Company profitability and finance

This article reviews the performance of UK industrial and commercial companies (ICCs) during 1987 and considers the implications of their behaviour following October's stock market collapse. Among the main points are:

- *The fall in equity prices appeared to affect only firms' financial behaviour, encouraging a switch from issuing equity towards bank borrowing and, to a lesser extent, eurobonds.*
- *The recovery in the oil price brought about a substantial improvement in oil company performance.*
- *The profitability of non North Sea companies also increased markedly in the wake of rapid output growth and wider margins.*
- *The dividend-payout ratio continued to rise rapidly.*
- *Total investment by ICCs was quite buoyant; however, there was some variation in the performance of different sectors.*
- *Considerable acquisition and merger activity persisted throughout the year.*

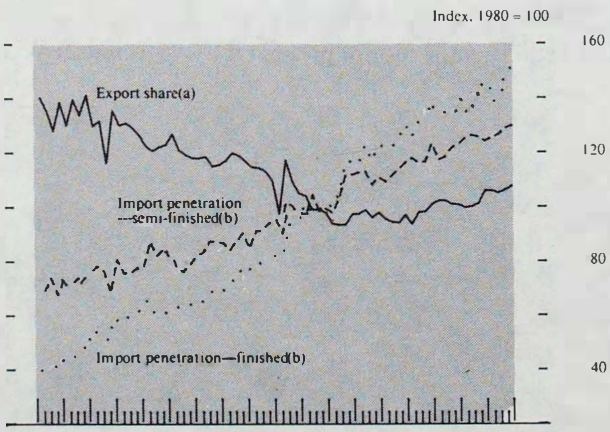
The recovery of output, which began in 1982, continued unabated throughout 1987. Domestic demand remained very buoyant and, despite some net appreciation of sterling during the course of the year, export demand was also strongly expansionary. The output measure of GDP rose by 4¾% and, while some concern was expressed at the perceived proximity of capacity limits, productivity (measured by output per head) accelerated, so that pressures from unit labour costs remained subdued. In this generally favourable environment, companies achieved some further widening of margins, particularly on domestic sales, giving rise to a sixth consecutive year of real profit growth for non North Sea companies—a performance reminiscent of the 1960s and early 1970s.

Gross trading profits (net of stock appreciation) increased in both the North Sea and non North Sea sectors, raising the overall rate of return on capital to 11½%, its highest level since 1964. The recorded profits estimates are, of course, affected by the Government's privatisation programme (although the rate of return measures are not, for the capital stock is also adjusted), yet the scale of any appropriate adjustment would be insufficient to weaken seriously the healthy picture which emerges.

Demand and output

The strength of output during 1987 rested primarily upon the continuing buoyancy of domestic demand (consumers' expenditure grew by over 5% in real terms), yet there was also an improvement in the contribution arising from net trade in the year as a whole (although this declined as the year progressed). To an extent this latter pattern must reflect the beneficial effects arising from earlier sterling depreciation, although offset in part by the gradual deterioration of competitiveness through the year. However, there remains the suggestion that, coming as it did after a prolonged period of growth, it was achieved in part as the consequence of an enhanced supply-side response. Given the strength of consumer spending, for example, import penetration remains somewhat below what might have been expected based on past relationships. Furthermore, since about 1984 the United Kingdom's share of world trade in finished

Chart 1
Import penetration and export share



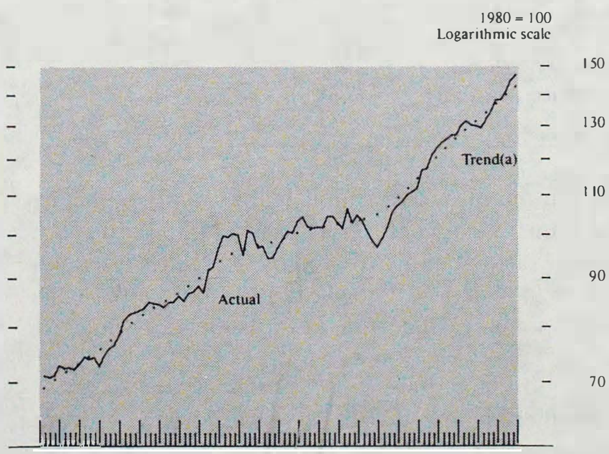
(a) UK share of world trade in manufactures.
(b) Imports of manufactures as a proportion of domestic demand for manufactures.

manufactures has risen (Chart 1) and remains above expectations.[1]

One aspect of these developments is an apparent improvement in non-price competitiveness. Thus, for example, the percentage of CBI survey respondents citing delivery dates (compared with those of overseas competitors) as a factor likely to limit their ability to obtain export orders over the next four months was considerably lower than at the previous cyclical peak in 1973.

