Company profitability and finance

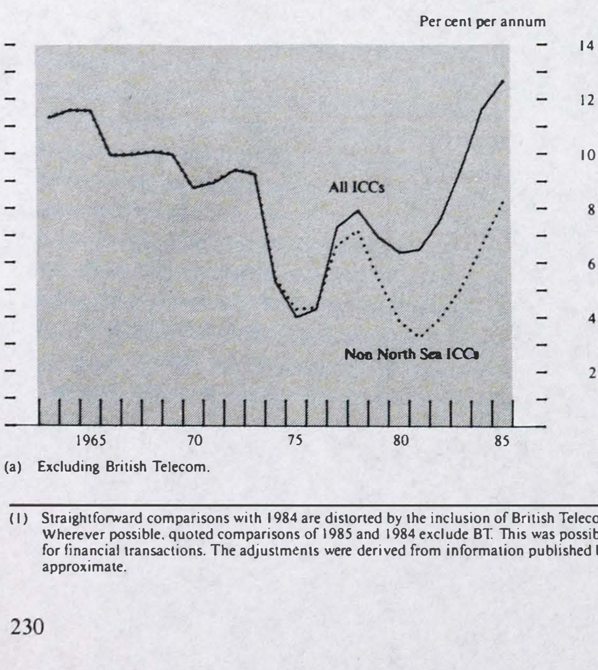
This note discusses the profitability and financing of industrial and commercial companies (ICCs) in 1985.[1] *The main developments were:*

- *non North Sea ICCs' profitability increased for the fourth successive year, with the pre-tax rate of return rising to 8%, the highest since 1973;*
- *non North Sea profits were boosted by falling prices for oil and imported raw materials, but profits in the North Sea sector fell;*
- *dividends were up by a quarter and taxes by a sixth;*
- *fixed investment increased by 8% in value, and by about 2%–3% in volume terms;*
- *ICCs' retained income and financial surplus fell;*
- *ICCs raised substantial amounts of external finance both from the equity market and, for the second year running, from banks;*
- *the value of takeovers and mergers was £7.1 billion, higher in real terms than in any year since 1972;*
- *both capital and income gearing showed modest rises.*

Domestic profitability

The recovery in the profitability of the domestic operations of industrial and commercial companies (ICCs) that began in 1981 was maintained in 1985 (Chart 1). Gross trading profits net of stock appreciation increased by 12%, about half as fast as in 1984 (Table A). The real rate of return on capital employed by ICCs showed further improvement in 1985, with the pre-tax profitability of non North Sea ICCs rising to 8%, the best since 1973. Pre-tax profitability of all ICCs was 12½%, the highest since 1960. The share of ICCs' profits in GDP, however, was little changed after four consecutive annual increases (Chart 2).

Chart 1
Pre-tax real rates of return[a]



(a) Excluding British Telecom.

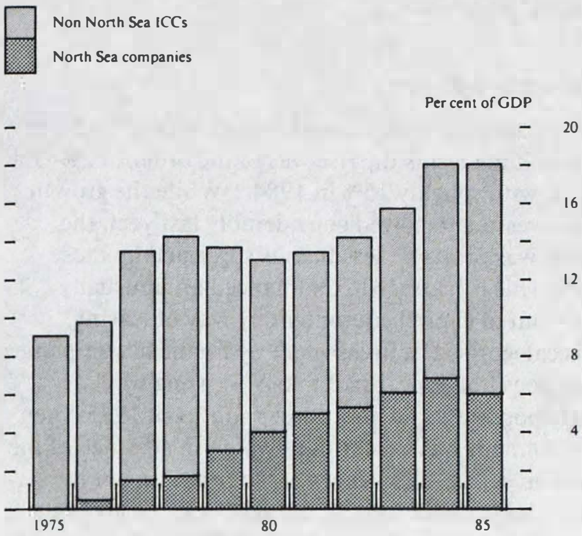
Table A
Industrial and commercial companies' income and appropriation accounts
£ billions

