Financing British industry

This is the first of a series of background briefing articles to be produced by the Bank which are intended to give an account of some aspect of financial developments and policy in non-technical terms—as distinct from specialist articles on technical subjects, which will continue. This article describes companies' financing needs, discusses balance-sheet and income gearing, and outlines some of the main ways in which companies are financed.[1]

Introduction

For much of the 1950s and early 1960s, the financing needs of private industry and trade were readily met within a financial system which was changing only slowly—the system described in the Radcliffe Report of 1959.[2] By and large, profitability did not place undue constraints on new investment, while companies' requirements for outside finance were met without the appearance of undue pressure, notably through the provision of equity finance and fixed-interest loans for the larger firms by the capital markets, and of overdraft finance for firms of all sizes by the banks. During the late 1960s and 1970s, however, the financial climate became increasingly harsh: companies' profitability was squeezed by accelerating inflation, and their liquidity became subject to intermittent but growing pressures. The long-term capital and equity markets to which companies had previously turned for funds fell into disuse, though the equity market only temporarily, while more novel forms of finance—most notably leasing—rapidly gained in popularity. These and other developments have been described in the recent report by the Wilson Committee,[3] whose field of study included the provision of funds for industry.

Before discussing the various changes that have taken place in outside sources of companies' finance, the article looks in broad outline at their financial needs as a whole, and the extent to which these can be satisfied without calling on external sources.

The need for finance

Businesses need finance, in a quite literal sense, simply to keep going: that is to say, they need working capital to pay for stock and work in progress, which increase with inflation, if for no other reason, and to finance trade debtors, which also increase with inflation (though this can be offset by the use of trade credit); and, more fundamentally, they need funds to replace plant and equipment as it wears out. All of this expenditure is required to be made or provided for even where no real expansion of a business takes place. For businesses concerned to increase their operating capacity, funds are also needed to finance new plant and equipment (or take-overs) and to allow for a greater scale of working capital. Table A sets out, for industrial and commercial companies as a whole, the relative sizes of these amounts over 1963–79.

Table A
Industrial and commercial companies: uses of funds
£ billions; annual averages

	1963–66	1967–70	1971–74	1975–79
Fixed assets	2.3	2.8	4.6	9.5
Acquisitions	0.3	0.3	0.6	0.8
Stocks	0.6	0.9	2.8	5.2
Other	0.8	1.2	3.6	4.0
Total (A)	**4.0**	**5.2**	**11.6**	**19.5**
Amount required to maintain:				
Stocks (= stock appreciation)	0.2	0.5	2.2	4.6
Fixed assets (= depreciation at replacement cost)	1.1	1.5	2.5	6.2
Total (B)	**1.3**	**2.0**	**4.7**	**10.8**
B as per cent of A	*33*	*38*	*41*	*55*

Source: derived largely from the national income accounts.

This table also illustrates the distinction made above between funds required to maintain the existing capacity of business, and expenditure that adds to capacity or to real working capital. The figures, which are inevitably rough and ready, suggest that just over half of companies' uses of funds over the five years 1975–79 will have been needed simply to maintain the existing scale of business, as against 40% in the period 1971–74 and one third in the mid-1960s.

Internal funds and profitability

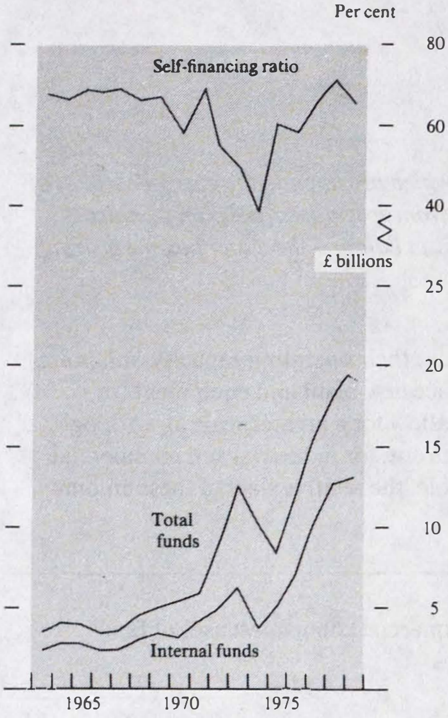
Turning to the sources from which companies have financed their requirements, it is clear that by far the most significant has been their internally-generated funds—that is to say, their trading profits, including provisions made for depreciation, after deduction of interest charges, tax payments, and dividends. On average during the past ten years, around 70% of company needs (as set out in Table A) were met from internal funds. If appreciation in the value of stocks is excluded throughout, the proportion comes down

(1) A more technical analysis of some of the latest trends in company finance was provided in 'Profitability and company finance: a supplementary note' in the June *Bulletin*, page 191. The various sources of finance available to companies are described in the Bank's publication *Money for Business*, a new edition of which was published in July. For details of how to obtain *Money for Business*, see the reverse of the contents page.

