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SHOULD FARFETCH MAKE AN (BR)EXIT?

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## Abstract

Brexit is a phenomenon that concerns the whole world. However, the ones residing in British territory are certainly the ones that fear it the most. The present report serves the purpose of determining whether it is probable that Farfetch, the leading technology platform for the global luxury fashion industry, will be highly impacted by the backlash of Brexit. In order to do so, the effects that may affect it were examined. A scenario analysis was performed to assess if the only probable impact on the company's operations – the extinguishment of the free movement of people – would harm the company. A conclusion of not likelihood was met. However, one must be always watchful and prepared.

Keywords: Farfetch, Brexit, Impact, Talent.

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## **Contextualization**

On June 23, 2016, the future of the United Kingdom and everything it involved changed when 52 percent of the voters that went to the poll that day decided they would be better off if they withdrew the European Union. Since then, Brexit has been on everyone's mouths. After three years of discussion, there are two options on the table – deal – the United Kingdom and the European Union formalize an international treaty, the Withdrawal Agreement Bill – or no-deal – the UK will be recognized by the EU as a third country, saying goodbye to the free trade. Brexit will impact the situation of all individuals and corporations that reside on the UK territory. Farfetch is no exception. The purpose of this report is to determine the extent of such impact on the firm and quantify the possible impacts of this crisis on the company.

## **Brexit possible impacts on businesses**

Currently, the UK is inserted in the European Union, a single market where there is free movement of goods, services, capital and people. There are two scenarios one needs to consider already mentioned above – the deal and the no-deal.

If the UK leaves the EU with a deal, the most desired scenario, there will be certainly impacts on businesses. The nature and terms of the agreement are still being discussed, so it is hard to predict the outcomes. However, the withdrawal agreement will be set to guarantee that those impacts will be smooth. Therefore, the analysis will not comprise the deal scenario.

If it leaves with a no-deal, the consequences are more predictable and material - the UK will no longer be part of the EU free trade area. For companies, there are several direct consequences. Firstly, it will no longer be exempt of customs, duties and VAT payments associated to the import and export of goods and services to and from countries that are part of the EU. Secondly, there will not be free movement of goods, making it difficult to transfer products in terms of transport and logistics, including fulfilment. Thirdly, personal data transfers will also be subject

to high restrictions. Lastly, if there is no free movement of people, the employment of EU citizens in the UK and vice versa will stop to be possible.

### **The case of Farfetch**

Farfetch Limited, headquartered in London, is one of the numerous companies that will suffer from the effects caused by Brexit.

In terms of the loss of exemptions of import/export of goods and services' duties and customs and the movement of goods and services from and to the UK, there won't be any real impacts in the company due to its business model. Farfetch is a marketplace that has minimal inventory risk – the only thing the platform does is to connect the seller to the buyer. For example, if a customer bought a pair of sneakers on the marketplace, the sneakers would be sent directly from the seller to the customer. Since the operations don't pass through the UK (unless the customer and/or the seller are in British territory), this won't brutally affect the company.

In terms of personal data transfers, this could affect the company, but also not severely. One of the great services Farfetch offers its partners is the rich consumer data sets and algorithms that help them to know its consumer base and improve its whole business. This is especially relevant for a company that operates in the luxury fashion industry – the customer always expects the best care, something data insights can provide. However, the same as above happens here – only data from transactions that go through the UK would suffer.

The only real impact that Brexit might have on the firm is on talent acquisition. Farfetch's main operation comes from its platform, designed and managed by the company itself. In order to perform these activities, the company needs a high number of employees with exceptional expertise. Its headquarters are in London, home of thousands, if not millions of emigrants. If the UK lost the free movement of people, Farfetch would probably not be able to attract and retain the best talent, being confined to choose among British people, and not the entire world.