	1983	1984	1985 Excluding BT	1985 Including BT
Income				
Gross trading profits(a):				
non North Sea ICCs	25.0	31.1	37.6	40.7
North Sea activities	15.8	19.1	18.4	18.4
Other income	10.3	12.5	13.5	13.6
Total income(a)	**51.1**	**62.7**	**69.6**	**72.7**
Allocation of income				
Dividends on ordinary shares	4.4	5.3	6.7	7.0
Interest and other dividends	8.8	10.3	12.8	13.3
Profits due abroad	4.7	5.7	6.5	6.5
UK taxes	12.5	15.1	17.5	17.5
Total allocations	**30.4**	**36.4**	**43.5**	**44.3**
Undistributed income(a)	**20.7**	**26.3**	**26.2**	**28.4**
Fixed investment	15.6	18.5	19.9	21.9
Physical increase in stocks	0.2	0.1	0.3	0.3
Financial balance (surplus +)	**4.9**	**7.7**	**6.0**	**6.2**

(a) Net of stock appreciation.

(1) Straightforward comparisons with 1984 are distorted by the inclusion of British Telecom in the ICCs sector from 28 November 1984. Wherever possible, quoted comparisons of 1985 and 1984 exclude BT. This was possible for most items of income and expenditure, but not for financial transactions. The adjustments were derived from information published by BT: the resultant estimates should be regarded as approximate.

Chart 2
Share of ICCs' profits in GDP[(a)(b)]



(a) Gross trading profits expressed as a percentage of the current price income measure of GDP.
(b) Excluding British Telecom.

The overall picture for 1985 masks a marked difference between the experiences of North Sea and non North Sea companies. North Sea profits fell, as sterling oil prices declined and production increased by only 2%. In contrast, the profits of non North Sea companies remained very buoyant. In 1985, as in the earlier stages of the upswing, non North Sea profitability benefited from continuing economic expansion, in so far as this allowed overheads to be spread over a larger output and stronger demand enabled margins to be maintained or widened. The main factor underlying the improvement in profitability in 1985, however, was a widening of profit margins arising from a substantial slowdown in the rate of increase of fuel and raw material costs.(1)

The influences on the profitability of manufacturing companies since 1980 are illustrated by Table B. Margins appear to have widened in each of the most recent five years. The principal influence in 1983 and 1984 was a substantial slowdown in the rate of increase of unit labour costs, reflecting not just a gradual deceleration in average earnings and other employment costs but also historically large productivity gains associated with cost cutting and the closure of relatively inefficient sources of production. However, largely because of a sharp slowdown in the growth of labour productivity, unit labour costs increased faster in 1985 than in any year since 1981. This unfavourable development was offset by an easing in the growth of fuel and raw material costs, which increased by only about 1½% in 1985. Indeed, manufacturers' fuel and raw material costs fell for much of 1985 on a scale not seen for more than twenty years; this reflected weaknesses in the world prices of a wide range of primary commodities as well as the comparative strength of sterling for much of the year. As a result, manufacturers' margins, particularly on domestic sales, appear to have widened significantly during the year, as the new cost levels were not immediately incorporated fully into selling prices.

Table B
Contributions to changes in manufacturers' output prices
Percentage changes

	Contributions to change in output prices					Output prices
	Labour costs per head	Labour productivity (minus = gain)	Total unit labour costs	Raw material costs	Margins and other costs	
1980	12.2	2.5	14.7	3.0	−3.7	14.1
1981	6.7	−2.3	4.5	3.2	1.8	9.5
1982	6.9	−3.9	3.0	2.6	2.2	7.7
1983	5.0	−4.9	0.2	2.4	2.9	5.5
1984	4.6	−3.1	1.5	2.8	1.7	6.1
1985	4.9	−1.8	3.1	0.6	1.9	5.5

(a) Figures were derived by weighting the changes in input prices by shares in total identified costs, with margins and other costs derived as a residual.

A further factor which probably contributed to the improvement in profitability in 1985—and which has not been allowed for in Table B—was continuing improvements in the efficiency with which fixed and working capital are used. There are, for example, reports of widespread improvements in stock control in recent years.

The weaknesses in world prices of oil and other industrial raw materials have benefited industry worldwide and so will not change the relative competitiveness of British companies. The underlying picture during 1985 was one of a gradual deterioration in cost competitiveness, as labour costs increased faster in the United Kingdom than in the other major industrial countries. This contributed to a loss of price competitiveness as sterling recovered sharply from its trough early in the year. However, export margins were probably constrained by international competitive pressures, and they appear to have expanded more slowly than domestic margins.

