Company profitability and finance

This article reviews the performance of UK industrial and commercial companies during 1989. The main points include:

- *The substantial slowdown in domestic demand growth during 1989 was accompanied by some fall in company profitability from its 1988 peak. Profitability nevertheless remained above the average for the past decade.*
- *Total company income was buoyed by revenue from exports and from overseas branches and subsidiaries, as world demand was relatively strong.*
- *Investment expenditure remained high, even when 'special projects' are omitted. This reflected high levels of capacity utilisation and expectations of good profitability.*
- *The company sector financial deficit rose to a record £24 billion (5% of GDP) in 1989. This was in large part a result of substantial investment expenditure and record dividend payments.*
- *Net company liquidity deteriorated still further. Bank borrowing was very high for the second year running, in part a result of record cash-financed merger and acquisition activity.*
- *As interest rates and companies' stock of financial liabilities both rose, income gearing increased to very high levels.*
- *Although some retrenchment is likely in 1990, both by sectors already badly affected by the slowdown and by others seeking to reduce exposure, adjustment is expected to be much more modest than that seen in the early 1980s.*

Introduction

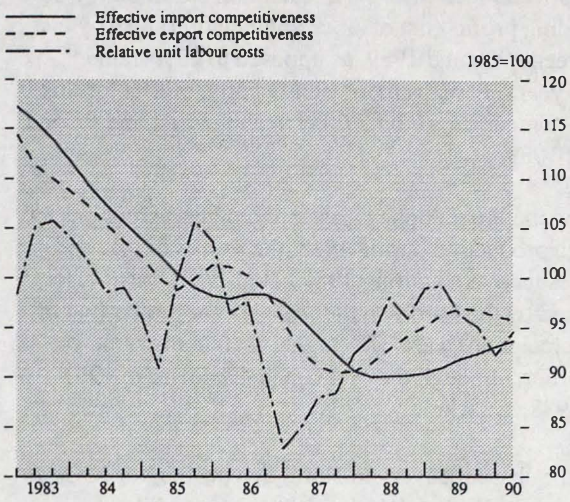
After seven years of sustained growth averaging 3½% per annum, 1989 marked a turning point for the UK economy. In the face of a rising current account deficit and upward pressure on inflation, monetary policy was tightened further in order to restrain domestic demand growth. Industrial and commercial companies (ICCs) consequently faced a fall in profitability. However, the rate of return fell from a peak of around 11%, which for non North Sea companies was significantly higher than at any time since the early 1970s, and companies therefore chose to maintain expenditure at high levels. Although experience has varied, the result for the sector as a whole has been a marked increase in interest rate exposure and in financial pressures to restrain spending.

Economic background

Following exceptional rates of increase in 1988, growth in the principal components of domestic demand, consumers' expenditure and investment, slowed considerably in 1989. The slowdown in domestic demand growth was also aided by some decline in the volume of stockbuilding between the second half of 1988 and the first three quarters of 1989 and, most notably, by destocking in the fourth quarter of last year. Although interpretation of the stockbuilding numbers has been hampered by the size of national accounts statistical adjustments (made necessary by the continued discrepancy between output and expenditure measures of GDP), there is some support for the profile given, at least for the manufacturing sector, both from recorded stockbuilding and from CBI survey evidence.

Despite the slowdown in domestic demand growth, improvement in the current account has been slow to materialise. In particular, the deficit in manufactures, which might have been expected to improve, actually grew from £15 billion in 1988 to £16 billion in 1989. However, the underlying path of the visible balance was obscured by movements in erratic items, and excluding these, the manufactures balance did show improved trends between the two years. Between 1987 and 1988 exports of manufactures excluding erratics increased by 6%, while imports rose 17%.

Chart 1
Effective manufacturing competitiveness (a)

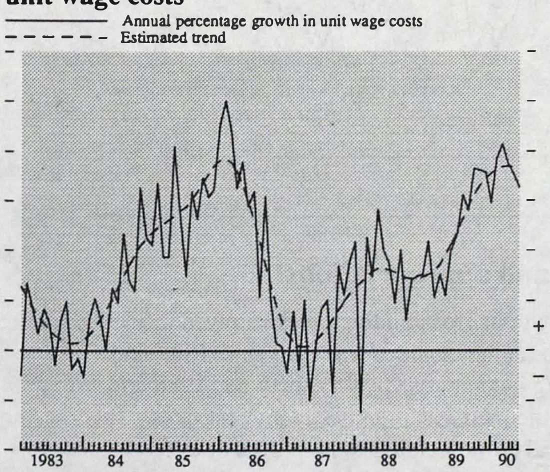


(a) Defined to take account of the delay with which changes in competitiveness are thought to affect trade volumes. Lags are derived from equations for manufactured trade volumes in the Bank model. The lower the index the more competitive is UK industry.

In 1989 both exports and imports rose by 11%, and data for the first six months of 1990 indicate a further improvement, with export growth exceeding that of imports. In addition to benefiting from the slowdown in domestic demand, the manufactures balance should be helped this year by the improvement in manufacturing competitiveness which occurred in 1989. This is not thought to have affected trade flows until recently (see Chart 1).

Although UK manufacturing industry became more competitive in 1989, this largely reflected a fall in the sterling effective exchange rate. Developments on unit wage costs were adverse. Whole-economy productivity fell marginally in 1989 and, although productivity in manufacturing rose for the year as a whole, it too fell slightly during the second quarter. The growth in average earnings therefore meant that whole-economy and manufacturing unit wage costs rose by 9.4% and 5.0% respectively between

Chart 2
Estimated trend growth of manufacturing unit wage costs



(a) Generated through application of a Kalman Filter.