Supply-side improvements may also be noted with reference to changes in the labour market. Anecdotal evidence suggests that employees have become more flexible in their approach to working practices, making possible both a reduction in the level of industrial conflict and more lasting improvements in efficiency. Thus, the total number of days lost through industrial stoppages fell from an annual average of 11.1 million between 1976 and 1985 to just 1.9 million in 1986 and 3.5 million in 1987. In addition, companies appear to have invested increasingly on grounds of efficiency rather than replacement or capacity expansion. In line with these improvements, underlying (or trend) productivity in the manufacturing sector has accelerated in the 1980s relative to the previous decade. A typical indicator of trend productivity is shown in Chart 2; this suggests a current rate of increase of about $3\frac{3}{4}$% per annum, which is clearly above the growth rate in the mid-1970s and represents a return to the experience of the 1960s. Moreover, in contrast with the rather wide disparity of performance between 1974 and 1979, virtually all manufacturing industries have shared in the recent enhanced productivity performance.

Chart 2
Productivity in manufacturing



(a) Generated through application of a Kalman Filter as described in the August 1987 *Bulletin*, page 336.

The sustainability of growth

Nevertheless, it is clear that last year's rapid growth in output was accompanied by some overall tightening in supply conditions and, more importantly, that conditions have apparently tightened further this year. Responses to the CBI's quarterly industrial trends survey, for example, indicate that the proportion of manufacturing companies working at or above a satisfactorily full rate of operation is now higher than in any year since 1965. This observation broadly concurs with evidence from a range of other indicators, both based on surveys and aggregate output indices, yet, for the most part, there is little to suggest that capacity constraints actually inhibited growth last year, and subsequent surveys and anecdotal reports appear to support the view that constraints are still not generally binding.

It thus appears that while utilisation rates are clearly very high, possibly as high as in any cyclical peak since the 1960s, companies may nevertheless be generally managing to sustain or to expand output. The extent to which this has been achieved may be associated as much with improvements in the reliability of supply as with measured productivity gains, although the two are not unrelated. Manufacturing companies are highly dependent upon one another for materials and components, so that one means of achieving further sustainable output growth will be the avoidance of the 'knock-on' effects of unplanned stoppages. As noted above, considerable progress has been made in one important aspect of this problem—labour disputes—but similar considerations are also relevant to areas such as stock control and product reliability. Evidence here is less tangible but suggests that substantial improvements have been achieved over recent years.

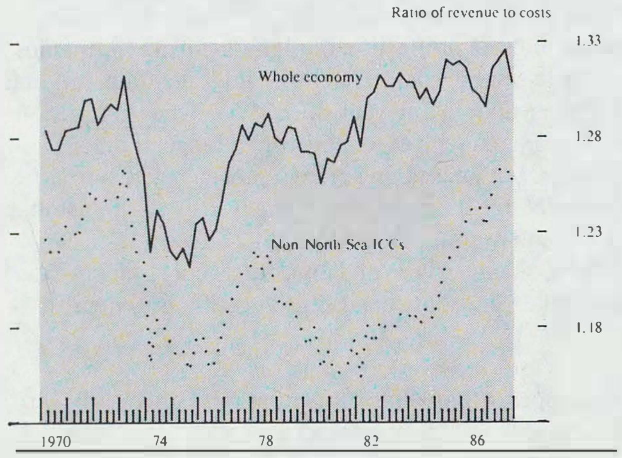
These considerations suggest that aggregate indicators of capacity utilisation may in one important respect have some tendency to overstate the acuteness of supply conditions. In addition, it seems clear that, other than in isolated areas, there remains sufficient slack in the labour market to suggest that, although plant capacity utilisation rates may be high, the stock of employed labour could be augmented fairly readily, if required by demand conditions. Nevertheless, it also seems clear that productivity gains associated with a reduced level of supply disturbances will become increasingly vulnerable as output continues to expand. Sustainability will, as ever, depend upon the strength of fixed investment, but the extent to which these other improvements can be maintained and enhanced will also be crucial for supply in the nearer term.

Profitability and margins

The strength of demand in 1987 not only permitted a surge in output growth but in addition provided some scope for the further widening of profit margins. Chart 3 demonstrates that whole-economy margins (including those of North Sea companies) recovered sharply from the impact of oil price falls in 1986, before falling back

(1) This result appears to break down at the beginning of 1988. However, there were statistical difficulties with trade data during this later period, so that this observation requires careful interpretation.

Chart 3
Whole economy margins



somewhat in the final quarter—although still remaining at an exceptionally high level by historical standards. The improvements in non North Sea ICCs' margins were even more marked, despite the fact that some consolidation had been expected following earlier gains (which were presumed to be temporary) from lower oil prices. Again, there was some slight decline in margins at the end of the year, but latest statistics suggest renewed growth in the first quarter, and it now appears that non North Sea margins have comfortably passed their previous peak.

