# Company profitability and finance

*This article reviews the performance of companies during 1986 and discusses some of the issues which they face in this, the sixth year of the recovery. It is principally concerned with the performance of non North Sea companies but also includes data and comment for the sector as a whole. Among the main points are:*

- *The fall in oil prices depressed the performance of North Sea companies, but helped boost margins, profits and rates of return in non North Sea companies to their highest levels since the early 1970s.*
- *Dividends continued to rise as a proportion of companies' income.*
- *Investment expenditure remained subdued, despite steady output growth, and capacity utilisation continued to rise.*
- *Acquisition and merger activity remained strong throughout the year, both at home and abroad.*
- *The pattern of company financing switched heavily towards capital issues (mainly in the equity markets), while the growth of bank borrowing may have eased a little.*
- *Companies continued to build up liquid assets rapidly.*

Economic conditions during 1986 produced a marked dichotomy in the performance of UK industrial and commercial companies (ICCs), with the fall in oil prices dominating developments, especially in the North Sea sector. Both domestic and overseas demand continued to strengthen and, aided by the depreciation of sterling during the year, output in the whole economy rose by some 3%, its fifth successive annual increase. Cost pressures were, nevertheless, subdued, due to the collapse in oil prices and falls in the prices of many other internationally-traded raw materials. Furthermore, as output gathered pace through the year, particularly within the manufacturing sector, large productivity gains became apparent, reducing the effects of continuing strong earnings growth. These factors between them gave scope for many companies to widen margins and allowed a further slowdown in the growth of output prices.

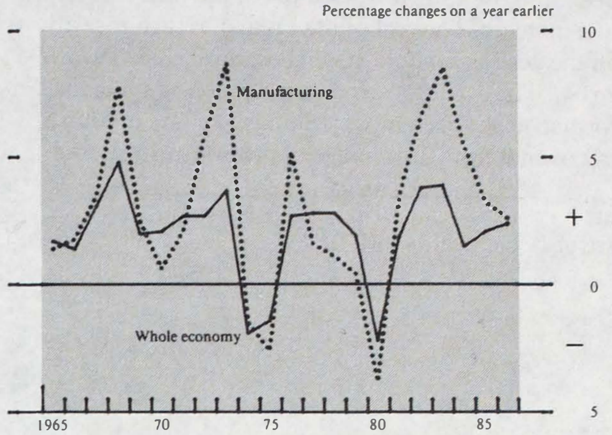
Gross trading profits net of stock appreciation—after excluding companies engaged in North Sea operations—increased for the fifth consecutive year, taking the real rate of return on capital to over 8%, its highest level since 1973. By contrast, the profits of those companies primarily engaged in North Sea operations were lower by more than 50%, although this still left their real rate of return above that of non North Sea companies. For all ICCs, taken together, there was a fall in profits of some 4%.

## Demand and output

ICCs were faced with strongly rising aggregate demand in 1986. The principal component, consumers' expenditure, grew by around 5% in real terms in the year, to a level some 16% higher than in 1979. At the start of the year such a profile might have suggested that a significant part of this growth would be met through higher import penetration. In the event, however, domestic producers maintained market share for the first half of the year (and subsequent losses have since been partially reversed). This was in part associated with the 13% fall in sterling's effective exchange rate that occurred between 1985 (average) and the end of last year, but also rested upon the further strengthening during the year of a supply response, measured by both output and productivity growth, which led to a significant slowdown in the growth of unit labour costs despite the continuing strong growth of earnings.

The productivity estimates for 1986 as a whole conceal the scale of the growth that occurred within the year. Within the manufacturing sector, productivity rose very sharply towards the end of the year: by the fourth quarter it stood 6% above its level a year earlier and around 30% above the previous cyclical peak in 1979. This latest rise, which reflected some further labour shedding as well as output growth, was not of itself exceptional—productivity rose by $10\frac{1}{2}$% in a similar twelve-month period in 1983. But coming as it did after five years of

**Chart 1**
**Productivity**[(a)]




(a) Output per person employed.

sustained output growth and a levelling-off of productivity during 1985, it suggests that the painful structural adjustments that occurred within the manufacturing sector following the cyclical downturn of 1979–80 may now be leading to a higher sustainable rate of productivity growth. The strengthening performance of productivity through 1986 was a significant feature of the strong financial performance of non North Sea ICCs.