**Scenario Analysis**

In order to quantify the impact that Brexit might have on Farfetch, more specifically in talent retention and acquisition, a scenario analysis was performed. Only two scenarios were considered – the downward and the base – since there is no direct upward scenario that may come from this situation.

If there isn't enough supply of human capital, its price increases. If free movement of people for the UK extinguishes, Farfetch will have to raise its employees' wages (the current and future employees will know their value). Therefore, the variable that will be influenced will be technology expense – the investment the company makes in people, product and infrastructure to maintain and grow the platform and to drive technological innovation in the luxury industry.

In order to know how much this expense would increase, data from a country with low supply of people with technological skills (engineers, developers, etc.) was retrieved. The chosen country was Israel, an emerging technology hub that year after year sees salaries associated to technology to climb due to low supply and high demand. The difference from UK salaries to Israel salaries was 58.53%.

*Table 1- Difference between Average Software Developer Salaries in the UK and in Israel*

<b>Average Software Developer Salaries (\$)</b>	
United Kingdom	40,497
Israel	64,198
<b>Difference</b>	<b>58.53%</b>

Based on this, the assumption in the model regarding the forecast of technology expense was reviewed – technology expense was forecasted as a % of revenue (the more/less capital the company generates, the more/less it spends). Technology expense in the base scenario can be seen in table 2.

*Table 2 – Technology Expense Base Assumption*

	<b>2019E</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>	<b>2024E</b>	<b>2025E</b>
Technology Expense	(82,850)	(102,269)	(140,653)	(166,292)	(271,685)	(308,831)	(425,270)
% of Revenue	-8.20%	-6.63%	-6.63%	-5.63%	-6.63%	-5.63%	-5.63%

Since that if a no-deal Brexit happens, it will be in 2020 (January 31, 2020, to be more specific), the technology expense as a percentage of revenue was set to start to increase in 2020 until 2022, where it reaches the maximum value it is expected to reach – the difference between UK

and Israel salaries – 58.53% - times the average of technology expenses as percentages of revenue – 6% - which gets us to 9.72%. From 2022 on, it is expected that the company finds ways to decrease this cost, since it is not sustainable.

Table 3 - Technology Expense Downward Assumption

	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Technology Expense	(82,850)	(138,853)	(198,560)	(287,031)	(368,873)	(438,934)	(453,319)
% of Revenue	-8.20%	-9.00%	-9.36%	-9.72%	-9.00%	-8.00%	-6.00%

A summary of the scenario analysis is presented in table 4. As one can see, the price per share in the downward case would be \$4.88, down from a base price per share of \$16.98. From the analysis, *ceteris paribus*, the expected value per share would be \$15.16, derived from the probability of 15%<sup>1</sup> for the downward case and 85% for the base case.

Table 4 – Scenario Analysis

	Downward	Base
Average Technology Expenses as a % of Revenues (%)	-8.51%	-6.13%
Enterprise Value (\$ thousand)	1,226,682	4,855,192
Net Debt (\$ thousand)	(235,682)	(235,682)
Equity Value (\$ thousand)	1,462,364	5,090,874
# of Outstanding Shares	299,857	299,857
Price per Share (\$)	4.88	16.98
Probability (%)	15.00%	85.00%
<b>Expected Value per Share (\$)</b>		<b>15.16</b>

## Conclusion

After the analysis, one might conclude that Brexit won't have a great impact on Farfetch, due to the company's business model and the low probability of a no-deal materializes. However, no one knows what the future hides. Farfetch doesn't necessarily have to move its headquarters from London but it should prepare for any casualty that may happen, and don't underestimate the importance of Brexit to the company.

<sup>1</sup> Probability of the UK leaving the EU in a disorderly manner according to economists polled by Reuters - Godbole, Omkar. 2019. *Probability of hard Brexit lowest since May - Reuters Poll*. 5 de December. <https://www.fxstreet.com/news/probability-of-hard-brexit-lowest-since-may-reuters-poll-201912050128>.

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