Nevertheless, this buoyancy has not been common to all sectors—rather, it appears to have been concentrated in those areas least exposed to international competition. Given the growth in demand, it might be expected that companies would raise their margins unless in so doing they were at risk of losing out to overseas competitors. The strength of sterling in 1987 appears to have encouraged UK manufacturers to restrain their margins in order to maintain price competitiveness. This does not emerge very clearly from Table A, which suggests that the major part of the increase in manufacturing output prices in 1987 was due to growth in profit margins. However, the table only presents yearly averages, and masks movements through the year: in fact, margins in manufacturing rose rapidly through 1986 (in part owing to sterling depreciation) and then remained around this exceptionally high level throughout 1987 and the early part of this year. Thus, while manufacturers' margins may continue to be characterised as remarkably strong, it is possible that their upward movement, and the inflationary pressures consequent upon it, has been restrained by the firm exchange rate.

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

	Contributions to change in output prices					Output prices
	Labour productivity(a)	Labour costs per head	Total unit labour costs	Fuel and materials input costs	Margins	
1981	−3.1	10.2	7.0	2.8	−0.7	9.1
1982	−4.1	6.9	2.1	2.2	3.5	7.8
1983	−6.0	5.9	−0.1	2.1	3.5	5.5
1984	−4.2	5.4	1.1	2.4	2.6	6.1
1985	−2.5	5.6	2.9	0.5	2.1	5.5
1986	−1.9	4.8	2.9	−2.4	4.0	4.5
1987	−5.3	5.2	−0.1	0.9	3.0	3.8

(a) Output per person employed.

Income and appropriations

The combined effect of the overall strength of margins and output growth was a further rise of around 20% in ICCs' gross trading profits (net of stock appreciation).[1] As a consequence, the real pre-tax rate of return averaged around 11½% (10¼% for non North Sea companies) over the year—its highest level since the mid-1960s. Furthermore, the share of profits in total GDP has also gone well beyond the peaks seen in recent business cycles (over 16% for non North Sea companies, compared with 12½% in 1978 and 13½% in 1972).

Total UK trading profits increased by £11 billion in 1987, reflecting increases for both North Sea and non North Sea ICCs (Table B). With other income also rising sharply, ICCs' total income (net of stock appreciation) rose by almost £15 billion (21%) to £85.7 billion. Current appropriations also rose, although less rapidly, leaving undistributed income higher by nearly £10 billion and raising the ratio of undistributed income to total income from 46% to over 48% in the year as a whole, although there was some small decline towards the year-end (Chart 4).

Table B
ICCs' income and appropriation accounts
£ billions

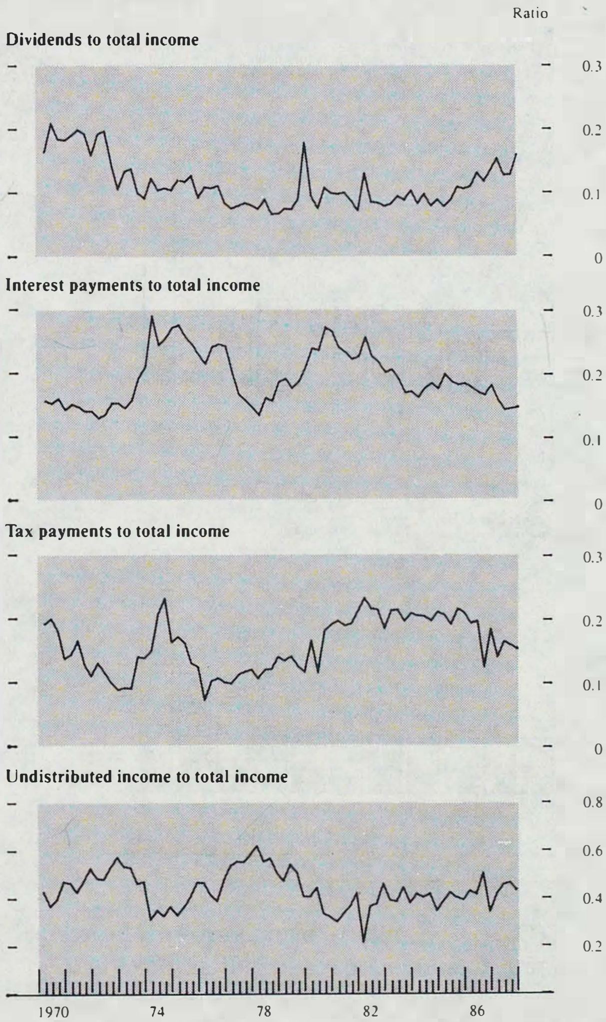
	1985	1986	1987
Income			
Gross trading profits:			
Non North Sea	38.6	47.3	57.2
North Sea activities	18.4	8.4	9.5
Other income	15.7	15.2	19.0
Total income(a)	**72.7**	**70.9**	**85.7**
Allocation of income			
Dividends on ordinary shares	6.9	8.7	12.4
Interest and other payments	13.9	12.5	13.0
Profits due abroad	6.4	4.7	5.5
UK taxes	15.1	12.5	13.5
Undistributed income(a)	**30.5**	**32.6**	**41.3**
Capital transfers	0.6	0.7	0.5
Fixed investment	24.6	26.0	28.8
Physical investment in stocks	0.1	0.3	1.4
Financial balance (surplus +)	**6.1**	**6.4**	**11.0**