## The sustainability of growth

Nevertheless, the continuing growth of output, coupled with the comparative weakness of industrial investment last year, has raised concern about the ability of ICCs to respond to further significant increases in aggregate demand. The difficulties of forming a precise view of the utilisation of employed factors were outlined in an article in the June 1986 *Bulletin.* They include problems in measuring the size of the capital stock, the extent to which new plant and machinery incorporate technical improvements and the efficiency with which energy and basic materials are used. With these qualifications in mind, comparisons between current levels of employed factor utilisation, however measured, and levels at previous cyclical peaks must necessarily be treated with a degree of caution. Some commentators have suggested that capital utilisation rates may already be at or close to the levels reached in 1973. However, this comparison is complicated by the acute shortages of skilled labour which emerged in that year and which, on survey evidence, have been less of a constraint on output so far this year. Moreover, the markets for many internationally-traded raw materials were subject to excess demand in 1973 but to excess supply in the past year. What is clear, however, is that employed factor utilisation has been rising. The Department of Employment, for example, report that over a third of operatives are now working overtime. In addition, the CBI surveys have, for the last two years, been indicating that the proportion of firms operating below capacity is lower than at any time since the early 1970s, and that the shortage of plant capacity is increasingly acting as a constraint on output. The increase in capacity utilisation is likely to have been one of the factors acting to widen margins. The most recent data relating to capacity utilisation are discussed more fully on pages 339–40.

**Table A**
**Contributions to changes in manufacturers' output prices**
Percentage changes

| | Contributions to change in output prices | | | | | Output prices |
|---|---|---|---|---|---|---|
| | Labour productivity(a) | Labour cost per head | Total unit labour costs | Input costs | Margin | |
| 1980 | 2.6 | 11.9 | 14.5 | 3.0 | −3.4 | 14.1 |
| 1981 | −2.3 | 8.1 | 5.9 | 3.2 | 0.5 | 9.5 |
| 1982 | −4.4 | 7.4 | 3.1 | 2.6 | 2.0 | 7.7 |
| 1983 | −5.6 | 5.7 | 0.1 | 2.4 | 3.0 | 5.5 |
| 1984 | −3.6 | 5.5 | 2.0 | 2.8 | 1.3 | 6.1 |
| 1985 | −2.2 | 4.9 | 2.7 | 0.6 | 2.3 | 5.5 |
| 1986 | −1.7 | 4.3 | 2.6 | −2.9 | 4.8 | 4.5 |

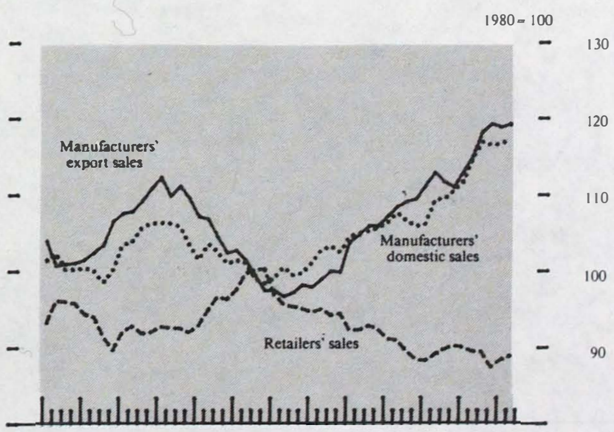
(a) Output per person employed.

## Company margins and profitability

Notwithstanding the acceleration of output and productivity through 1986, the main influences on company costs over the year as a whole were the falls in the price of oil and other raw materials. The DTI's price index for materials and fuels purchased by the manufacturing sector fell by 8% in 1986, having risen $1\frac{1}{2}$% the previous year. This was sufficient to offset the rise in unit labour costs, leading to a widening of manufacturers' margins while maintaining a gradual slowdown in the growth of output prices. Table A sets out the relative contributions of labour costs, productivity and the price of materials to the change in output prices. It shows a steady fall since 1983 in the moderating effects of productivity growth on other costs but also shows the sharp turn-round in the influence of the price of materials. It is this latter feature which characterises the change from 1985 to 1986 and, as the table suggests, producers chose to absorb most of this largely unforeseen benefit in higher margins.