1988 and 1989. By the fourth quarter the annual rate of increase in manufacturing unit wage costs had reached 6.8% (Chart 2).

Rising labour costs in 1989 put pressure on ICCs' domestic margins, although for manufacturers this was offset by weak input prices. In 1990 a rising rate of increase in the headline RPI has put further pressure on labour costs. While the recent appreciation in the exchange rate may further depress manufacturers' input prices, it is also likely to depress domestic margins, as price inflation of imported manufactures falls. ICCs may also have difficulty competing abroad. This will have adverse consequences for company profits this year.

The contribution of the supply side

As the economy has slowed down, attention has focused on the speed of adjustment, both in the current account and in 'core inflation'. In each case the answer will depend in large part on the degree to which the supply side of the UK economy has become more adaptable and efficient during the 1980s.

There is some evidence to suggest that there has been an increase in the underlying rate of manufacturing productivity growth in the United Kingdom during the 1980s.[1] Although it is possible that this measured improvement simply reflects in part the sustained cyclical upturn, as efficiency has been enhanced by the reduced volatility in demand, it is thought that other factors have had a favourable impact in the 1980s. These include the shakeout of some inefficient manufacturing plant in the early 1980s, improved industrial relations, a higher rate of investment (which has reduced the average age and hence increased the reliability of the capital stock) and techniques for quality control. Both industrial relations and quality control have benefited from inward investment. The latter covers a wide range of innovations which form part of what is now referred to as total quality management, and which were particularly promoted by Japanese firms. These innovations include quality circles, where members of the workforce meet to discuss means of improving quality in their area, and statistical process control, which enables badly performing machines to be identified *before* they start producing poor quality output. As a consequence of these and other improvements in workplace organisation, an increasing number of manufacturing firms have been able to reduce stockholding to just-in-time levels. This may further raise productivity by releasing capital for investment in new technology.

Developments such as these do appear to be improving the relative performance of the UK economy, in terms of economic growth, trade and investment. While average output growth in the United Kingdom over the period 1979–89 was slightly less than over 1960–89 (2.3% as opposed to 2.4%), growth in the major six overseas economies slowed rather more (to around 3% from 4%),

(1) See 'Productivity trends' in the February 1989 *Bulletin*, pages 23–26.

raising the United Kingdom's relative position from seventh to fifth. The relative trade performance has also improved. Over the past two decades, manufacturing imports have had a tendency to grow faster than exports whenever the United Kingdom's growth rate equalled or exceeded that of the rest of the world. In the second half of the 1980s the country's share of world manufactured exports stabilised, while growth in import penetration slowed. Finally, the improvement in the United Kingdom's relative investment performance is noteworthy. Average annual growth in investment in this country was about 3½% over both the periods 1960–89 and 1979–89. For the major six overseas economies the average growth rate fell from around 4% to 3% between the two periods.

Although UK firms are achieving improvements in productivity, and economic performance is benefiting, in the 1980s these were frequently offset by rapid growth in earnings. Consequently, unit wage costs have moved adversely in the past few years, which has been damaging for both competitiveness and domestic inflation. Rapid earnings growth continues. The CBI estimates that manufacturing sector pay settlements in the first quarter averaged 8.5% and service sector settlements in the first half of the year averaged 9.0%. This would become a particularly severe problem if other costs started to rise, as that would cause more of the rise in unit wage costs to be passed on into producer prices.

Profitability and margins

Despite the slowdown in domestic demand, manufacturers' margins on domestic sales hardly fell in 1989. Table A shows that relatively weak input prices and some rise in productivity helped to offset the substantial rise in labour costs. In addition, buoyant world markets have enabled manufacturers, among others, to maintain sales volumes by increasing exports. This has reduced the pressure to cut margins on domestic sales. However, competition in world markets did mean that margins earned on manufacturers' export sales fell slightly in 1989. Furthermore, margins of some non-manufacturing sectors—notably retailers—are also thought to have fallen, as sales were encouraged through price reductions. As a result non North Sea ICCs' gross trading profits (net of stock appreciation) rose by just 4% between 1988 and 1989, as opposed to 22% in the previous year. Perhaps more significantly, profits for this group of companies *fell* by 5% between the first and second halves of 1989.

Table A
Contributions to year-on-year percentage change in domestic output prices in manufacturing[(a)]
Percentage points

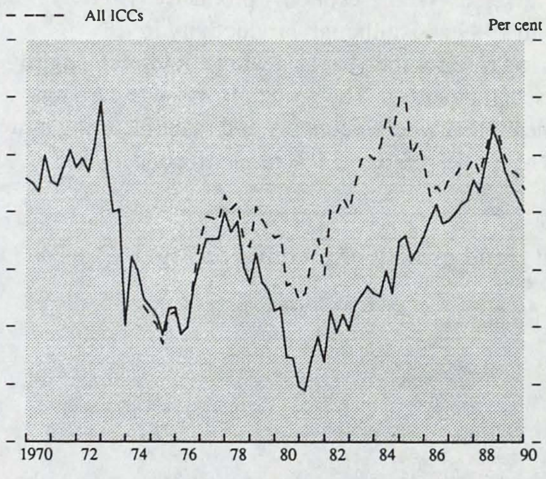
	Labour productivity (increase -)	Labour costs	Unit labour costs(b)	Input prices	Bought-in services	Margins (residual)(b)	Output prices
	1	*2*	*3=2+1*	*4*	*5*	*6=7-(3+4+5)*	*7*
1980	1.7	7.8	9.8	3.8	5.2	-3.5	15.4
1981	-1.9	6.5	4.4	2.9	2.7	-2.6	7.5
1982	-3.0	4.4	1.3	2.3	1.1	2.2	6.9
1983	-3.6	3.7	0.1	2.6	0.8	1.8	5.4
1984	-2.8	3.4	0.6	3.0	1.1	0.4	5.1
1985	-1.5	3.5	2.0	1.0	1.0	1.7	5.7
1986	-1.6	3.2	1.6	-3.4	0.8	5.2	4.1
1987	-3.1	3.4	0.3	1.7	0.7	1.6	4.4
1988	-2.6	3.6	0.9	1.6	1.7	0.6	4.8
1989	-1.7	3.7	1.9	1.8	2.2	-0.4	5.4

(a) Excluding food, drink and tobacco.
(b) Figures may not add to totals because of rounding.