Other income

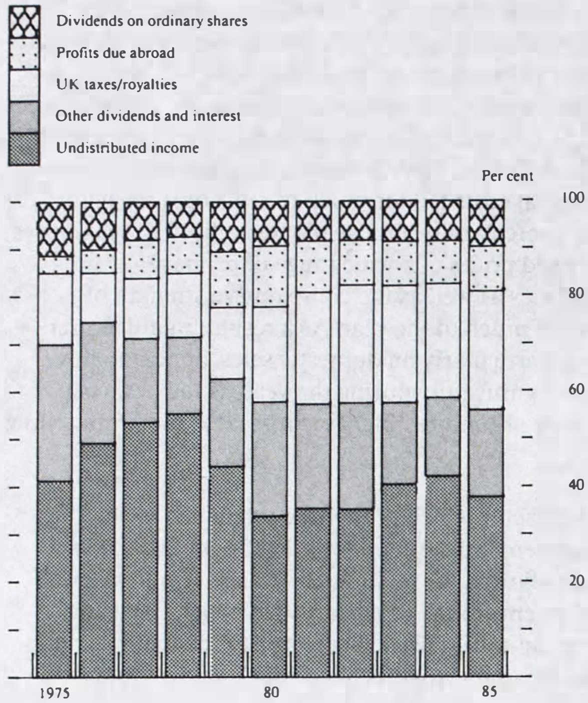
Company income other than domestic profits increased by 9% in 1985. It comprises two main elements: investment income and income from abroad. The former increased by almost 25%, reflecting in part continuing high interest rates. (Payments of interest were also sharply higher for the same reason.) Income from abroad, by contrast, showed little change from the previous year, in part because the appreciation in the relative value of sterling offset any increase in overseas profits valued in local currencies. This was the opposite of what had happened in 1984, when the sterling value of overseas profits was boosted by the depreciation of sterling.

Appropriations of income (Chart 3)

ICCs' income (net of stock appreciation) totalled £70 billion in 1985, 11% higher than in 1984, but current appropriations, at £43 billion, were 19% higher, so that

(1) The term 'margin' refers in this article to the mark-up on current (ie unlagged) costs.

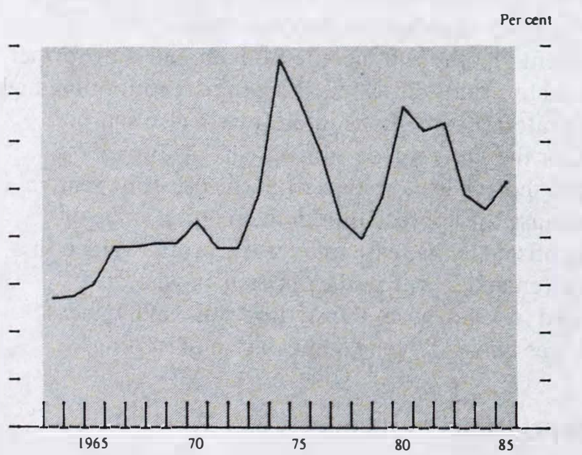
Chart 3
Appropriations of company income[a]



(a) Excluding British Telecom.

undistributed income, at £26 billion, showed little change. As a result, the ratio of undistributed income to total income fell from 42% in 1984 to 38%, the first fall since profits began to recover in 1981. Some fall in this ratio is to be expected as the recovery in profits slows, since the buoyancy of dividends and taxes reflected the faster growth of profits in earlier years. Payments of interest and other dividends were also substantially higher in 1985, reflecting higher interest rates and the continued growth of companies' debt. As a result, ICCs' gross income gearing rose three percentage points to almost 26%, the first rise for two years. But it remains well below the levels

Chart 4
Income gearing (gross)[(a)(b)]



(a) Gross interest payments as a percentage of income net of stock appreciation and tax payments.
(b) Excluding British Telecom.

