

Profitability of large companies

The two tables which form the basis of this article present estimates of company profitability, before interest and tax, as derived from the published accounts of a sample of the largest UK companies.⁽¹⁾ These estimates complement and supplement those based on national accounts data which were published in the August 1989 Bulletin.⁽²⁾

The figures reveal that, measured on the conventional historical cost basis, the profitability of large non-oil companies in 1988 was on average much the same as in 1987. There was a slight rise in the profitability of companies producing capital goods, which was offset by a small fall in the profitability of consumer goods companies. The profitability of oil and gas companies fell back slightly in 1988 and remained well below the level of years prior to 1986.

The estimates of profitability which are presented in this article, return on capital employed and return on trading assets, are derived from the published accounts of a changing sample of some 1,600 of the largest UK companies, which are made available in a computerised form by Datastream Limited. The number of companies in the sample varies from year to year as some companies are introduced and others are excluded because of failure or takeover. For years prior to 1980, the annual samples consisted entirely of listed companies, but, for years since then, they have also included some 400 unquoted companies and around 50 USM companies. The companies in the annual sample represent only a small proportion by number of the total population of UK companies but are thought to account for about three quarters of corporate assets and income. Because of delays in the preparation and submission of annual accounts, the sample of companies for the most recent year is about 25% smaller than those for earlier years; the estimates of profitability for this year should therefore be regarded as provisional.

The estimates reported for a given year include all companies whose financial year ends between April of that year and March of the next. Thus, for example, '1988' refers to the financial years ending between April 1988 and March 1989.

When comparing these estimates with those derived from the national accounts, it is important to bear in mind definitional differences in the underlying data. Probably the most important is that company accounts and hence the estimates of profitability presented here cover both the domestic and overseas activities of UK companies: in contrast, national accounts data cover only business done in the United Kingdom. In addition, estimates based on the national accounts cover all corporate activity in the

United Kingdom, whereas the estimates presented here are based on information from a sample, albeit sizable, of larger companies.^{(3) (4)}

The industrial classification of companies follows that used in the FT-Actuaries all-share index.

Return on capital employed

The average rate of return on capital employed (that is the profitability of both trading and non-trading activities) for non-oil industrial companies was 19.8% in 1988, the same as in 1987 (Table A). This reflected a small rise in the profitability of companies classified as making capital goods and an offsetting fall in the profitability of consumer goods companies. In the oil and gas sector, profitability fell back to 14.6%; this partially reversed the advance in 1987 and reflected continuing weaknesses in the oil price and disruptions to North Sea output. These findings suggest that 1988 may mark the end of the cyclical upswing in profitability which began in 1981/82, when the return on capital employed in the non-oil and gas sectors was 14%.

In the capital goods group, against a background of a strong rise in industrial investment, every sector except metals and metal forming showed an increase in profitability. The largest rise was in mechanical engineering although, in this sector, the rate of return has yet to recover to its pre-1979 levels. The profitability of the electricals sector, where the return on capital rose from 20.2% to 23.0%, was also particularly buoyant. Despite falling to 19.4%, the profitability of the metals and metals forming sector was the second highest since 1975. The significant improvement in the motor sector which was noted in 1987 has been maintained and has shown a slight further improvement in 1988.

(1) Previous articles in this series were published in the September 1985, September 1986, November 1987 and November 1988 *Bulletins*.

(2) See 'Company profitability and finance', pages 375-82.

(3) The results of a study which attempted to reconcile the two measures of company profitability were reported in *Economic Trends*, August 1984, pages 97-100.

(4) In this context, see also 'Trends in real rates of return', in the August 1988 *Bulletin*, pages 376-81.

rate of return in the leisure sector declined by 2.2% to 12.9%. This fall, however, appears to have been somewhat exceptional and largely reflected certain substantial acquisitions, some overseas, by leading hotel and entertainment companies which increased year-end capital employed without contributing a full year's profits. In addition, several of the companies in the sector revalued their fixed assets, leading to significant increases in measured capital employed.

Among the other consumer goods sectors, the rate of return in textiles also showed a marked fall from 22.7% in 1987 to 19.2% in 1988. In part, this reflected a significant increase in the level of capital employed, largely due to acquisitions, but there was also some erosion of margins with greater overseas competition arising from the comparative strength of sterling.

Return on trading assets

The return on non-oil industrial groups' trading assets, at 22.5% in 1988, was, like their return on capital employed,

little changed compared with 1987 (Table B). However, contained within the total are some noteworthy changes for individual sectors. Two in particular are the sharp increase in the return in printing and publishing from 36.7% to 58.1% and the steep fall in the return in the agencies sector (that is service companies, including estate and advertising agencies) from 93.0% to 70.3%. Printing and publishing showed an increase in profit across the majority of its constituent companies with little material change in trading assets.

The fall in the return earned by agencies is a fall back from 1987's exceptionally high level of 93% which was partly due to the fact that the return on trading assets had been greatly inflated by goodwill written off following acquisitions. With a lower level of acquisitions in 1988, and hence a lower goodwill write-off, spending on tangible assets was reflected in an increase in the level of trading assets and hence had the effect of reducing the return on trading assets. The agencies sector shows a high level of return on trading assets compared with other sectors because businesses in this sector tend to be people rather than asset based.