Following the Piper Alpha disaster and other disruptions to North Sea production during 1988, the profits of oil companies recovered during 1989. Higher oil prices also helped, and by the fourth quarter of last year profits (net of stock appreciation) were 37% higher than in the same period a year earlier, although they remained 4% lower in 1989 than in 1988 as a whole.

Despite the sharp recovery in North Sea profits, for ICCs as a whole, profits declined during 1989. Meanwhile substantial gross investment is thought to have made significant additions to the capital stock. As a result profitability fell from a peak of around 11% in the fourth quarter of 1988 to about 9½% by the end of last year.[(1)] It is estimated that profitability fell slightly further (to just under 9%) in the first quarter of this year. However figures for this particular quarter were distorted by inclusion of the water industry. If the ten newly privatised water companies are omitted, it is estimated that profitability hardly changed in the first quarter. Despite the fall during 1989, profitability compares favourably, particularly with the recessionary years of 1974–75 and 1980–81 (Chart 3).

Chart 3
Profitability[(a)] of the company sector



(a) Pre-tax real rate of return on capital employed.

Income and appropriations

While growth in gross trading profits slowed in 1989, income from other sources was buoyant. Rent and non-trading income rose by 45% between 1988 and 1989, reflecting the increase in domestic interest rates. Income from abroad (which includes the profits of overseas branches, and the dividends and parent companies' share of

(1) The 1988 peak has been revised down following substantial revisions to profits data from 1987.

Dividend payments

Movements in industrial and commercial companies' dividends over time have proved difficult to explain, and their recent extremely high level has been a particular puzzle. The dividend-payout ratio (that is dividends as a proportion of cashflow) provides perhaps the best summary statistic of trends in the strength of distributions over time. The payout ratio was high in the 1960s (average of 46%), but low in the 1970s and 1980s (averages of 25.8% and 26% respectively). It has been unusually volatile over the most recent time-span; quite high in 1980–82, subdued in 1983–85 and subsequently very strong, reaching a yearly record of 50.7% in 1989.

One method of evaluating explanations of dividend behaviour is through the use of econometric techniques. In this context, the most widely used specification is:

$$D = a0 + a1C + a2\theta + a3G$$

Where, D = dividends;

C = cashflow;

θ = a variable describing the nature of the tax system;

G = government controls on dividends;

and all variables are transformed into logs.

Cashflow is included on the grounds that managers have some target payout ratio for dividends in relation to income. In addition, Miller and Modigliani's [(1)] irrelevance theorem suggests that shareholders' attitudes to dividend policies will be critically affected by the tax system. θ is defined under an imputation system of corporation tax as $(1\text{-}M)/(1\text{-}Z)(1\text{-}S)$, where M is the effective marginal rate of tax on dividends, Z is the effective marginal capital gains tax and S is the imputation rate (currently the standard rate of income tax). Finally, government controls are generally considered since these can also exert some influence; for example, the payout ratio was significantly depressed by government policy over the period 1973–79.

Such a model is, however, unable to account for the recent exceptional growth of dividend payments, and empirical work undertaken at the Bank (Lomax [(2)]) considers alternative and additional reasons for observed dividend behaviour. In the first place, as regards tax effects, changes in tax rates were not found to determine dividend policy. While this contradicts some earlier studies, it is not necessarily fallacious. Indeed, it has been convincingly argued (Feldstein and Green [(3)]) that for any aggregate value of θ, a segmented equilibrium in which companies specialize should emerge, since almost all shareholders will prefer either no dividends or no retained earnings. By contrast, movements in the incidence of tax exhaustion (that is the extent to which companies have insufficient tax credits against which to offset their advance corporation tax payments) were found to influence dividend policy. Presumably this is because, in such circumstances, distributions impose an additional tax burden on all shareholders.

A further explanation for dividend behaviour stems from the dichotomy between ownership and control in the modern corporate form. The managers of the firm (insiders) typically have better information about its prospects than shareholders (outsiders); however, the latter have a collective interest in receiving news from management in order to improve their portfolio allocation decisions. Information cannot be conveyed directly (for example specific information on investment plans), since the firm's competitors would also benefit from its availability. Instead the dividend can represent a useful and timely signalling device. The theory suggests that one reason for the present strength of dividends could be that management are unusually confident about company prospects. This is reflected in the record level of the investment-output ratio, and in fact it was found that capital expenditure could usefully be included in the dividend equation as a proxy for managers' expected profit flow (see also Anderson [(4)]).