(2) *Report of the Committee on the Working of the Monetary System*, Cmnd. 827, HM Stationery Office: 1959.

(3) *Report of the Committee to Review the Functioning of Financial Institutions*, Cmnd. 7937, HM Stationery Office: 1980.

Industrial and commercial companies: internal funds[a]



(a) Excluding stock appreciation.

to around 60%. The chart illustrates the relative importance of this source.

As the chart shows, the proportion of internal funds to total funds—the 'self-financing ratio'—can fluctuate from year to year, depending chiefly on profits and capital spending; plans for the latter can, in turn, also depend on the cost of external finance. In the mid-1970s, when companies' internally-generated funds were under some pressure and rapid inflation had added significantly to the costs of holding and replacing stocks, external finance accounted for a particularly high proportion of companies' needs. However, a study of the self-financing ratio in isolation is of limited value. It can be taken further by comparing internally-generated funds with the amounts estimated as needed to maintain the scale of existing business (shown in Table A). On average, these amounts were covered only 1.4 times in the 1970s: in 1979 the cover was 1.7, as against 2.1 in the mid-1960s.

These figures serve to underline the most serious problem in the finance of British business—the inadequate return on assets after allowing for the maintenance of capital in real terms. Over the past ten years, profitability at historic cost has risen slightly, but after adjustment for inflation—allowing, that is, systematically for the depreciation of fixed assets at their replacement cost rather than at their original prices, for the higher costs of holding stocks, and for the revaluation of assets employed in the businesses—the rate of return has fallen substantially, before tax from $8\frac{1}{2}$% in 1970 to 4% in 1979 and after tax from $4\frac{1}{2}$% to $3\frac{1}{2}$%. With such low averages, a large number of individual firms must be operating with no real profitability.[1] These poor rates of return affect not only the availability of internal funds to finance new capital spending; they have also had a profound impact on the willingness of industry to make new investment of any type, whatever the source of finance. Since 1974, the estimated real rate of return on investment has been below the estimated real cost of capital.[2]

Gearing

Declining industrial profitability must have had an adverse effect on plans for industrial investment and thus limited the demand for finance. Poor rates of profit have also thrown into sharper focus questions relating to the amounts of indebtedness that balance sheets can support and to the adequacy of cash flow to meet interest charges. Each of these questions is an aspect of gearing: in broad terms, if a high proportion of a company's assets is financed by debt rather than by shareholders' funds (shares and accumulated profits) the company is said to have high capital gearing; and if interest payments pre-empt a large proportion of trading profits, it is said to have high income gearing. Traditionally, a ratio of debt to equity of 1:2 has been regarded as reasonable in much of British industry, and although (for reasons discussed below) this ratio has at present only limited relevance, it is clear that a number of practical consequences can flow from excessive borrowing.

One obvious consequence is that lenders become reluctant to increase their exposure to a company in which shareholders are unwilling or unable to increase their financial commitment. Because shareholders' funds bear the brunt of any losses incurred by a company (just as the shareholders benefit through higher dividends or retained profits when the company does well), a company with a high ratio of debt to shareholders' funds tends to be viewed by lenders as inherently more risky than one where shareholders' funds are more substantial. Certainly, companies which have borrowed on a large scale are more vulnerable to a downturn in business conditions: in contrast to dividends to equity holders, over which company boards have discretion and which can be varied with the success or otherwise of the business, interest payments have to be met regardless of companies' circumstances. When the return on investment exceeds the cost of servicing debt, high gearing may be advantageous to shareholders in that the return on equity is enhanced. When profitability worsens, however, the risk of loss to shareholders increases.

Rates of interest are liable to change, too, and this factor—which is outside companies' control—adds further to the risks inherent in high gearing. A large part of companies' borrowed funds has in fact been taken at rates which vary with market conditions. When interest rates increase, income gearing (the proportion of profit pre-empted by interest—in the figures below, net of interest

(1) See also 'The profitability of UK industrial sectors', December 1979 *Bulletin*, page 394.
(2) For further details see the supplementary note in the June *Bulletin*.

received) will present a more alarming picture than capital gearing, especially when profitability is poor. In 1979, when interest rates rose very sharply, the income gearing of industrial and commercial companies rose to 24%, as against 17% the previous year and 19% in 1970. By contrast, their capital gearing fell (at historic cost) from 19% to 18%.