Chart 2 presents this response in a longer perspective. Manufacturers' margins rose for the sixth consecutive year in 1986 but in so doing they have widened to an extent

**Chart 2**
**Price cost ratios**[(a)]

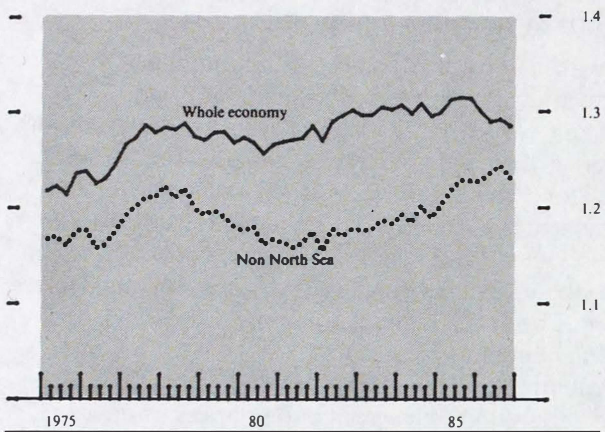



(a) These ratios indicate the direction, but not necessarily the scale, of changes in profit margins.

which goes beyond anything experienced in recent cycles. In part this must reflect the different impact of oil prices, which rose in 1973–74 and 1979 but fell sharply last year. However, oil prices have since reversed around half of last year's losses while margins have been maintained.

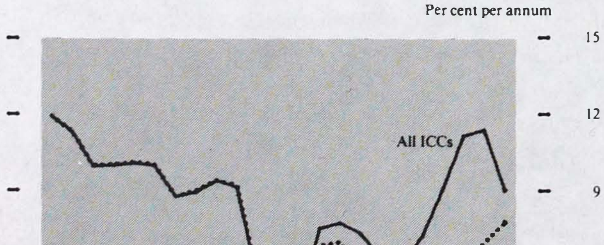
Outside the manufacturing sector, the behaviour of margins has been less extreme. In retailing, for example, where the cyclical pattern is quite different, margins (as proxied by the price-cost ratio) tightened somewhat through 1986 but were on balance little changed over the year as a whole. Taken together, the margins of non North Sea ICCs widened in 1986 but remain within the range of past experience (Chart 3).

**Chart 3**
**Whole economy margins**




The generation of company profits may, therefore, be considered as arising from two rather different patterns of sectoral behaviour. For the manufacturing sector, profits resulted principally from a significant widening of margins. Manufacturing output for the year as a whole was only ¾% higher than in 1985, although, as already seen, it rose strongly through the year. By contrast, outside the manufacturing sector (and again excluding North Sea operations) margins may have shown little net change, while output grew by some 4½%.

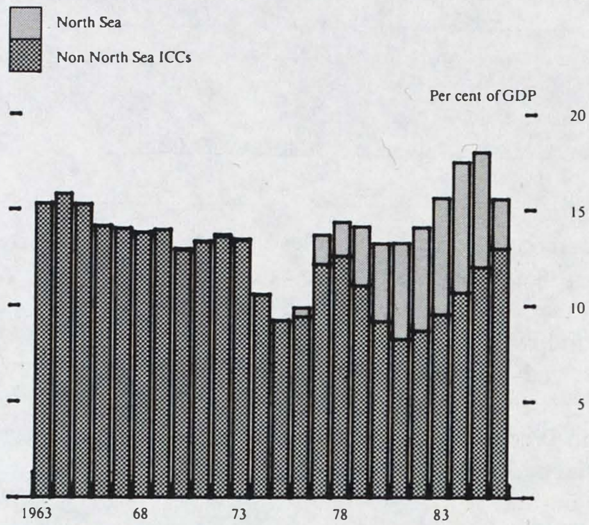
**Chart 4**
**Real rate of return on capital(a)(b)**




(a) Excluding British Telecom
(b) Pre-tax profits net of stock appreciation and capital consumption as a proportion of total capital employed.