An additional important facet to the story is, however, that the interests of management and shareholders may not coincide. One important consequence is that trends in takeover activity are likely to be associated with movements in dividend payments. In particular, changes in the ease with which mergers and acquisitions can be undertaken, such as those facilitating the recent emergence of hostile takeover bids (for example, the availability of low grade debt finance) could have influenced dividend policies. At least two lines of causation have been suggested. One theory (Easterbrook [(5)] and Jensen[(6)]) is based on the premise that management typically prefer a low payout in order to pursue growth maximising strategies or consume perquisites, while shareholders generally wish for a high payout since this will force management to incur the inspection of the capital markets for each new project undertaken. Takeover activity could partly resolve the conflict, since firms which deviate most extensively from shareholder objectives—and which consequently tend to have lower market values—have a greater likelihood of being acquired. Innovations in the market for corporate control alter the balance of power between management and shareholders, and could therefore lead to dividend increases. An alternative interpretation of the takeover-dividend relationship, which suggests that merger activity is likely to aggravate rather than reconcile management-shareholder conflicts of interest, stems from signalling theory. In particular, distribution increases could represent a false signal about the future prospects of the firm, made to assist management to retain control (King [(7)]). It is possible that the costs associated with making such a signal are low. While it is not clear which of these two explanations is more plausible, there is quite substantive empirical evidence that the recent growth in dividend payments has been strongly associated with the boom in hostile bids.

(1) Miller, F H and Modigliani, F, (1958), 'The Cost of Capital, Corporation Finance and the Theory of Investment', *American Economic Review*, June 1958.
(2) Lomax, J W, 'A Model of ICCs Dividend Payments'. Bank of England *Discussion paper* (forthcoming), 1990.
(3) Feldstein, M and Green, J, 'Why do Companies Pay Dividends', *American Economic Review*, March 1983.
(4) Anderson, G J, 'The Internal Financing Decisions of the Industrial and Commercial Sector: a Reappraisal of the Lintner Model of Dividend Disbursements', *Economica*, August 1986.
(5) Easterbrook, F H, 'Two Agency Cost Explanations of Dividends', *American Economic Review*, September 1984.
(6) Jensen, M C, 'Agency Costs of Free Cash Flow, Corporate Finance and Takeovers', *American Economic Review*, May 1986.
(7) King, M, *Public Policy and the Corporation*, Chapman and Hall, 1977.

Table B
ICCs' income and appropriation accounts
£ billions

	1987	1988	1989
Income			
Gross trading profits(a)	57.2	65.0	66.8
Non North Sea	47.7	58.1	60.3
North Sea	9.5	6.8	6.6
Rent and non-trading income	7.9	8.6	12.4
Income from abroad	11.6	14.4	17.8
Total income(a)	**76.7**	**88.0**	**97.1**
Allocation of income			
Dividends on ordinary and preference shares	11.1	14.7	18.7
Interest and other payments	12.2	14.3	24.0
Profits due abroad	6.7	7.4	9.0
UK taxes	13.3	15.0	18.0
Undistributed income(a)	**33.5**	**36.6**	**27.4**
Capital transfers	0.4	0.2	1.3
Fixed investment	32.3	40.1	46.5
Physical increase in stocks	1.8	5.1	3.6
Financial balance (surplus +)	**-0.9**	**-8.8**	**-24.0**

(a) Net of stock appreciation.

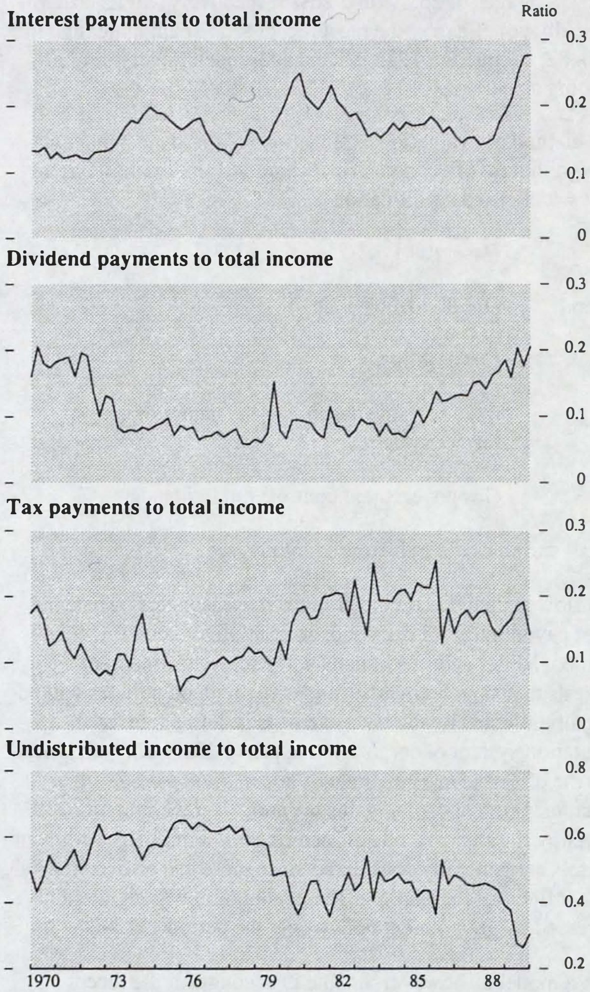
the undistributed income of overseas subsidiaries) rose by 24% over the same period. As with income from exports, included in gross trading profits, this component of income has benefited from the relative strength of world demand and from a weak exchange rate. ICCs' total income (net of stock appreciation) therefore rose by 10% in 1989, although the fall in gross trading profits meant that it was unchanged between the first and second halves of the year.

As in 1988, growth in distributions in 1989 exceeded growth in income. The result, on this occasion, was a *fall* of 25% in undistributed income. Between the first and second halves of 1989, a fall of as much as 33% was recorded.