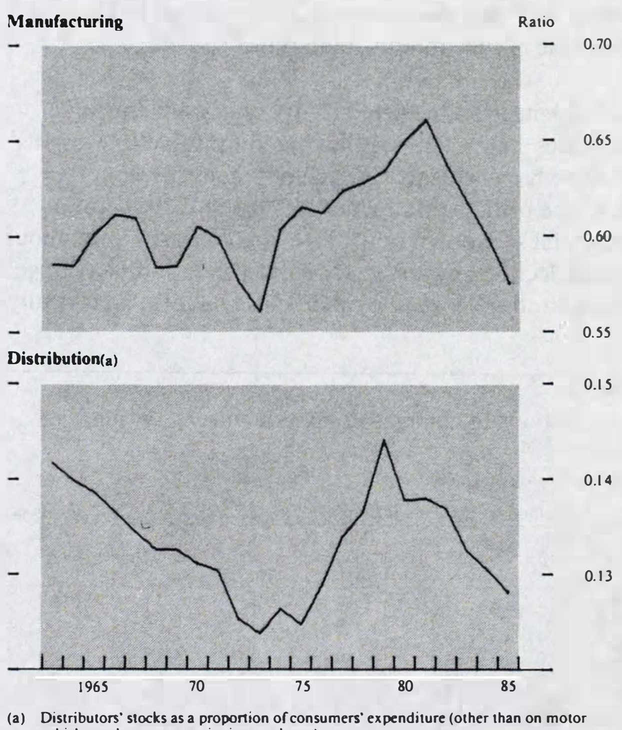
of the mid-1970s and early 1980s (Chart 4). Profits due abroad increased by 13%, roughly in line with the growth of gross trading profits.

Capital expenditure

Directly financed capital expenditure increased by 8% in 1985; in volume terms the rise was of the order of 2%–3% compared with roughly 15% in 1984.[(1)] While the growth of fixed investment slowed considerably last year, the slowdown was probably less than is suggested by these numbers. This is because ICCs financed an unusually large amount of capital equipment by way of leasing, which is categorised as investment by financial companies and thus does not appear in Table A. Leasing was especially popular in the first three months of 1985 when fixed investment was exceptionally high in advance of the reduction in capital allowances at the beginning of the new financial year; the benefit of higher capital allowances was thus obtained largely in the form of lower leasing rentals.

There was modest stockbuilding in 1985, as in the preceding two years, but, within the year, there were large quarterly fluctuations. Stock/output ratios fell once again, maintaining the downward trend that began in the early 1980s (Chart 5). However, most firms participating in the CBI survey of industrial trends consider their stocks to be adequate or more than adequate. This view probably takes into account both the high cost at present of financing stocks and a feeling that there is further scope for adopting more efficient stock control methods.

Chart 5
Stock/output ratios



(a) Distributors' stocks as a proportion of consumers' expenditure (other than on motor vehicles and owner-occupier imputed rent).

(1) The estimate for 1985 is especially uncertain since British Telecom's capital expenditure is substantial and an estimate on a National Accounts basis is not available. The margin of error is, however, not wide enough to alter the conclusions in the text.

Table C
Industrial and commercial companies' financial transactions
£ billions

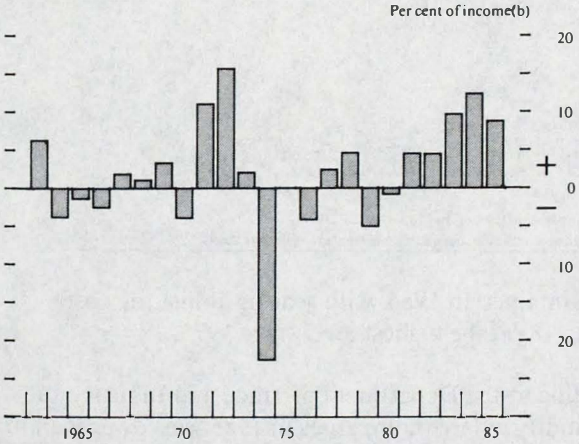
	1983	1984	1985(a)
Financial balance (surplus +)	**4.9**	**7.7**	**6.2**
Financial transactions(a)			
Investment in UK company securities	-1.4	-3.9	-4.6
Investment abroad	-3.3	-4.6	-3.4
Borrowing: from banks(c)	1.6	7.3	8.2
other	5.0	2.1	4.5
Financial assets: liquid	-5.9	-2.2	-4.7
other	-1.7	-1.9	
Changes in tax balances and other accruals adjustments, including net unremitted profits	-0.8	-0.5	1.0
Total transactions	**-6.5**	**-3.7**	..
Balancing item	**1.6**	**-4.0**	..