The combined effect of these developments was a rise of 19% in the current price gross trading profits (net of stock appreciation) of non North Sea ICCs, the fifth successive annual increase. The real pre-tax rate of return rose above 8% in the year as a whole, its highest level since 1973 (Chart 4). The cyclical recovery in the sector's financial performance has been most striking. The rate of return has recovered from an average of just 3% in 1981 and

**Chart 5**
**Share of ICCs' profits in GDP(a)(b)**




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

shows signs of moving higher this year. The share of profits in total GDP has also gone beyond the peaks seen in recent cycles (Chart 5). This impressive performance by non North Sea ICCs was more than offset by a halving of profits in the North Sea sector. The end result was a fall of around 4% in total ICCs' profits (Table B).

## Income and appropriations

The divergent experiences of the North Sea and non North Sea sectors in 1986 are reflected in the income data shown in Table B. Total trading income of both sectors taken

**Table B**
**Industrial and commercial companies' income and appropriation accounts**
£ billions

| | 1984 | 1985 | | 1986 | |
|---|---|---|---|---|---|
| | | Excluding BT | Including BT | Excluding BT | Including BT |
| **Income** | | | | | |
| Gross trading profits(a): | | | | | |
| non North Sea ICCs | 30.0 | 36.7 | 39.7 | 43.8 | 47.3 |
| North Sea activities | 19.0 | 18.4 | 18.4 | 8.4 | 8.4 |
| Other income | 12.9 | 13.9 | 14.0 | 13.3 | 13.4 |
| **Total income(a)** | **61.9** | **69.0** | **72.1** | **65.5** | **69.1** |
| **Allocation of income** | | | | | |
| Dividends on ordinary shares | 5.3 | 6.6 | 6.8 | 8.0 | 8.5 |
| Interest and other payments | 11.6 | 13.6 | 14.1 | 12.4 | 12.9 |
| Profits due abroad | 5.7 | 6.4 | 6.4 | 4.6 | 4.6 |
| UK taxes | 12.6 | 15.2 | 15.3 | 12.7 | 12.9 |
| **Undistributed income(a)** | **26.8** | **27.4** | **29.6** | **27.8** | **30.2** |
| Capital transfers | −0.3 | −0.4 | −0.4 | −0.5 | −0.5 |
| Fixed investment | 19.5 | 21.6 | 23.5 | 22.9 | 24.9 |
| Physical increase in stocks | 0.3 | −0.0 | 0.0 | 0.5 | 0.4 |
| **Financial balance** (surplus +) | **7.4** | **6.3** | **6.6** | **4.8** | **5.3** |

(a) Net of stock appreciation.

together fell by £2½ billion and, with other income also lower, ICCs' total income, net of stock appreciation, fell by 4% to £69 billion. Current appropriations also fell, however, leaving undistributed income higher by around £½ billion at over £30 billion. This caused the ratio of undistributed income to total income to increase to 44% after falling to 41% in 1985.

Within other income, overseas income fell by £1 billion in 1986, having risen substantially in the preceding three years. The fall was concentrated within the unremitted profits of ICCs' subsidiaries and probably reflected the lower profits of oil companies; it was sufficient to offset the effects of both the depreciation and the substantial overseas investments by ICCs in recent years.

Dividend payments continued to rise strongly. This strength may partly have been a lagged response to the surge in profits through the recovery. However, the recent growth in the dividend pay-out ratio suggests that rather more of the explanation may lie in companies' desire to signal likely future improvements in performance in order to stimulate continued investor confidence in the capital markets. Additionally, the 1984 corporation tax reforms, by reducing the degree of tax exhaustion, may have added to the incentives to increase dividends (although survey evidence reported by Edwards and Mayer[1] casts some doubt on the likely strength of this phenomenon).