Dividend payments on ordinary and preference shares rose by 28% between 1988 and 1989 and, by the fourth quarter of last year, the dividend-payout ratio had reached an almost unprecedented 62%.[1] This was the second year of exceptional dividend growth. On this occasion the growth rate was hardly affected by the dividend payments of recently privatised companies, and Bank estimates suggest that, even if such firms are omitted, dividend payments were a near record proportion of GDP in 1989. The high payments reflect managers' expectations of future profits. At a time of large scale hostile merger and acquisition activity there has been particular pressure to make such expectations clear, whether they are realistic or not. (See the note on page 355).

Tax payments have also risen sharply, reflecting the lag—fifteen months on average—between the earning of profits and the payment of tax. In 1989 tax payments were also affected by a change in Inland Revenue regulations, which resulted in a number of companies moving payments forward from the first quarter of 1990 into the fourth quarter of 1989. With tax allowances remaining quite high, because of substantial recent capital expenditure, the economic slowdown is thought to have caused a limited rise in the number of tax exhausted companies. The IFS forecasts a rise in the proportion of quoted manufacturing companies that are tax exhausted from a low point of 9.6% in 1988 to 12.2% in 1990.[2] This move into tax exhaustion will serve to maintain tax payments at a higher level than otherwise during 1990.

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.

The rapid rise both in ICCs' stock of debt and in domestic interest rates led to a 68% rise in interest payments between 1988 and 1989. ICCs' net borrowing requirement exceeded £50 billion in 1989 (having been in excess of £40 billion in 1988) and stocks of sterling bank debt and of debenture and loan stock rose by 32% and 25% respectively between mid-1988 and mid-1989. As a result, ICCs' net income gearing rose sharply, reaching 33% by the end of the year. This exceeds the peaks reached in 1975 and 1981 (Chart 4).

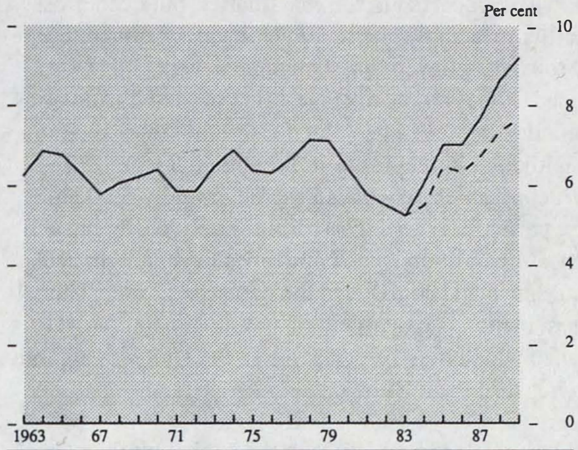
Capital expenditure

Despite the fall in undistributed income, ICCs continued to invest strongly in the United Kingdom in 1989. Investment

(1) The dividend-payout ratio is defined as the ratio of dividend payments to income after tax and interest payments. This differs from the definition used in Chart 4 which is the ratio of dividend payments to gross income.
(2) These figures are an updated version of those published in the *Oxford Review of Economic Policy* Vol 3, No 4. They refer to ACT exhaustion. The sample now contains 750 companies and the results are now based on accounting data up to 1986.

Chart 5
ICCs' gross domestic fixed capital formation as a proportion of GDP

——— Including newly privatised companies and major construction projects
- - - - Excluding newly privatised companies and major construction projects



expenditure rose a further 16%, after the 24% increase in 1988. This represents 9% of GDP. Even if newly privatised companies and major construction projects (Canary Wharf, Channel Tunnel etc) are omitted, estimated investment expenditure by ICCs was a higher proportion of GDP than at any time since at least 1963 (Chart 5).

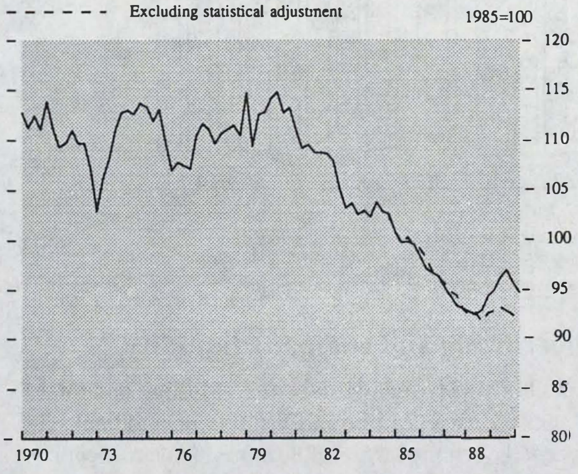
Continued strong investment, despite growing financial constraints for at least some sectors and companies, reflects in part the long lead times between investment planning and implementation. However, profitability has continued to be healthy and capacity utilisation high. In such a climate, as the figures for the first quarter of 1990 suggest, it is unlikely that investment expenditure will be first to be curtailed, although ICCs must eventually consider reducing it if financing difficulties persist.

Stockbuilding

If the national accounts statistical adjustment is included, it is now thought that stocks (largely owned by ICCs) rose by £4.3 billion in 1988 and a further £3.0 billion in 1989.

Chart 6
Stock-output ratio

——— Including statistical adjustment
- - - - - - Excluding statistical adjustment



Even the scale of *recorded* stockbuilding is now sufficient to have produced a rise in the stock-output ratio in 1988 and the first half of 1989 (Chart 6). Evidence from the quarterly CBI survey confirms this profile for stocks in manufacturing, with significant positive balances of firms reporting throughout 1989 that stocks were considered excessive.