(a) Including British Telecom.
(b) Outflow of funds/acquisition of assets-.
(c) Includes Issue Department transactions in commercial bills.

Financial transactions[1]

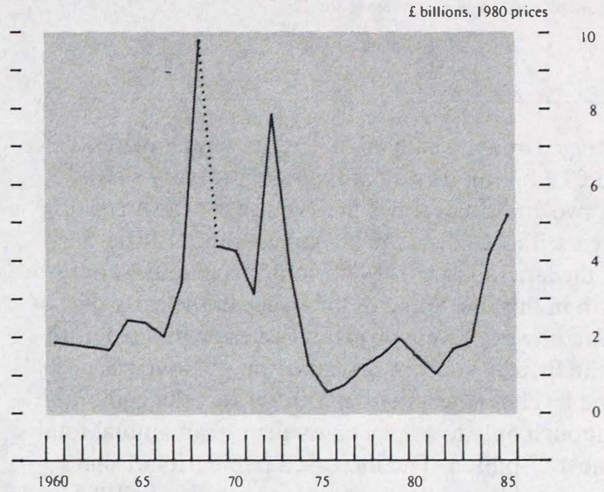
As a result of the strength of capital expenditure in nominal terms and the relatively slow growth of undistributed income, the estimated financial surplus of the ICCs sector fell to £6 billion in 1985 from £7¾ billion in 1984. This was equivalent to 8½% of company income, which, while high by the standards of all but the most recent years, represented the first significant fall in this ratio since 1979 (Chart 6). ICCs' financial balance, which indicates the additional funds available for financial investment, should in theory be equal to the sum of their net financial transactions. In practice the two estimates are rarely equal because of errors and omissions in the various component statistics, and a balancing item of 'unidentified transactions' is included to ensure that the ICCs sector's accounts add up. This 'unidentified' item has fluctuated both in size and sign and, in recent years, has been uncomfortably large: the initial estimate for 1984 implied unidentified acquisitions of assets of almost £10 billion; but subsequent downward revisions, especially to estimates of profits, and the re-classification of securities dealers' bank borrowing have reduced this to £4 billion.[2] Initial estimates of the balancing items for the first three quarters of 1985 are also large.

Chart 6
ICCs' financial balance(a)



(a) Excluding British Telecom.
(b) Net of stock appreciation.

Chart 7
Real expenditure on acquisitions and mergers(a)



(a) Deflated by GDP deflator.

Mergers and takeovers

Investment in UK company securities increased by almost a fifth in 1985, reflecting the strength of the UK equity market and the high level of takeover activity. The value of takeovers and mergers by ICCs was £7.1 billion; when allowance is made for increases in the general price level, this was a far higher annual total than for more than ten years but was lower than the totals recorded for the previous peaks in 1972 and 1968 (Chart 7).[3] Recent takeover activity has been dominated to an unusual extent by a few very large transactions; the ten largest completed acquisitions in 1985, for example, had a combined value of almost £4 billion (Table D). Indeed, the number of acquisitions and mergers by ICCs in 1985 was 474, almost exactly the annual average during the previous five years. The large takeovers which have taken place have tended to be between companies which were not close competitors. This type of 'conglomerate' takeover has been stimulated in part by the recent emphasis on referring bids for scrutiny by the Monopolies and Mergers Commission because of their implications for limiting competition, rather than on grounds of size alone.[4]

Capital issues

Buoyant market conditions during 1985—in large part based on expectations of continuing profits growth—also

(1) None of the figures for financial transactions which are quoted have been adjusted for the effects of British Telecom's inclusion in the ICCs sector.
(2) Recent investigations showed that securities dealers' acquisitions of overseas securities had been allocated to the personal sector (along with investments by stockbrokers and jobbers) while most of their bank borrowing was included in lending to ICCs. The data since the first quarter of 1984 have been reclassified so that estimates of securities dealers' investment and borrowing associated with overseas securities have been credited to the other financial institutions sector.
(3) £7.1 billion includes both cash payments (£2.9 billion) and issues of equities, preference shares and loan stocks (£4.2 billion). The figure of £4.6 billion in Table C for investment in company securities embraces expenditure on both takeovers and trade investments but includes only payments by ICCs to other sectors of the economy; whereas the £7.1 billion figure also includes transactions between ICCs.
(4) This policy was announced by the Secretary of State for Trade and Industry on 5 July 1984.