(a) Net of stock appreciation.

Within other income, the strong upward trend of income from abroad was re-established. This reflected both the effect of higher oil prices upon the remitted profits of oil company subsidiaries overseas and the growing stock of overseas investments held by UK companies. ICCs made further heavy investment abroad during 1987 (see below) so that income generated outside the United Kingdom may develop as an increasingly important element in total

(1) This comparison, and others that follow, are distorted by the inclusion of British Gas, British Airways, British Airports Authority and Royal Ordinance in the figures for ICCs since privatisation.

Chart 4
Income and appropriations[(a)]



(a) The items in the chart do not comprise companies' total appropriations and thus do not sum to unity.

income. In 1987 it represented about 13% of total income (net of stock appreciation) compared with only 11% in 1986.

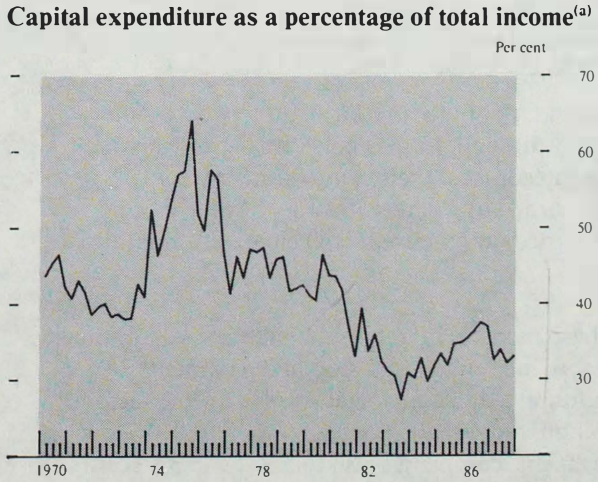
ICCs' payments of dividends on ordinary shares increased by over 40% between 1986 and 1987: this is rather more rapid than the recent scale of increase (an average of 16% per annum between 1980 and 1985). This pattern reflects the general buoyancy of profits but will also have been affected by both the servicing of the wave of new equity and privatisation issues in recent years and the need to maintain investor confidence during last year's bull market. In addition, some companies are emerging from tax exhaustion (ie they are using up their overhang of tax losses or surplus ACT) and so are paying corporation tax against which ACT on dividends may be set.

By contrast, tax payments by ICCs rose by only 8% over the year. However, this figure conceals a disparity of behaviour, with payments by non North Sea ICCs continuing to rise strongly, although less rapidly than in 1986, while those of North Sea companies fell very sharply. Tax payments by the non North Sea sector moved broadly in parallel with the slowing of income growth between 1985 and 1986—there is typically a lag between the earning of profits and mainstream tax payments—but continued to gain some additional impetus, although again less than in 1986, from a further reduction in the number of companies moving out of tax exhaustion. The collapse in tax payments by oil sector companies reflected both the fall in their income during 1986 and an associated reduction in petroleum revenue tax (PRT) liabilities.

Capital expenditure

Set against the strength of ICCs' financial position, the 10½% rise in fixed capital spending appears rather modest (Chart 5). In volume terms it represented a rise of just 5% which, notwithstanding the improvements in productivity (discussed above), may be insufficient to support even a fairly slow rise in output this year without some additional tightening of supply conditions. Following the rather weak overall outturn for fixed investment in 1986, a stronger recovery had been looked for, particularly within the manufacturing sector. In the event, however, it was here that the recovery in investment was weakest, with the engineering industries actually recording a sizable fall. The reasons are not entirely clear, although one factor may be that the 1984 tax reforms have, according to the Institute of Fiscal Studies,[(1)] raised the post-tax cost of capital on certain forms of investment (especially plant and machinery) but may have lowered the costs of others (notably commercial buildings). Survey evidence suggests that inadequate rates of return have become more important as a limiting factor on investment even though the recorded rates are now at their highest level for around twenty years. This may reflect a shortening of pay-back periods in response to a presumption of increasing uncertainty over future output growth.