In the fourth quarter of 1989 significant destocking was recorded, particularly in manufacturing. CBI surveys report limited destocking in that quarter and substantially more in the first half of 1990. It appears that ICCs may now be adjusting output, in order to run down involuntary stocks. Although increased uncertainty about output may have raised desired stockholding, the stock-output ratio is expected to resume its downward trend in the early 1990s, as improvements in production and stock-control techniques that have already occurred in parts of the manufacturing sector are adopted elsewhere.

Financial transactions

As a result of substantial distributions, record capital expenditure and sizable stockbuilding, ICCs' financial deficit reached £24 billion (5% of GDP) in 1989. This was the second successive year of significant financial deficit, which is unusual. However, it is notable that, whereas in 1974 and 1979 the deficit reflected a decline in profitability, on this occasion it was largely the result of discretionary expenditure. In particular ICCs have chosen to increase dividend payments and capital expenditure, and to inflate the stock of financial liabilities on which interest is paid by extensive acquisition and merger activity.

Table C
ICCs' financial transactions
£ billions

	1987	1988	1989
Financial balance (surplus +)	**-0.9**	**-8.8**	**-24.0**
Identified financial transactions (outflow/acquisition of assets -)			
Investment in UK company securities	-4.1	-12.1	-18.1
Investment abroad	-14.5	-13.9	-17.1
Balance of import and export credit received/given	-0.3	-1.3	0.8
Bank borrowing	12.1	31.1	33.4
Ordinary share issues	13.4	3.5	2.3
Other capital market issues (a)	2.9	4.4	7.0
Other capital issues	1.9	2.7	7.4
Overseas investment (other)	1.3	3.2	8.5
Other loans and mortgages	3.0	4.2	7.3
Financial assets: liquid	-8.7	-5.7	-14.5
other	-2.5	1.4	2.4
Changes in tax balances and other accruals adjustments, including net unremitted profits	-3.1	-6.3	-4.8
Balancing item (b)	—	**-2.4**	**9.4**

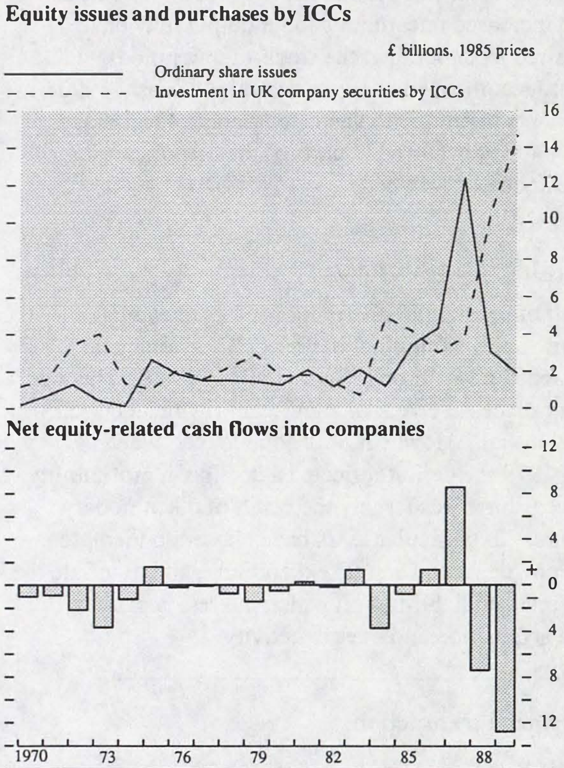
(a) Debentures, preference shares and capital issues overseas (including eurosterling).
(b) Figures may not add to totals because of rounding.

Interpretation of the deficit is, however, made difficult by a large balancing item, equal to £9.4 billion over the year. Furthermore, 1989 was only the third year since 1963 when recorded outflows *exceeded* recorded inflows, rather than the other way round. However more of the explanation may lie in overrecording of financial outflows than in overrecording of expenditure or underrecording of profits. There therefore appears to be little doubt that ICCs' financial deficit was very large in 1989.

Acquisitions

Domestic acquisition and merger activity reached a value of £26 billion in 1989. Although not much higher than the £22 billion figure recorded for 1988, 82% as opposed to just 70% was cash financed. The result was a 50% increase in ICCs' investment in UK company securities between the two years. For the second successive year ICCs' net equity creation was significantly negative (Chart 7). So far in 1990 financial constraints have curtailed domestic acquisition activity. In the first quarter, total expenditure was just £1.9 billion and cash expenditure on independent companies was offset by trade disinvestments, so that net investment in UK company securities was nil.

Chart 7
Equity creation by ICCs



Cross-border activity also increased in 1989. Net acquisitions abroad by UK companies (including financial companies) were valued at £19 billion. Net acquisitions in both the European Community and the United States rose by 50% between 1988 and 1989. Meanwhile overseas companies made net acquisitions in the United Kingdom with a value of £8 billion, and it is noticeable that net acquisitions by EC companies rose by over three times, to exceed UK companies' net acquisitions in the European Community. For strategic reasons cross-border activity seems unlikely to fall much below the 1989 level in 1990, despite financial constraints. Globalisation of markets, emphasis on short supply chains, and developments in Europe in the light of 1992 and the opening up of Eastern European markets, all suggest that, in order to compete, UK companies will need to expand abroad. At the same time the relative ease with which acquisitions can be made will continue to encourage overseas companies to invest here.

