Mixed economic growth and the impact of Brexit on Start-ups

Brexit Monitor
A European view
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Eurostat recently published the first estimates for economic growth in the second quarter of this year. These preliminary figures may change in the coming months and do not yet contain much detail. According to the statistical bureau, in this period gross domestic product (GDP) for the EU its 28 members (EU28) increased by 0.4% compared to the first quarter of 2016. In the case of the Eurozone, GDP growth was 0.3% compared to the first three months of this year. In the first quarter, GDP growth was 0.5% in the EU28 and 0.6% in the Eurozone. The pace of economic growth declined in most of the countries that share the euro as a common currency.

Although not all country data is yet available, preliminary growth estimates show a particular deceleration in France and Austria on a quarter-to-quarter basis. Germany saw its GDP growth slow too, from 0.7% in the first quarter to 0.4% in the second quarter. The Netherlands maintained its economic growth pace at 0.6%, while Belgium saw it GDP growth increase to 0.5% in the second quarter, compared to 0.2% in the first three months of 2016.[1]

On the whole, first growth estimates suggest a decline in growth momentum in Europe's largest economies. Although economic growth in the UK held up well in the second quarter with GDP growth at 0.6%, it remains to be seen if it can maintain momentum in the wake of uncertainty surrounding a Brexit. A prolonged deceleration in the Eurozone may add fuel to discussions surrounding the current effectiveness of monetary policy by the ECB. As there is little room left for the ECB to loosen monetary policy further, increasingly attention is given to fiscal stimulus as a means to support economic growth in Europe. The Bank of England has more options available than the ECB, and recently lowered its Bank rate to 0.25%. However, in the UK too there are discussions whether this will be sufficient to compensate for a potential slowdown in growth after the referendum, and there is a possibility of tax cuts or infrastructure spending increases later this year.

1 NB: all figures are quarterly.

The European political context

While the timeline for the UK to leave the EU has been clear for some time, a few details may still upset the intended process. A timetable which sees the UK trigger article 50 in early 2017, theoretically means a UK exit from the EU in 2019. Realistically few people think that a deal between the EU and the UK can be ready at this time given the complexity of the task. As a point of reference, it took Greenland three years to leave the European Economic Community in the 1980s.[2] Negotiations with the UK are both a highly political process and deemed to be much more complex than negotiations with Greenland. Yet, it is important to bear in mind that we are talking about two separate processes – one process for the UK to leave the EU, and one for establishing a new EU-UK relationship post-Brexit. While it may well be decided to deal with the two processes as one, article 50 sets a formal requirement for the first process to be concluded within a two-year time frame (unless it is unanimously decided by all EU28 members to extend the negotiation period), while there is no deadline for the second one. It is worth noting that when the Council President Donald Tusk states that he expects negotiations with the UK to last a minimum of seven years it is the latter process he refers to.

Theoretically at least, this means that the UK could be forced to leave the EU without the adequate arrangements for its relationship with the EU in place. This could happen if as few as one of the EU28 member states, including the UK, decides to veto the extension of the negotiating period beyond the two years. It is true that such a scenario would create uncertainty of unprecedented magnitude and would certainly not benefit neither the UK nor the EU, but political moods are hard to predict, especially those which are far ahead in time. Yet again, this shows why domestic politics in all the EU28 capitals matters a great deal in the forthcoming Brexit negotiations.

Nonetheless, if the negotiating period is extended beyond the initial two years, this may prove just as challenging as a scenario whereby the UK leaves the EU within the time period. Moving towards 2020, UK domestic politics start coming into play with a UK general election scheduled for May that year. An election in the UK could reverse the result of the Brexit vote if a pro-EU party would win. In this context, it is worth noting that a scenario in which the UK referendum result is either confirmed or reversed in a general election, could materialise also prior to 2020. If there is no election in the UK until 2020, and Brexit occurs by late 2019, as the UK's Brexit Minister David Davis has said, then the UK public would not have had a say on the terms of the EU-UK deal. Therefore, it is possible that either general elections in the UK will be held earlier, or Brexit will happen later than the current timetable suggests.

Legally however, once article 50 has been invoked there is no turning back. This means that should a future UK government wish to reverse the course of action, then technically the UK would need to formally reapply for membership to the European Union. As such the decision about if and when to trigger article 50 remains essential.

2 In 1982, Greenland voted to leave the European Union, but it took until 1985 until negotiations were completed, following more than 100 meetings with EU officials. This was also prior to the establishment of the Single Market. Nowadays Greenland is an autonomous territory within the Kingdom of Denmark and is associated to the EU under an Overseas Association Decision.