Chart 5
Capital expenditure as a percentage of total income[(a)]



(a) Total income is defined as gross trading profits (net of stock appreciation) *plus* rent and non-trading income and income from abroad, *less* tax payments.

(1) See eg 'On the Growth of Corporation Tax Revenues'; M Devereux; *Fiscal Studies*, May 1987; 'Corporation Tax: The Effect of the 1984 Reforms on the Incentive to Invest', M Devereux; *Fiscal Studies*, February 1988; and 'Taxation and the Cost of Capital: The UK Experience'; M Devereux, *Oxford Review of Economic Policy*, Vol 3, No 4.

Stockbuilding

While stocks remained broadly unchanged during the first half of 1987, the second half saw a sharp increase. Nevertheless, stock/output ratios fell in most industries, continuing the decline which began in the early 1980s. In part this decline appears to reflect a reduced precautionary demand for stocks, associated both with efficiency gains in the overall responsiveness of supply to changes in demand and with the lower level of supply disturbances associated with the reduction in days lost through strikes. In part it no doubt also reflects the impact of positive real interest rates in recent years, together with the abolition of stock relief.

Financial transactions

From the company sector financial accounts it should be possible to determine how companies have used their available funds. In practice, however, because of errors and omissions in the various components, this estimate will rarely equal that derived from the income and appropriation accounts, so a balancing item of unidentified transactions is included to ensure that the various totals 'add up'. The balancing item in 1987 totalled an unprecedented £16.3 billion (Table C), which

Table C
Industrial and commercial companies' financial transactions
£ billions

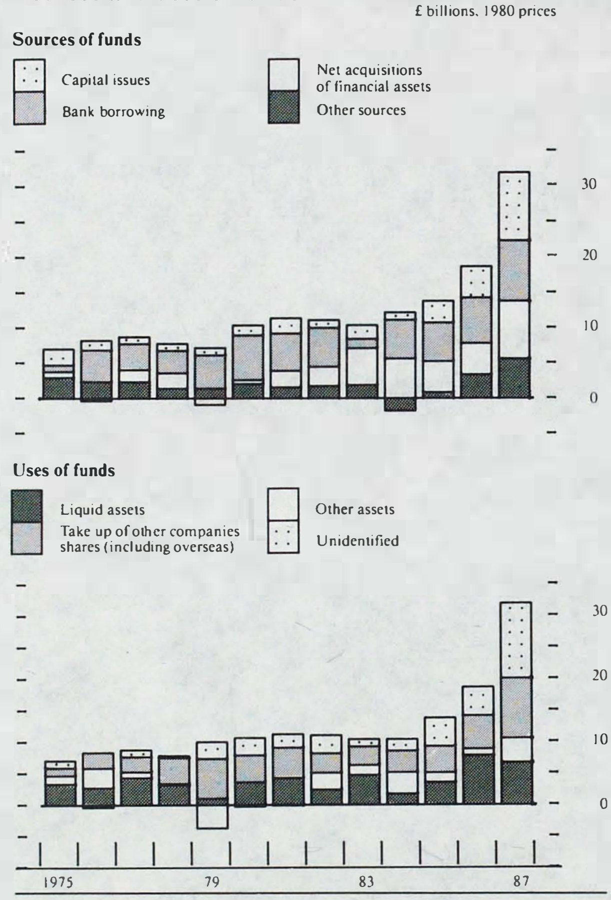
	1985	1986	1987
Financial balance (surplus +)	**6.1**	**6.4**	**11.0**
Identified financial transactions (outflow/acquisition of assets–)			
Investment in UK company securities	-1.4	-1.9	-4.2
Investment abroad	-4.4	-5.7	-9.9
Bank borrowing	7.6	9.2	12.8
Equity finance(a)	3.8	6.5	14.5
Loan stock issues(b)	1.6	2.2	4.7
Other borrowing(c)	—	2.3	3.4
Financial assets: liquid	-4.9	-11.1	-9.9
other	-0.7	1.3	-1.9
Changes in tax balances and other accruals adjustments, including net unremitted profits	-1.4	-2.7	-4.2
Balancing item(d)	**-6.3**	**-6.5**	**-16.3**

(a) Ordinary share issues and overseas direct investment in securities.
(b) Debentures, preference shares and capital issues overseas (including eurosterling).
(c) Other loans and mortgages and other overseas investment.
(d) Figures may not add because of rounding.

makes the task of interpreting company behaviour extremely difficult. In particular, it is not clear whether certain categories of their expenditure are being underrecorded or whether income may have been overrecorded: in practice it is likely to be a mixture of the two.