Table D
Ten largest mergers and acquisitions by ICCs in 1985

Target	Buyer	Value of merger (£ millions)
Hambro Assurance	BAT	662
Debenhams	Burton	579
MFI	Associated Dairies	571
House of Fraser	Al Fayed	570
Sterling Guarantee Trust	P & O	385
Arthur Bell	Guinness	361
Fleet Holdings	United Newspapers	305
Nottingham Manufacturing	Vantona Viyella	217
Initial	BET	176
Saxon Oil	Enterprise Oil	122
Total		3,948

Source: *British Business*, various issues.

encouraged an unusually high level of capital issues. ICCs raised £3.3 billion by way of issues of ordinary shares, about two and a half times the average for the preceding five years. Table E lists the ten largest capital issues in 1985; the largest issue in 1984 would have ranked only seventh in this list. Some of the issues in the early part of the year, however, were probably issues postponed until after the British Telecom privatisation in November 1984 and the level of new issues fell off towards the end of the year, though only to a level equivalent to an annual total of almost £2 billion. The increased popularity of share issues may in part reflect a stronger incentive in 1985 than previously (because of the reduction in corporation tax rate to 40%) for companies to issue equity rather than debt. Besides equities, there was also something of a revival of issues of preference shares and convertibles during 1985, with almost £700 million raised by these means.

Table E
Ten largest domestic capital issues by ICCs in 1985

Month announced	Name	Method of issue	Type of Security	Amount (£ millions)
June	Hanson Trust	Rights	Equity/Pref	519
May	British Aerospace	Offer for sale	Equity	188
February	Trafalgar House	Rights	Equity	181
February	Standard Telephones & Cables	Rights	Equity	180
April	Tesco	Rights	Equity	151
March	ICI	Placing	Equity	149
May	Woolworth Holdings	Rights	Conv. loan	146
January	Pilkington Brothers	Rights	Equity	109
January	Grand Metropolitan	Placing	Equity	107
March	United Biscuits	Rights	Equity	101
			Total	1,831

Bank borrowing

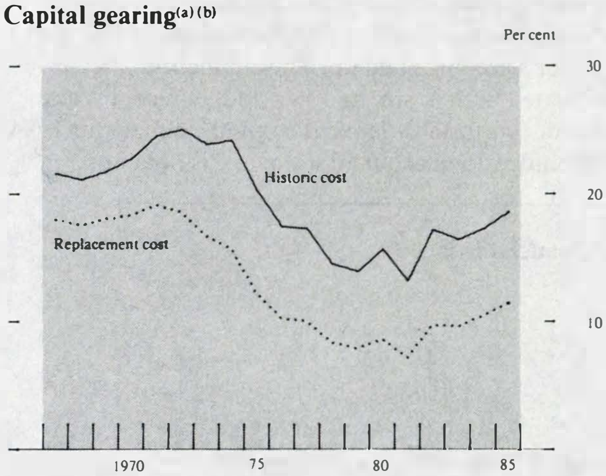
Companies continued to borrow heavily from the banking system during 1985, raising £8.2 billion more than in 1984 and five times as much as in 1983. Within the year, the level of net borrowing (after allowing for seasonal influences) fell until the third quarter, but this downward trend was reversed in the final quarter, probably reflecting in part the exceptionally high level of capital issues during the first half of the year. The considerable takeover activity, particularly towards the end of the year, also led to increased demands for temporary facilities. Nevertheless, these factors do not fully explain companies' continuing appetite for bank loans at a time when their profitability was improving.

As in previous years, increased bank borrowing by ICCs was accompanied by a substantial rise in their bank deposits and holdings of other liquid assets. ICCs increased their bank deposits by £4 billion in 1985, so that their net borrowing from the banking system was £2.6 billion. This simultaneous increase in bank borrowing and holdings of liquid assets is difficult to explain with complete satisfaction. To some extent, it reflects the differing financial circumstances of companies. Similarly, it may partly reflect a policy within some large groups of companies for responsibility for short-term financing to be delegated to individual operating divisions or subsidiaries. More generally, liquid assets, as well as underutilised overdraft facilities, are undoubtedly held for precautionary reasons.