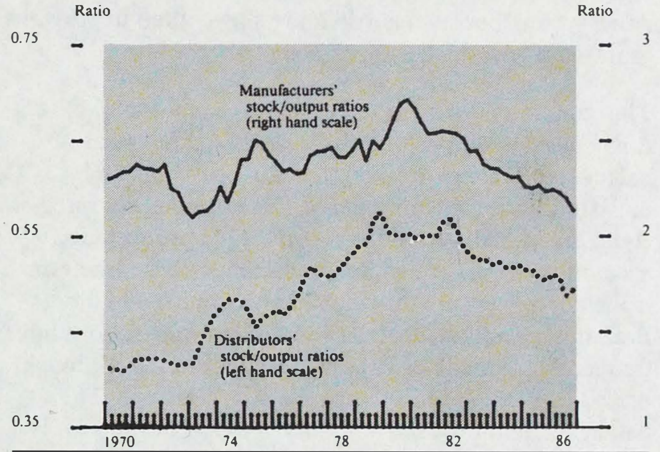
Among other current appropriations, profits due abroad were sharply lower, as were payments of interest and tax. Interest and other payments fell by £1 billion, reflecting both the lower level of interest rates and lower royalty payments on North Sea production. As a result, the gross income gearing ratio fell to 23%. The £2½ billion fall in tax payments was also a reflection of developments in the oil market, which gave rise to lower payments of petroleum revenue tax. By contrast, tax payments of non North Sea ICCs rose through the year and were particularly large in the fourth quarter, reflecting payments of ACT associated with the high dividends, but also a transitional rise in the effective tax rate due mainly to the increase in profits but also to the effects of the 1984 corporation tax reforms.

## Capital expenditure

Directly financed capital expenditure increased by 6% in 1986 but in volume terms was little changed. Investment by manufacturing companies was particularly subdued—an outturn not foreseen at the time of the DTI's mid-year survey—and sits uneasily with stronger output growth and higher rates of return. The weakness was in part associated with the phasing out of first-year capital allowances as announced in the 1984 Budget. These changes, which were completed at the start of the 1986/87 financial year, encouraged the bringing forward of projects during the transition to attract a higher rate of allowance. This led to some bunching of expenditure in 1985 and the first quarter of 1986 and a consequent weakening of spending later in the year. The full effect on ICCs' direct expenditure may, however, have been mitigated by the realignment of leasing rates which followed the changes as a result of the reduced tax incentives to lease. This led to a disproportionately large fall in capital expenditure by leasing companies (not included within Table A) as manufacturers in particular adjusted the composition of their fixed investment between direct and leasing finance.

There was modest stockbuilding in 1986, mainly concentrated in the final quarter. Nevertheless, stock/output ratios fell, maintaining the decline that began in the early 1980s (Chart 6). Until recently, most firms participating in the CBI's industrial trends surveys have considered their stocks to be adequate or more than adequate, but there are now some indications that fewer firms are planning to reduce stocks further in the immediate future so that the fall in stock/output ratios may begin to ease.

**Chart 6**
**Stock/output ratio**




## Financial transactions

The combination of a rise in undistributed income and an increase in capital expenditure in nominal terms led to a slight fall in the estimated financial surplus of ICCs in 1986. The company sector has now experienced a prolonged period of financial surplus. The cumulative balance since 1981 is over £26 billion, with surpluses averaging around 9% of company income over this period. The accumulation of funds has supported the acquisition of both UK company securities and overseas investments (Table C) but there has, in addition, been a striking and simultaneous build-up of both liquid assets and debt. This phenomenon became particularly marked in 1986 when total external financing increased by £16 billion, while liquid assets rose £11½ billion. Furthermore, the increase in financial liabilities resulted principally from capital

(1) Edwards, Jeremy and Mayer, Colin. *An Investigation into the Dividend and New Equity Issue Practices of Firms.* IFS Working Paper No. 80, Institute of Fiscal Studies, London, 1985.

**Table C**
**Industrial and commercial companies' financial transactions**

£ billions

| | 1984 | 1985 | 1986 |
|---|---|---|---|
| **Financial balance** (surplus +) | **7.4** | **6.6** | **5.3** |
| **Identified financial transactions** (outflow/acquisition of assets–) | | | |
| Investment in UK company securities | –3.9 | –4.6 | –3.7 |
| Investment abroad | –1.6 | –4.8 | –4.9 |
| Bank borrowing(a) | 7.0 | 7.3 | 5.3 |
| Equity finance(b) | 1.5 | 3.7 | 6.0 |
| Loan stock issues(c) | 0.5 | 1.6 | 2.2 |
| Other borrowing(d) | –2.3 | — | 2.6 |
| Financial assets: liquid | –2.2 | –5.0 | –11.5 |
| other | –1.8 | –0.6 | 0.2 |
| Changes in tax balances and other accruals adjustments, including net unremitted profits | –2.6 | –1.3 | –2.8 |
| **Total transactions** | **–5.3** | **–3.8** | **–6.6** |
| **Balancing item** | **–2.0** | **–2.8** | **1.3** |

(a) Including Issue Department holdings of commercial bills.
(b) Ordinary share issues and overseas direct investment in securities.
(c) Debentures, preference shares and capital issues overseas (including eurosterling).
(d) Other loans and mortgages and other overseas investment.

issues—bank borrowing rose more slowly than in previous years—a point which is discussed further below.