The sharp increase in undistributed income, combined with more moderate expansion of investment expenditure, led to a financial surplus for the sector of £11 billion, more than 70% higher than its 1986 level. Nevertheless, companies also increased their recourse to external finance, raising a further total of some £35 billion against just over £20 billion in 1986. Equity issues by ICCs totalled around £13½ billion, with other UK issues raising over £½ billion and capital issues overseas a further

Chart 6
Sources and uses of funds



£4 billion (Chart 6). Similarly, bank borrowing proceeded at a rapid rate, totalling nearly £13 billion. How these funds were used is only partially understood, yet much was clearly associated with company acquisitions.

Acquisitions

The high level of acquisitions expenditure continued in 1987, encouraged by the ready availability of equity finance. Total expenditure by ICCs on acquiring UK companies exceeded £15 billion, slightly higher than in 1986 and comparable in real terms to the last major peak in 1973. The number of UK companies acquired increased from 696 in 1986 to 1,125 in 1987, only slightly lower than in 1972 and 1973.

A key feature of the recent past, however, has been the parallel growth of international merger activity, with UK companies both acquiring and being acquired. ICCs' long-term investments abroad (which include portfolio as well as direct investment) virtually doubled last year to around £11 billion as UK firms expanded into foreign markets by means of acquisitions (Chart 6). These have, for the most part, been concentrated in the United States. The declining dollar may have helped to stimulate this demand by making US companies relatively cheap and encouraging UK firms to enter the US market directly as an offset to the impact of worsening competitiveness. Alternatively, these acquisitions may be viewed simply as

Stock prices

The theory of market fundamentals

The standard efficient markets hypothesis states that all available relevant information is taken into account by stock market participants when deriving the price of a share. The return on holding a share in any period is comprised of two components: the capital gain (or loss) on the share in that period and the dividend paid on the share in the period, ie

$$R_t = \frac{P_{t+1} - P_t + M_t}{P_t}$$

where R_t is the return on holding a share in period t,
P_t is the price of the share at the beginning of period t,
P_{t+1} is the price of the share at the beginning of period $t + 1$ and
M_t is the dividend paid on the share in period t (this is assumed to be paid at the end of the period).

In an efficient capital market, in order to induce investors to hold equity, the expected return on a share must equal the required return on corporate assets. It can be shown that,

$$P_t = \sum_{i=1}^{\infty} \left(\frac{1}{1+r}\right)^{i+1} M_{t+i/t}$$

where r is the required return on corporate assets and
$M_{t+i/t}$ is the expectation of dividends in period $t + i$, taken at time t.

So, under the efficient markets hypothesis, the price of a share is the present value of expected future dividends (expectations being taken at time t). This is often referred to as the 'market fundamentals' solution.

Market fundamentals in practice

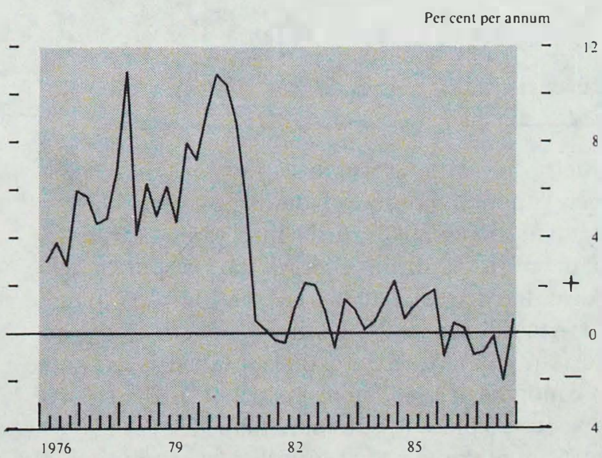
However, it is often argued that equity markets are not efficient, ie that current prices do not reflect the expected future dividend flow. Instead, stock prices are subject to 'speculative bubbles' whereby the actual price drifts away from the price warranted on fundamental grounds. Many people think a speculative bubble was responsible for the rapid rise in equity prices in 1987, in which case the fall in equity prices in October was no more than a correction to the market.

The market's valuation of the future dividend flow will depend on the relative attractiveness of alternative investments. If it is assumed that the alternative to investing in equity is to invest in bonds, then, at least in the long run, it would be expected that the returns to these two investments would be equal after allowing for risk differentials.

Company earnings net of tax payments, interest payments etc are available either for distribution as dividends to shareholders or for reinvesting in the company. If they are paid out as dividends then the equity holder has received a return on his share, but if they are reinvested in the company, future profitability should rise and hence expected future dividends should rise and therefore the price of the share should increase in anticipation of these higher expected future dividends. This suggests that to compare the returns to holding equity and bonds, the earnings yield on equity (earnings as a percentage of share price) should be compared with the bond yield (the coupon plus the capital gain on holding the bond until redemption), rather than the dividend yield (dividends as a percentage of share price) with the bond yield.