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The Brexit effect on Innovation and Start-ups

The UK referendum result impacts innovation in several ways, for instance innovation is threatened by decreasing diversity and less international cooperation. When it comes to technology, which is an important driver for innovation, Gartner and Forrester both predict decreasing investments in new technology projects[3]. Forrester has even advised CIOs to find a new balance between cost reduction and investment in revenue generating investments. Further, the adoption of technology trends like the use of cloud technology may be negatively impacted by the UK's exit from the EU.

Increasingly innovation occurs through various forms of collaborative relationships, partnerships and/or acquisitions of start-up and scale-up companies. Start-ups are entrepreneurial by nature and tend to be agile in their business models. This makes them able to quickly adapt to new circumstances and they are often also able to move relatively fast from one location to another. Radical innovation is often difficult to foster within an existing rigid organisational structure making start-ups the ideal hotbed for innovative ideas. For established companies, cooperating with start-ups or investing in start-ups, provides these organisations an access to new technologies and business models which could otherwise be out of reach. In this context the role of start-ups for innovation should not be underestimated. The UK EU referendum and a looming Brexit will affect innovation thorough its effect on start-ups.

3 Gartner, *Understand the Brexit Impact on IT*, 24 June 2016 and *IT Spending Forecast*, 7 July 2016. Forrester, *European Tech Market Outlook For 2016 To 2017; Brexit And Sluggish Economies Will Lead To Stagnant Tech Demand*, 13 July 2016.

Investment

There are several ways in which Brexit could impact start-up and scale-up companies. Firstly, uncertainty will affect investments in start-up and scale-up companies. The inherent uncertainty about a typical start-up business model, combined with market uncertainty following the UK's vote to leave the EU, could lead to more conservative investment strategies. In the second quarter of 2016, the amount and number of investments in start-ups decreased worldwide compared to the first quarter as well as compared to the year before. One of the reasons for this decline was economic uncertainty, caused by the UK's vote to leave the EU. Venture capital backed investment in UK companies fell to USD 729 million in the

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second quarter of 2016 – down 43% on the previous quarter and down 46% on the same period last year[4]. Major venture capital firms pulled out of doing larger deals in Europe due to economic and regulatory uncertainties. Venture capitalists could spend larger portions of funds on European start-ups outside the UK. But for now and during the negotiating period, the rules and regulations remain unchanged. In this period of time, companies in the EU and in the he UK, will have an opportunity to work on cooperation models that may hedge against any Brexit uncertainty.

The European Investment Fund (EIF) is the biggest institutional investor in the European venture capital market. In 2014 investment activity backed by the EIF represented 41% of total investments in Europe. London is EIF's prime investment hub, with other UK cities also ranking high in receiving investments. The uncertainty surrounding funding could deter venture capitalists from investing future funds in the UK if a viable and well-funded alternative exists elsewhere. This could mean that venture capitalists would be more likely to spend larger portions of funds on European start-ups outside the UK. Post-Brexit, unless the UK government steps in to replace these funds, UK venture capitalists may need to move to the EU to keep receiving funding. While this would be negative for UK start-ups a move from the UK to the EU could prove positives for EU start-ups. However, it is worth noting that until the UK leaves the EU it remains a full member of the EU, retaining all its memberships rights and obligations. As such, the EIF has confirmed that the fund will not change its approach to operations in the UK at present. The UK Treasury further announced on 13 August, that it will guarantee EU funding beyond the date it leaves the EU and until 2020. The announcement was made to remove uncertainty and to encourage UK organisations to proceed with applications for new funds.

Ranking of EIF-backed venture capital hubs by time window

City (country)	Rank 1996-2001	Rank 2002-2007	Rank 2008-2014	Overall period rank
London (UK)	2	1	1	1
Paris (FR)	1	3	3	2
Cambridge (UK)	4	2	6	3
Berlin (DE)	8	13	2	4
Munich (DE)	6	7	4	5
Dublin (IE)	5	4	10	6
Milan (IT)	3		8	7
Stockholm (SE)		9	5	8
Amsterdam (NL)	9	6	7	9
Copenhagen (DK)		8	9	10

Source: EIF Research

Labour mobility

In addition, start-ups benefit from international labour mobility with both staff and founders operating across borders. The UK's exit from the EU will likely negatively impact the free flow of talent between the UK and the rest of the EU.