The component financial transactions set out in Table C can be used to derive an estimate of ICCs' financial balance. In practice, however, because of errors and omissions in these components, this estimate will rarely equal that derived from the income and appropriation account, so a balancing item of unidentified transactions is included to ensure that the sector accounts add up. Preliminary estimates of the component transactions have frequently implied rather large balancing items, although these are usually reduced in successive revisions. The balancing item for 1986 amounts to over £1 billion.

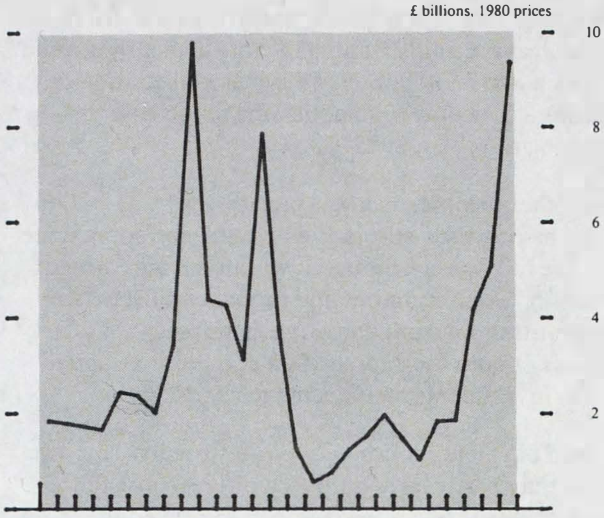
## Acquisitions and mergers

1986 witnessed a high level of takeover activity with a number of exceptionally large acquisitions taking place (Table D). In constant price terms, the level of activity was comparable to that of earlier peaks, most recently 1972 (Chart 7). Up to mid-1986 the boom had not shown in the number of acquisitions, but in each of the third and fourth quarters there were over 400 acquisitions—the two highest quarterly totals since 1973. Notwithstanding the high value of takeover and merger activity in 1986 (around £13½ billion) ICCs' net investment in UK company securities fell, in part because cash expenditure on acquisitions actually fell in both 1985 and 1986 as

**Table D**
**Ten largest acquisitions and mergers by ICCs in 1986**

| Aquiring company | Aquired company | Value of merger (£ millions) |
|---|---|---|
| Hanson Trust | Imperial Group | 2,564 |
| Guinness | Distillers Company | 2,531 |
| Vantona Viyella | Coats Patons | 738 |
| Habitat Mothercare | British Home Stores | 488 |
| P & O Steam Navigation | Stock Conversion | 362 |
| British Printing | Philip Hill Investment Trust | 339 |
| Next | Grafton | 275 |
| Ladbroke Group | Home Charm Group | 201 |
| F H Tomkins | Pegler-Hattersley | 198 |
| Trusthouse Forte | Imperial Hotels and Catering | 175 |

**Chart 7**
**Real expenditure on acquisitions by UK ICCs(a)**



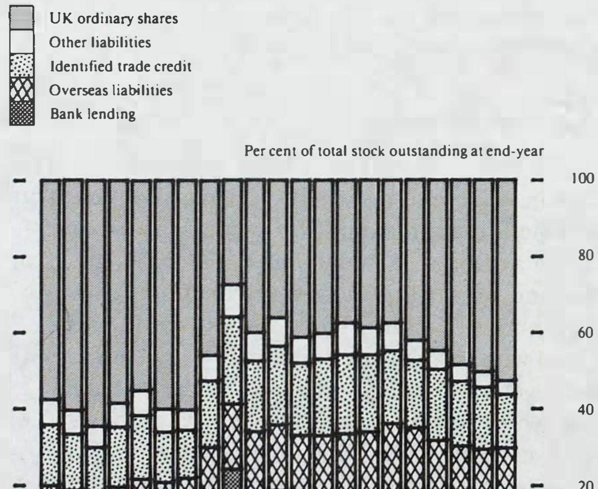

(a) Deflated by GDP deflator.