The earnings yield is a 'real' yield in the sense that it is the ratio of two nominal values and hence it should be compared with a real bond yield. As the chart shows, there has been a reasonably stable relationship between

UK yield differentials[a]



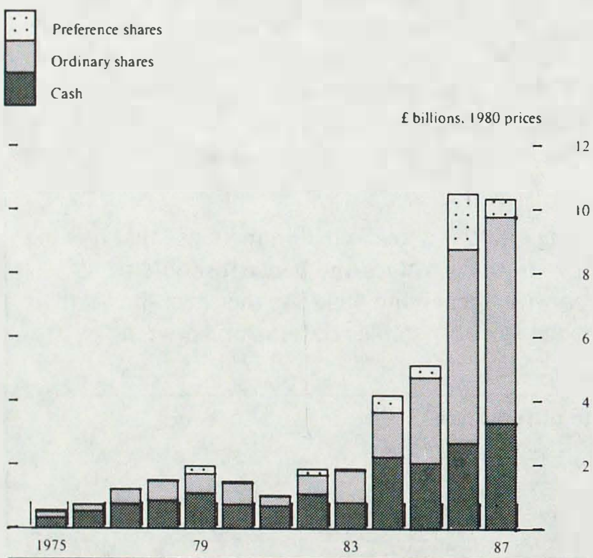
(a) Earnings yield less real bond yield.

earnings yields and real bond yields in the United Kingdom for much of the 1980s. Given the higher risk associated with equity, a positive yield gap (ie with the earnings yield greater than the bond yield) would be expected. However, in the period before 19 October the yield gap had become significantly negative and for the earnings yield to rise back to parity with the bond yield a significant fall in equity prices was needed: this was what occurred on 19 October.

another aspect of the wider merger boom, given the increasing globalisation of both product and capital markets. UK companies have themselves not been free from predators. Foreign acquisitions of UK companies intensified last year with expenditure probably in the range £2½–3 billion (alternative sources vary) compared with under £1 billion in 1986.

The buoyancy of the domestic equity market prior to October's collapse made share financing a popular and cost-effective method of settlement (Chart 7). During the first nine months of the year less than 30% of deals were cash financed and much of this cash seems also to have been raised through earlier equity issues. After the October crash, however, this key source of funding was effectively closed off and companies were obliged to

Chart 7
Funding of mergers



review their plans with respect to acquisitions in the light of this new situation. For many companies, particularly those that had successfully raised equity capital earlier in the year, the most significant effect of the stock price fall was to lower the market valuation of the company to be acquired. Accordingly, cash-rich firms took advantage of the opportunity to buy up companies inexpensively. In the first three months of 1988, merger expenditure had already passed £6 billion, with more than 70% cash financed. Capital raised had also shifted from equity to bank borrowing and the euromarkets.

Capital issues and capital markets

The pattern of company financing through 1987 and into this year has been overwhelmingly dominated by the rapid collapse and subsequent recovery of world stock markets. UK companies issued around £13½ billion of new equity during 1987 but, while much of this finance appears to have been merger related, it seems frequently to have been raised initially in response to a favourable funding opportunity, rather than with a specific venture or acquisition in view. Companies generally took advantage of favourable equity market conditions to raise capital and accumulate liquid assets.

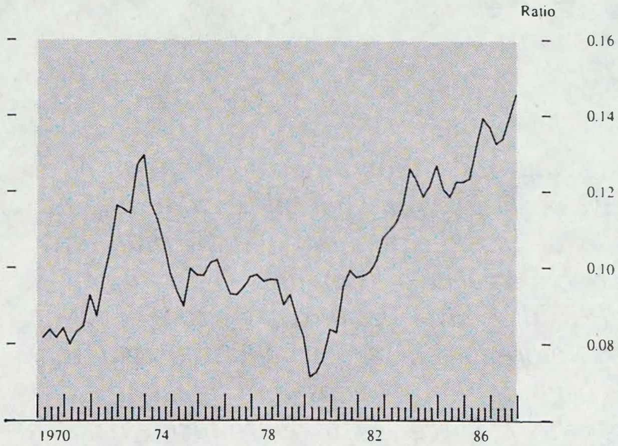
The fall in prices on 19 October abruptly ended this pattern of behaviour. Over the following few weeks a number of issues did proceed, in general where companies felt themselves to be locked into plans, but most were heavily undersubscribed. By the first quarter of this year, issues of ordinary shares had fallen to just £0.3 billion from a peak of £5.9 billion in the third quarter of 1987. The uncertainties created by the scale and suddenness of the price collapse have inevitably spilled over into other areas of company behaviour. Yet, on current evidence, it has been only in the financing decisions of firms that uncertainty has clearly translated into actual changes of behaviour. The events of last October appear to have represented a correction to an unsustainable speculative bubble. The evidence for the United Kingdom suggests that correction was achieved very promptly—market valuations appear to be back in line with economic fundamentals (see the note on page 361)—so that there may now be good grounds for supposing that the major impact of the stock market collapse will be largely confined to these transitory effects upon financing. In the meantime, companies have largely withdrawn from the equity market and have made increasing recourse to the euromarkets and to bank borrowing.