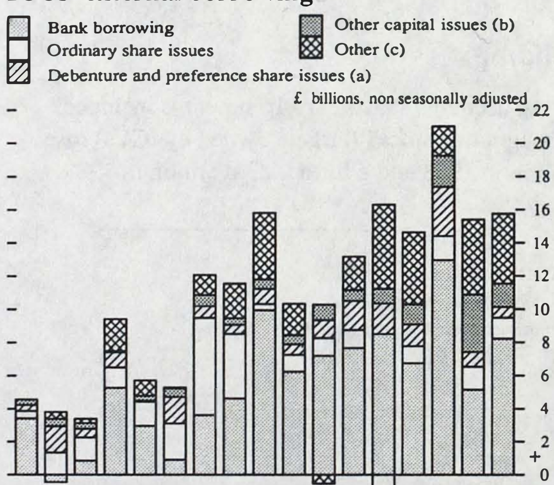
Capital issues and capital markets

Despite a rising stock market for much of the year, net issues of ordinary shares in 1989 reached only two thirds of the level of 1988. The figure was somewhat distorted by the BP buyback which occurred in the first quarter, but even gross issues hardly rose above the low 1988 level. Companies are unlikely to have believed that their shares were still underpriced. In 1989 the average value of the FT-Actuaries all-share index exceeded its value for the first three quarters of 1987, although in real terms it did remain lower. However, companies may have been deterred by market volatility, particularly as underwriting is very costly in such conditions. In addition some companies have bought back their own shares and so reduced the net issue figure. This latter phenomenon is one aspect of a more general move to debt finance which may be occurring in the United Kingdom and which is discussed below.

The total value of net debt issues in the capital markets was relatively high in 1989. The net volume of domestic debenture and preference share issues more than doubled between 1988 and 1989 and international debt issues (largely eurobonds) rose by around 60%. Developments in the gilt-edged market, in particular a gilts shortage and an inverted yield curve, have encouraged the growth of the domestic market in corporate debt. It has become more sophisticated in managing event risk, and the volume of issues is gradually enhancing liquidity.

Other capital issues were also substantial in 1989. This reflects the volume of management-buyout activity and a number of acquisitions by overseas companies of subsidiaries of UK companies (Chart 8).

Chart 8
ICCs' external borrowing



(a) Includes eurobond issues in sterling and foreign currency.
(b) Includes issues connected with management buyouts, with employee - based schemes and overseas direct investment in securities.
(c) Other overseas investment and other loans and mortgages.

Bank borrowing and company liquidity

Given a net borrowing requirement of £53 billion and total capital issues of just £17 billion, ICCs' recourse to banks in 1989 exceeded even the large 1988 figure. (A significant

Long-run movements in gearing

The gearing of UK industrial and commercial companies (ICCs) has risen sharply over the past two years. In explaining and assessing this, it is useful to look at longer-term movements in gearing. There are a number of ways of measuring gearing, of which three are examined here. The first is income gearing, defined as the ratio of interest payments to post-tax cash flow. Two measures of capital gearing, defined as debt at book value over net capital stock, are also illustrated, the one using historic, the other replacement cost capital stock. Net gearing is used throughout, as the sector has financial assets and liabilities. However, the typical firm is less likely to have both in large amounts, and these measures of gearing may therefore be unrepresentative of the position of individual firms.[1]

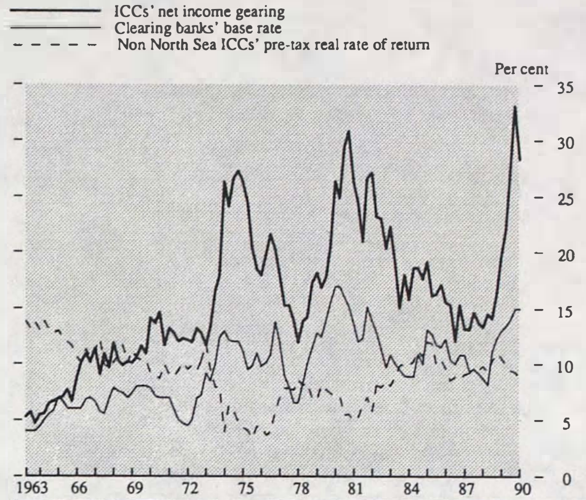
Given the relatively good rate of return, income gearing is currently unusually high (see chart). It is not unusual for income gearing to rise significantly as nominal interest rates rise, but on previous occasions when the ratio has been particularly high, profitability has been low. During 1989, profitability was relatively healthy. The fact that this was insufficient to offset high nominal interest rates suggests that the rise in indebtedness of the late 1980s was in some sense atypical.

Chart 10 (page 360) shows the two measures of capital gearing. It gives an indication of ICCs' indebtedness, which is now back at levels last seen in the early 1970s. The gap between the two measures widened during the 1970s as successive years of high inflation raised the replacement cost of the capital stock. Capital gearing was high in the late 1960s and early 1970s. Relatively high profitability, combined with quite low real interest rates and a favourable tax regime, encouraged debt finance. In the mid-1970s, however, a rapid rise in long-term interest rates and increase in their volatility curtailed the issue of long-term debt. A simultaneous slump in profitability deterred bank borrowing, as firms tried to limit their interest rate exposure and banks restricted lending.[2] For much of the 1980s capital gearing remained low. Profitability recovered but real interest rates remained high. Reforms to company taxation in 1984 (which reduced the corporate tax rate and therefore the advantage of tax deductible interest payments) also reduced the incentive for debt finance.