Recent research within the Bank gives some clues as to why there was a simultaneous buildup of debt and liquid assets.[1] It suggests that increments in profits are primarily used, in the short run, to build up liquid assets rather than to run down stocks of debt, while higher investment, again in the short run, is largely financed out of debt. Thus, the combination of buoyant profits and investment in 1985 is, on this view, consistent with a simultaneous buildup of debt and liquidity.

ICCs' high bank borrowing in recent years has led to a gradual rise in capital gearing (Chart 8). This upward trend

Chart 8
Capital gearing[(a)(b)]



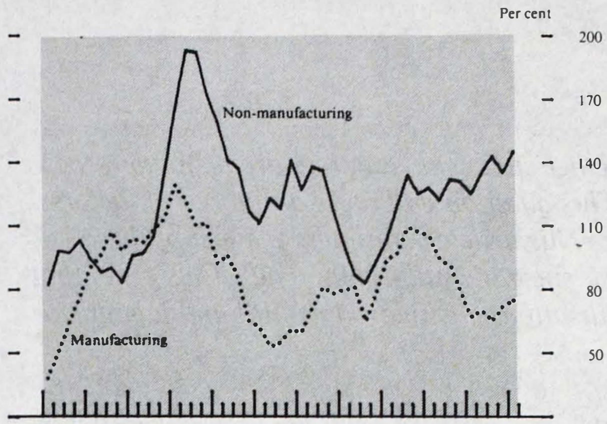
(a) Including British Telecom in 1985.
(b) National accounts data; net debt as a percentage of trading assets.

was maintained in 1985, with gearing at historic cost rising to 18½%, the highest level since 1975.

According to the Department of Trade and Industry, the net liquidity of large companies in 1985 was lower than in 1984. Liquidity fell in the first quarter (after allowing for seasonal influences) but, since then, has been on a gently rising trend continuing into the first quarter of 1986 (Chart 9). A recent CBI survey suggests that the net liquidity of small companies has been more buoyant than that of large companies.

(1) See 'Companies' short-term financial decisions' in the March *Bulletin*, page 78.

Chart 9
Liquidity of large companies[a]



Source: Department of Trade and Industry survey of company liquidity.

(a) Current assets as a percentage of current liabilities.

Prospects for 1986

The improvement in company profitability since 1981 has been remarkable both for the scale of the recovery and for the fact that it has been sustained for five years. However, while the improvements from 1981 to 1984 can be attributed to an expansion of output, better control over costs and improved international competitiveness, some of the rise in the profitability of non North Sea companies in 1985 may be described as a windfall, reflecting an improvement in the terms of trade for industrial countries. The fall in profits in the North Sea sector was the counterpart to this.

Non North Sea profitability will probably rise further in 1986 since economic growth is expected to be maintained and manufacturers' fuel and raw material costs have continued to fall in the early part of 1986. However, while the immediate signs are for the prices of most non-food commodities to remain weak, the rate at which input prices have been falling in recent months will eventually slow. In this event, the recent widening of margins may gradually be reversed as the recent falls in the costs of fuel and raw materials are incorporated in output prices. In addition, labour costs (in local currency terms) are continuing to rise faster in the United Kingdom than in the other major industrial countries. While this deterioration in relative costs has so far been largely offset by the depreciation of sterling since mid-1985, margins may come under increasing pressure later this year as companies strive to maintain the competitiveness of their prices.

The volume of fixed capital expenditure by industry during 1986 depends to a large extent on expectations of future output growth. The latest DTI survey of investment intentions suggests that industrial investment will grow by about 3%, roughly in line with recent forecasts, for example by the CBI. Investment growth is consequently expected to be lower than in 1985 (which was considerably less than in 1984). Indications are that stockbuilding is likely to be modest, and that the downward trend in stock/output ratios since 1980 will be maintained.

ICCs' appetite for external finance remained undiminished in the first three months of 1986, with equity issues of £400 million and bank borrowing of £3.1 billion. A reduction in long-term bond rates, reflecting firmer expectations of lower inflation, has encouraged a flurry of issues of long-term bonds, both in the domestic markets and in the eurosterling markets. This, together with the new arrangements to permit issues of sterling commercial paper, should help to ease the demand for bank finance during the second half of the year.