Capital gearing is frequently difficult to measure with any confidence. There are several possible ways of valuing the equity interest in companies' balance sheets, and there are items that cannot be neatly apportioned as between borrowed funds on the one hand and shareholders' equity on the other. A notable example of the latter is deferred tax, representing tax which companies have provided for but which has yet to fall due for payment. In recent years this has grown significantly as a result of relief for stock appreciation and of allowances given in respect of companies' spending on industrial investment. Expenditure on most fixed assets can be set against taxable income in the year it arises; increases in the value of stocks (less a percentage of profit) can also be set against tax. However, these allowances effectively or actually only defer the liability to tax; for example, should the value of stocks fall from one year to the next, stock relief can be subject to clawback.(1) A growing firm doing well is unlikely to pay such tax, but if the outlook turns sour, deferred tax can loom as a genuine liability. Under a recent accounting standard,(2) companies have been encouraged to write deferred tax back into shareholders' funds wherever the liability is not thought likely to crystallise in the foreseeable future, though the threat often remains, accounting for as much as 20% of some companies' (historic cost) balance sheets.

The other major uncertainty in company balance sheets is the valuation of assets. In Britain, company balance sheets have been struck at historic cost, though in some of them land and buildings have been periodically written up to market values. The new standard for current cost accounting,(3) applicable to larger companies, requires the inclusion of a balance sheet showing assets at the lower of current cost or recoverable amount. One effect of this will be to reduce significantly the apparent importance of debt, which is, of course, usually fixed in money terms. National accounts figures indicate that debt would account for 10% of companies' balance sheets in 1979 if they were valued at current cost, as against 18% at historic cost; for 1970 the ratios would have been 21% and 27% respectively.

It is frequently remarked that British companies—like American ones—make less use of borrowed funds, and are consequently more dependent on shareholders' funds, than companies in the other countries in the European Community and in Japan. These differences are sometimes ascribed to the characteristics of the British and American financial systems—which are said to be market-oriented—compared with other countries' systems—which are described as bank-oriented. Differences in accounting systems make international comparisons hazardous, and while it is probably true that larger British firms with access to the Stock Exchange are less highly geared than their continental and Japanese counterparts, the same can scarcely be said of smaller companies, which often tend to be almost wholly dependent on bank finance. From OECD figures, however, and measuring gearing as the proportion of loans to equity-plus-loans, historic cost gearing for companies in the United Kingdom, the United States, and West Germany during 1975–77 appears to have been in the region of 30%; in France it appears to have been around 40%; and in Italy and Japan around 65%. Both in Britain and abroad, historic cost gearing reached a peak in the mid-1970s, and subsequently declined.

External finance

Although the ratio of outstanding debt to shareholders' funds has been declining in recent years, the composition of new external finance has been increasingly weighted in favour of bank borrowing, at any rate for the sector as a whole (see Table B), though the larger companies with ready access to the Stock Exchange and to the big institutions have continued to make wide use of other sources.

Table B
Industrial and commercial companies: external finance
£ billions; annual averages

	1963–66	1967–70	1971–74	1975–79
Bank borrowing	0.5	0.7	3.2	2.7
Other loans and mortgages	0.1	0.2	0.3	0.4
Ordinary shares	0.1	0.2	0.2	0.9
Other capital issues	0.3	0.3	0.1	—
Overseas finance	0.2	0.3	0.8	1.2
	1.2	**1.7**	**4.6**	**5.2**

Source: derived largely from the national income accounts.

One consequence of rapid inflation has been historically high nominal interest rates, accompanied by volatile expectations about future financial and economic conditions: capital markets have been uncertain, and prices, both of ordinary shares and of fixed-interest securities, have fluctuated widely. The channelling of long-term funds into industry has thus become less smooth than in the past, and has in fact been subject to periodic interruption. The market for new equity had a prolonged pause in 1973 and 1974, when share issues accounted for only 2% or 3% of industrial and commercial companies' external finance. But the recovery in 1975 was more abrupt than the decline, with new issues of more than £1 billion then providing a third of the sector's external funds. Subsequently, the equity market has remained a reasonably steady source of finance: in 1979 it provided around a sixth of external funds. Indeed, despite the general problems of low industrial profitability and dividend restraint, substantial creditworthy companies

(1) The 1980 Finance Act, however, has provided that a material, temporary decline in stocks will mostly not be so treated.
(2) 'Accounting for deferred taxation', *Statement of standard accounting practice No. 15*, The Institute of Chartered Accountants in England and Wales, October 1978.
(3) 'Current cost accounting', *Statement of standard accounting practice No. 16*, The Institute of Chartered Accountants in England and Wales, March 1980.

have found little difficulty in raising new equity, though the market is principally used by larger companies—generally by way of rights issues to existing shareholders.