Reduced mobility of talent from the EU to the UK and vice versa, would adversely affect corporates who engage in cross-border innovation activities, start-up acquisitions or business ventures. In PwC's conversations with start-up and scale-up companies, we see that some companies are rethinking whether the UK is the right place for doing business. The ability to scale up business easily across the EU is one major reason quoted. Prior to the referendum, Tech City UK polled 240 technology founders and investors, and found that 70% favoured "Remain", citing access to the EU single market and access to a skilled EU workforce as one of the main reasons. Relocation from the UK would likely depend on the availability of the right skillset and labour force, including language capabilities, and access to capital and market.

4 KPMG CB Insights, *Venture Pulse Q2 2016*, 19 July 2016.

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As such whether companies will actually move is dependent on many factors among which the future relationship between the EU and the UK in terms of labour mobility is one of the most important.

An opportunity for Europe?

From a European perspective, a possible move of UK start-ups to the rest of the EU could provide the impetus needed to further develop the European start-up and scale-up ecosystems. This could increase the innovative power and make the EU more attractive to young ambitious entrepreneurs. Cities like Amsterdam and Berlin with their vibrant start-up ecosystems could be well positioned to replace London as global start-up hubs. This development was partly already ongoing prior to the UK's vote to leave the EU. For example Berlin attracted more venture capital funding than London in 2015, surpassing the $2 billion mark in venture capital investments. But Berlin does not only have sufficient capital, there is also access to young, motivated and well-educated staff. In a recent PwC survey, nearly 90% of Berlin's start-up leaders rated their location as "good" or "very good" in terms of being start-up friendly.

Likewise, Amsterdam, is an attractive start-up location due to its great start-up infrastructure and a mix of smart government, businesses and citizens interacting together in an ICT enabled community. Amsterdam's success stories include initiatives such as Startupbootcamp, a global accelerator program now rolled out in more than ten countries, Nimbuzz, a cross-platform instant messaging aggregator for smartphones, tablets and personal computers, and the first Dutch tech unicorn Ayden, an online payments firm, which has been valued over $1 billion. Fast growing start-ups such as Uber established their European headquarters in Amsterdam and use it as the gateway to continental Europe.

In addition, many other EU countries and cities are heavily investing in a start-up/scale-up friendly legal and tax environment, focussing each on special niches. For example Brussels, the capital of the EU, is a city to which more and more young entrepreneurs in for example data analytics and e-games are attracted by its unique tax shelter measures.

Brexit may offer European cities an opportunity to boost their attractiveness. For example, both Brussels and Istanbul appear as runner ups in the 2015 Global Startup Ecosystem Ranking.

It is to be noted as well that the Brexit could impact the current flexible legal and tax framework for cross-border migrations of UK incorporated start-up/scale-ups. Another issue hitting especially the (big) data focussed start-ups is the strict new EU privacy law (GDPR), although the UK could install an equivalent framework post-Brexit. In absence thereof, however, storing and processing private information in or transferring it to the UK will become more complicated than it is now.

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On the other hand, a UK exit from the EU would have negative implications for the EU start-ups and their business with UK customers. The level of impact will depend on the sector and the business model of the start-ups. It is predicted that, the larger and more global the start-ups are, the more they will suffer from the effects. Trade will be an important factor for all companies to take into consideration, but it also an area where the future is difficult to predict. For example import duties or export restrictions, would have an impact on the activities of some start-ups and their opportunities on the UK market. Nonetheless, the bottom line is that Brexit would have a significantly greater impact on the UK start-ups than on their peers in the EU.

The Global Startup Ecosystem Ranking 2015

Rank	Rank 1996-2001
1	Silicon Valley
2	New York City
3	Los Angeles
4	Boston
5	Tel Aviv
6	London
7	Chicago
8	Seattle
9	Berlin
10	Singapore
11	Paris
12	Sao Paulo
13	Moscow
14	Austin
15	Bangalore
16	Sydney
17	Toronto
18	Vancouver
19	Amsterdam
20	Montreal

EU capitals like Berlin, Paris, Amsterdam are catching up with London as start-up hubs

Source: The Global Startup Ecosystem Ranking 2015

The takeaway

While Brexit is causing planning uncertainty for start-ups and investors, the final outcome is still too early to predict. There are mixed reactions - positive and negative - about what could happen in the future. For start-ups the primary concerns are about hiring talent and the potential to scale up businesses across the EU including the UK. These concerns are causing small companies and start-ups to be more cautious about their operations. Some investors are holding back and watching how the economic and regulatory uncertainties will unfold in the future.

At the same time, uncertainty in the UK, could benefit the start-up scene in Europe. In particular Berlin, Paris and Amsterdam and runner-ups such as Brussels, could stand to benefit in the short and medium term, as they provide access to well-managed infrastructure, a skilled workforce, a conducive ecosystem for growth and access to Europe's single market.