ICCs were already active in the euromarket during 1987 but, with growing investor concern that longer-term interest rate prospects were damaging the liquidity of the market, issues dwindled somewhat during the months prior to the stock market collapse. New issues fell further in the immediate aftermath of the events of 19 October, no doubt reflecting the increased general uncertainty, but revived quite sharply in the first quarter of this year to nearly £1.8 billion, or virtually half the 1987 total. Most of these issues have been relatively short-term (five to seven years) which may reflect the reluctance of the market to absorb longer-dated issues, but may also, to an extent, show companies' preference for shorter-term debt until conditions in the equity market become clearer.

Bank borrowing and company liquidity

Companies continued to acquire liquid assets throughout 1987. In total they accumulated a further £10 billion, largely offsetting the rise of nearly £13 billion in their borrowing from banks. The gross liquidity ratio (gross liquid assets as a proportion of capital base) continued to trend upwards while net liquidity was little changed (Chart 8). The simultaneous growth of liquid assets and short-term borrowing, which has been a feature of company behaviour in recent years, remains something of a puzzle. There are good grounds for supposing that many companies took advantage of the favourable conditions which prevailed in the equity market for much of the year to raise funds for subsequent use in takeovers and other activities and that these funds would have found a temporary home as liquid assets. More surprising,

Chart 8
Gross liquidity ratio[a]



(a) Liquid assets as a proportion of replacement cost capital base

however, is that, in a year when companies substantially raised their use of capital markets, they should also have increased their bank borrowing. Part of the explanation is probably given by the timing of these flows, with more than a third of bank borrowing occurring in the final quarter of the year when new equity issues were rapidly drying up. Borrowing was equally heavy, however, in the third quarter when capital market activity was at a peak, so that there were some *a priori* grounds for supposing that factors encouraging the raising of equity finance—such as takeovers and mergers—might also be reflected in bank borrowing. An industrial analysis of sterling lending provides some support for this view. Taking 1986 and 1987 as a whole, around a third of all new industrial and commercial lending was to property companies while, of the remainder, lending was heavily weighted towards those sectors where takeover and merger activity was most concentrated.

More generally, however, the build-up of bank borrowing, matched by an accumulation of liquid assets, to the extent that it occurs within the balance sheets of individual companies, may be viewed as a means of raising the liquidity or flexibility of the company and may accordingly be seen as a consequence of a narrowing in spreads between loan and deposit rates for corporate customers which is thought to have occurred over recent years.

Prospects for the company sector

Less than a year after the sudden collapse of world stock markets, initial fears that demand could slow too rapidly have been replaced by the re-emergence of concern about overheating and the build-up of inflationary pressures. The effects of the crash upon both world and domestic demand appear to have been quite muted. In the United Kingdom, consumer spending remains buoyant, while investment expenditure has been stronger than in the first half of 1987, with intentions surveys continuing to signal a further rapid recovery throughout this year and into 1989.

Within this environment, companies should continue to prosper, although the pressure from both capacity constraints and competitiveness, which built up through 1987, may have increased further. Output may already have slowed somewhat and, with margins likely to come under increasing pressure both from domestic cost pressures and from the need to maintain export price competitiveness, profits growth should now be more modest. By comparison, tax and dividend payments will grow relatively quickly—perhaps faster than in 1987—and with capital expenditure also expected to rise quite sharply the prospect must be for a substantially reduced financial surplus this year.

Merger activity meanwhile appears to be no less intense. As companies, both within and outside Europe, position themselves to take advantage of the changes due to take effect in 1992, the expectation must be that the tailing-off of activity seen in earlier merger cycles will now be less pronounced, with international acquisitions, both inward and outward, as an increasingly important feature.

Companies may accordingly maintain a continuing high demand for external finance. How this is raised will be heavily influenced by conditions in the equity market. New issues of ordinary shares by ICCs picked up in May but the fall back in June suggests that market sentiment is still fragile, so that domestic equity issues are unlikely for the present to absorb more than a fraction of the demand which ICCs might wish to make. In the short term, therefore, companies may continue to draw heavily upon the euromarkets and bank borrowing (particularly in the form of syndicated credits, which have proved increasingly popular). Capital gearing may accordingly rise while the net liquidity ratio is likely to fall. Longer term, companies are likely to return to the equity market in some strength but, depending on the outlook for interest rates, there may also be increased interest in fixed-coupon debt issues which, for blue chip companies, may be viewed as a close substitute for the holding of gilts, given the changing supply conditions now in prospect in that market.