fallout. This is troubling, given the EU’s economic weakness, but it can be absorbed without major consequence.

**Structural challenges:** With the unprecedented “leave” vote, the British electorate has crossed the Rubicon: the possibility of contagion to other member states is real. Anti-EU sentiment runs high on the Continent, and, prior to the vote, there were already proposals for in/out referenda in other countries, like the Netherlands. The likelihood of another near-term departure remains low due to joint dependencies and the fear of economic instability. Member states will adopt a wait-and-see attitude while observing Britain’s future relations with the EU. If the country’s economy performs well outside the EU, the hand of the “leavers”, as well as the existential threat to the EU, will be strengthened.

**Brexit negotiations:** The EU is likely to take an initial hard line in negotiations with the UK. Friendly relations are in both sides’ long-term interest, but the EU’s immediate imperative is to hold itself together. To that end it cannot offer Britain better terms than those under which the 27 remaining members live. A tough line may also be a way to head-off future would-be “exiters”. Recent statements by EU leaders, particularly Chancellor Angela Merkel of Germany, supports this view.

**Flight risk:** The vote has placed a lever into the hands of the disaffected in other EU countries that can be used as a final check on Brussels’ power. From now on, “flight risk” will be an investment consideration and will be factored into asset prices accordingly. This was demonstrated by the widening of spreads for sovereign debt of EU peripheral countries in the wake of the vote (they have since tightened).

**The Way Forward**

**UK: Gloom prevails, but an optimistic view exists**

Markets have stabilized and doomsday scenarios have not come to pass; however, the consensus view of the post-Brexit UK future is gloomy. The pessimistic view has some merit, in light of political and economic uncertainty and faltering consumer and business confidence. But a more optimistic case can be made.

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¹ the study was commissioned by TheCityUK and completed by PwC and the Confederation of British Business.
² 1.8% to 4.0% and 10,000 to 30,000.
The UK has long been an attractive destination for investment, independent of the EU, due to a variety of longstanding strategic advantages. It is the fifth largest economy in the world, with a robust domestic market, as well as the most flexible and dynamic of the major EU economies. Relative to its major EU peers, the UK stands out for its free market orientation, including relatively fluid labor markets and a less onerous regulatory regime. Its corporate tax system is competitive. London’s financial infrastructure is in the top rank and has long made it a magnet for educated and ambitious foreign professionals. The UK has been a trading nation for hundreds of years and maintains several natural trading relationships, including the US and Commonwealth countries, that can be further developed in order to replace what is lost from the EU. UK-EU trade losses should be material, but not catastrophic. The UK is an important export destination for several EU countries that will wish to maintain market access, especially in today’s demand-starved world. Finally, the EU’s share of the UK export pie has been falling over the past decade, from over 50% to about 44% more recently.

The worst case scenarios have failed to materialize, but for now the UK is a much higher risk proposition post-Brexit. Those who think Brexit set it irrevocably on the path of decline are best advised to exit the market entirely. Our view is that the UK will remain a going-concern, and even has a chance to thrive in future years if its leadership is up to the challenge. The country has been in worse situations before. In the 1970s, inflation ran rampant, labor strikes routinely shut down vital sectors, GDP was slipping, an International Monetary Fund (“IMF”) bailout was required, political leadership was ineffective, and public confidence was at an ebb. The country was the very picture of decline. It could have continued that way, but the crisis set the stage for the ascendancy of a reformist government which implemented policies that led to a more prosperous economy. Though the particular circumstances differ, the country faces a similar choice today. If the UK chooses a more insular, protectionist path and substantially disengages from the EU, the prophecy of a “Little England” will likely come to pass. If the country remains engaged with the EU and the larger world and maintains its commitment to free markets and open trade, its prospects will be good. It could go either way. History suggests a more outward-looking posture, but the anti-globalization strain running through much of the West suggests a turn inward.

EU at a fork in the road

Brexit is a challenge to the EU’s survival. However, it has also opened up its best opportunity for reform in years by exposing its schisms, the persistence of nationality over a “European” identity, and breaking the momentum of the anti-democratic bureaucracies that have been the primary target of anti-EU sentiment. A difficult task awaits the EU: hold the community together while maintaining momentum toward economic harmonization. In the short run, this means talking tough and extracting a price from the UK for leaving. Longer term, the EU has two broad options:

1) the status quo prior to Brexit: tighter bureaucratic control and more top-down integration, in spite of popular objections to “ever closer union”; or

2) a more flexible and accommodative approach to the political/regulatory aspects of the EU agenda.

The former approach is likely to fail and lead to the dissolution of the EU, in whole or in part, while the latter promises to usher in reforms that may hold the EU together. Recent conciliatory pronouncements from leading EU figures suggest significant support for the latter path. However, there is little visibility as to which direction will prevail.

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3 The Wall Street Journal (July 2016) “Britain is Open for Business”
Investing

Not the time to walk away

For investors eyeing the UK, the coming two years should provide one of the best opportunistic investment windows since the financial crisis. So far, defensive bets like the FTSE 100, healthcare, government bonds, and yield-producing securities are getting the most attention; however, pricing remains full in these areas. Assuming a positive point of view on the UK, a longer term horizon, and the stomach for some volatility, the best opportunities are likely to be found in out of favor assets: medium and small cap enterprises with higher domestic exposure than large caps; or financials, which have been severely beaten down due to Brexit-related uncertainty and a continuing low rate environment. The outlook for traditional growth investments or strategies predicated on a bounce-back to the pre-vote status quo is not favorable. Rather, those that take advantage of disruption and scarce investment capital should do well. Consolidation plays should be attractive, given the expected turbulence and higher volatility of the next few years.

Certain strategies should work well on both sides of the Channel. Secondary investments may become attractive if a rocky, drawn-out Brexit path prompts investor reductions in UK and EU exposure. Credit strategies should benefit from a variety of factors, including downside protection; bank lending gap in the lower middle market; the dampening effect of increased volatility on capital market capital sources; and lower availability and higher cost of debt. Credit strategies should perform well in either market, but may find particularly fertile ground in the EU, due to the weaker state of its banking system.

Good entry point ahead?

A reserve of dry powder will be important in this environment, but conviction and pricing discipline will be critical. The political and economic uncertainty brought on by Brexit justify a significantly higher risk premium, which should be reflected in investment pricing. Investors should be patient. The drawn-out exit process and the inevitable twists and turns of the negotiation will heighten market volatility and provide multiple inflection points for capital deployment. The first such point is likely to occur around the decision to invoke Article 50. Paying attention to the politics will be more important than usual in this environment. As noted above, either or both of the UK and EU could move in directions that are decidedly unfavorable for economic growth and stability; therefore, investors should monitor the tone and trend of political developments and adjust investment exposures accordingly.

Brexit has opened the door to a world of uncertainty for the UK. But with increased uncertainty comes increased opportunity. Private equity investors, who can ride out down markets and actively manage investments, exist for just such an environment. For investors willing to assume some additional risk, retrenchment is not the answer. Rather, increasing commitments to focused, high quality, disciplined private equity managers should prove one of the best ways to transform the disruption of Brexit into opportunity.