acquiring companies turned to equity finance. The current pattern of merger behaviour may be due to the ease with which takeovers have been financed. If funds for acquisitions purposes are widely available internationally, this would help to explain the coincidence of merger booms in the United Kingdom, the United States and elsewhere. UK companies were themselves active abroad and expenditure on foreign companies by British-based acquirers rose to its highest level by a very wide margin in 1986. Overseas investments by ICCs increased to almost £5 billion, boosted, in particular, by a number of large acquisitions in the United States.

## Capital issues

As shown in Chart 8, capital issues rose markedly last year. This growth was due to two quite distinct phenomena. First, ICCs have been substituting equity for

**Chart 8**
**ICCs' financial liabilities**



debt, partly because corporation tax changes have reduced the relative cost of equity and partly, perhaps, because of the buoyancy of the stock market.[1] Second, the rise in capital issues by ICCs is an instance of a widespread shift away from bank borrowing towards more marketable forms of financial debt. The causes of this process of securitisation were explored in the Cross Report,[2] and the factors of importance are thought to include the reappearance of positive real interest rates in the last few years, the emergence of a large and active secondary market for eurobonds, and the easier capital requirements with respect to on-balance-sheet loans (permitting banks to offer better terms for securitised loans).

ICCs were particularly active in the euromarkets last year, with the fall in long-term interest rates in the second quarter producing a flurry of new issues. The majority of eurobond issues were quite long term, having maturities of between ten and twenty years, and almost all of them were fixed rate. The volumes involved testify to the willingness of ICCs to restructure their balance sheets towards longer-maturity debt. The revival of the long-term eurobond (though not the domestic bond) markets signals a departure from the pattern of the last decade; this may be linked with the reduced supply of new government debt in recent years, but, more importantly, it may also indicate a consolidation in expectations of greater stability for inflation and interest rates over the medium term.

## Bank borrowing[3]

The shift to equity finance and marketable debt led to a sharp fall in ICCs' reliance on bank borrowing within total external sources of funds. Net new borrowing rose by over £5 billion during 1986, against £7 billion in each of the preceding two years; it was principally concentrated in the final quarter and may have been associated with takeover activity and a strong rise in stocks. Chart 8 sets the compositional changes in ICCs' financial liabilities into a longer-term perspective. It shows that, as a proportion of the stock of ICCs' liabilities, bank lending has now fallen to under 15%, similar to its level in the mid-1970s.

## Prospects for the company sector

The combination of a prolonged period of rising profitability and subdued capital spending has given rise to a substantial accumulation of financial assets which leaves non North Sea ICCs' balance sheets looking stronger than they have done for some years. Strong profits growth should continue; output seems set to rise further in 1987, while margins at the start of this year were at their average 1986 level for the whole sector, but significantly higher in manufacturing. With rates of capacity utilisation likely to rise further, there may well be scope for even wider margins in the future.

Nevertheless, the financial balance for non North Sea companies is likely to be substantially reduced. Capital spending seems set to rise during 1987 and tax payments are forecast to increase, less rapidly than during 1986 but for much the same reasons. These developments are unlikely to create serious constraints: both income and capital gearing are currently at quite low levels, ICCs have substantial holdings of liquid assets and seem to have had little difficulty in raising funds through the capital markets. The recovery in longer-term fixed-rate borrowing seems set to continue, and the stock market should remain an attractive proposition for firms seeking additional finance, while the growth in bank borrowing might slow even further.

(1) The evidence in Edwards, Mayer (op cit) would support this argument.
(2) *Recent Innovations in International Banking*. The Bank for International Settlements, Basle 1986.
(3) The data on bank borrowing by companies for the period from end-1983 to September 1986 may be distorted by adjustments intended to take account of foreign currency borrowing by securities dealers. A fuller account of these adjustments is presented on page 478 of the December 1986 *Bulletin*.