While the equity market recovered from its 1973–74 trough, the market for fixed-interest company securities did not. The demise of the fixed-interest market as a source of company finance seems to be attributable to the high rates of interest prevailing in it (themselves due, at least in part, to heavy government borrowing from it and to high rates of inflation) and to uncertain expectations about future rates of inflation and interest. This combination has made companies reluctant to borrow at fixed interest except in the short term. Thus new issues of loan stocks and debentures, formerly a familiar method of corporate financing for large listed companies (and which accounted for larger amounts in the early 1970s than did the equity market), almost ceased in 1974. At the same time, international fixed-interest markets have remained active, but British companies have not been major takers of funds from this source, partly because the weakness of sterling for much of the period discouraged them from acquiring foreign currency debts, and several who did suffered losses on the depreciation of sterling (and were unable to claim tax relief against these losses). The peak year for issues abroad remains 1972.

The banks increased their share of industrial and commercial companies' external finance in the 1970s. In the 1960s, as Table B shows, they had provided rather less than half the total, while in the 1970s they contributed about 60% of it, often more. Traditionally, bank lending has been at short term (largely on overdraft) and designed to finance companies' working capital requirements; and it is still possible to trace a relationship between bank lending and movements in companies' stocks. Since the early 1970s, however, banks have emphasised term lending, and for the clearing banks this has grown to account for over 40% of their total advances. This shift has been advantageous both to companies, which have had funds firmly committed to them for periods of up to ten years (if at slightly greater cost), and to the banks, which have been able more accurately to monitor and control the growth of their lending.

Term lending has been a partial substitute for the debenture market, but with one important difference: interest on term lending is almost always at variable rates. Typically, rates are reviewed every three or six months, and commonly fixed at the outset of each period at an agreed margin over the London inter-bank offered rate for deposits in the money market. As with debentures, a loan agreement may include restrictive covenants on borrowing from other sources.

Although bank loans are the main source of borrowed funds for industrial and commercial companies, and especially for small firms, a number of other institutions are active in the provision of company finance. One such is Finance for Industry (FFI), whose capital is subscribed by the clearing banks and the Bank of England. It provides medium-term loans to industry at both fixed and floating rates; its subsidiary, Industrial and Commercial Finance Corporation (ICFC), makes funds—including equity finance— available to small firms. Finance houses (often associated with banks) provide hire purchase and instalment credit facilities and short to medium-term loans. Pension funds and insurance companies can also provide funds direct to firms—loan finance as well as equity—and finance of various kinds is also available through a number of development capital companies and other specialised bodies.

Government can also make funds available in certain circumstances. Under the Industry Act 1972, the Department of Industry is able to provide loans and grants for investment in the assisted areas, and some specific assistance is also available to certain sectors. The National Enterprise Board, and the Welsh and Scottish Development Agencies, are also able to supply equity and loan finance to encourage investment. Other sources of funds to the individual firm include lending and trade credit between companies, though these do not, of course, increase the supply of funds available to companies generally. Foreign investment, meanwhile, is a growing source of company finance; as noted above, however, companies make relatively few capital issues abroad, and most foreign investment takes the form of direct inflows from foreign companies to their British subsidiaries and branches.

Low profitability and the various deferments of tax outlined earlier have significantly reduced industrial companies' liability to current taxation. Many companies have therefore become unable to benefit directly from the 100% first-year tax allowances on new plant and machinery: their tax liability is simply not big enough. Stemming in large part from all this, the leasing industry has grown rapidly over the past few years: by leasing assets from other firms, generally in the financial sector, a company whose capacity to offset tax has been exhausted can benefit from the lessor's tax capacity. The terms of leases are, of course, set in such a way as to allow the lessee a good share of the benefit from allowances so secured. Consequently, since 1974, when profitability fell dramatically and the stock relief scheme extinguished a large part of industry's tax liability, leasing business has grown rapidly. Many banks have taken over or established equipment leasing subsidiaries. In 1970 leasing accounted for a negligible proportion of new fixed investment by manufacturing industry; by 1975 it had risen to some 6% and by 1979 to nearly 14%. Some companies have favoured leasing because under present accounting conventions, now being reviewed, it is not recorded in balance sheets and finance raised in this way does not increase recorded capital gearing and may not count against borrowing limits set by previous lenders. Leasing has usually been at fixed rates, though a growing proportion of leases are currently being written at floating rates. (1)

(1) For further detail see the article on page 304.

Conclusion

It is clear that the system of company finance outlined above has shown considerable resilience in a time of great pressures. Some sources of finance have receded in importance—most notably the market for fixed-interest securities—but new methods of finance, closely attuned to the tax system and to companies' needs, have taken their place. It is, of course, not possible to judge from aggregate statistics whether or not companies have felt themselves constrained by the availability of external finance, but the rapid expansion of new forms of finance does suggest healthy competition among suppliers of funds.