However, capital gearing rose sharply between 1987 and 1989. This was partly in response to the stock market crash of October 1987. Subsequently, low equity prices deterred share issues and encouraged a number of acquisitive firms to run down liquid assets. Net capital gearing therefore increased. The crash also led to a significant fall in short-term interest rates. Coinciding with a period of healthy profitability, this may have encouraged a further increase in short-term borrowing. Following the subsequent increase in short-term rates, firms have been reluctant to cut expenditure, in spite of short-term finance costs, suggesting that they expected the rise to be quickly reversed. Such expectations kept long-term rates lower and less volatile than in the 1970s, encouraging the issue of long-term debt. The result has been a rise in income gearing which is likely to be in excess of that desired by many firms.

Nevertheless, gearing in the United Kingdom has typically been lower than in some OECD countries, notably West Germany and Japan, and a number of theories suggest that higher gearing can be expected in this country too over the longer term. First, recent changes in the taxation of high income earners, including a

Income gearing



reduced upper marginal tax rate and a higher marginal tax rate on capital gains, have lessened the advantages to these individuals of retained earnings as opposed to distributions. This may stimulate issues of securities, including corporate bonds.

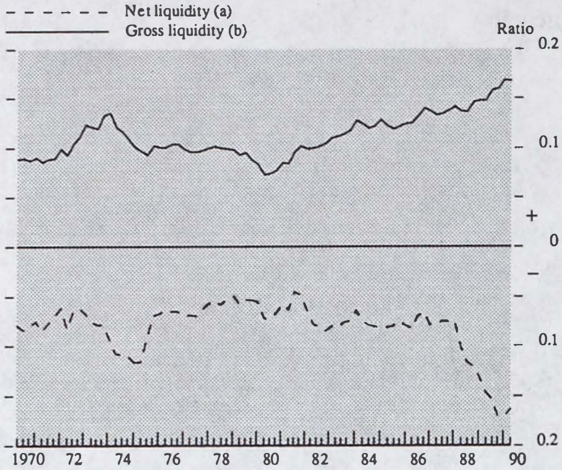
Second, it is argued that conflicts between managers and shareholders over a firm's investment strategy may have intensified in the 1980s. In such situations shareholders may support increased debt finance (and share buybacks), as this forces managers to pay out a large proportion of cash flow in interest payments, and enables them to invest only those funds provided by external capital markets.[3] Suggested causes of *heightened* conflict include increasing numbers of 'maturing industries' and conglomerates. In each case current cash flow may be substantial, but in 'maturing industries' there may no longer be profitable investment opportunities, while in conglomerates it is argued that such opportunities are not exploited, owing for example to diseconomies of scale. As a result shareholders wish to extract cash flow to invest in more profitable firms. Leveraged takeover activity is an example of financial restructuring that enables this to happen. Even if genuinely needed, such industrial reorganisation will, however, only be beneficial if shareholders act in the best long-term interests of the firm. As the continuing debate on short-termism suggests, this remains an open question.

Finally, higher gearing may also be expected if firms' ability to manage risk is improved. There is evidence to suggest that the proliferation during the 1980s of tools for management of interest rate risk has benefited larger firms. However, in economies where gearing has typically been higher than in the United Kingdom, much risk management has occurred through close relationships between the financial—principally banking— and corporate sectors. For example in the largest West German quoted companies banks typically hold a large proportion of votes at annual shareholder meetings and seats on the firm's supervisory board. There is little evidence that similar relationships have developed in this country.

Therefore, although there are some reasons to expect an increase in gearing over the long term in the United Kingdom, this is likely to be a gradual process and the recent substantial increase would appear to be outside any such trend.

(1) Data from Datastream show that in 1988 the income gearing (calculated using company account definitions) of a sample of 422 firms earning positive profits ranged from -74% to +123%.
(2) For detailed comment on this period see 'The financial behaviour of industrial and commercial companies, 1970-86' in the February 1988 *Bulletin*, pages 75-82.
(3) See Jensen, M C, 'Agency costs of free cash flow, corporate finance and takeovers', *American Economic Review*, May 1986.

Chart 9
ICCs' liquidity

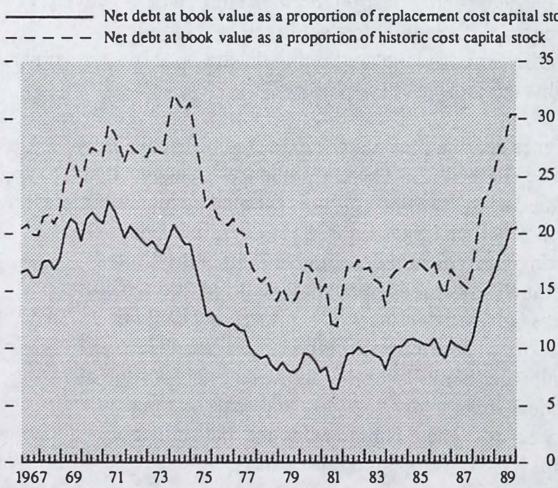


(a) Net liquid assets (liquid assets less bank lending) as a proportion of replacement cost capital base.
(b) Liquid assets as a proportion of replacement cost capital base.

tranche of lending also came from other loans and mortgages.) Although ICCs also accumulated substantial bank deposits, their net liquidity declined sharply in 1989, to levels much below the previous trough in 1975 (Chart 9). Exposure to interest rate changes has consequently increased still further.

The result of this increase in ICCs' indebtedness has been a rapid rise first in capital gearing and, more recently, as interest rates rose, in income gearing. This may in part reflect a longer-term move towards debt finance, stimulated by structural and institutional change (see the note on page 359). However, levels of gearing would currently seem to be well above any such long-term trend. Many UK companies would be in a difficult position today were profitability to decline sharply or unexpectedly (Chart 10).

Chart 10
ICCs' capital gearing



Diversity of experience

While national accounts data indicate the impact of the economic slowdown on profitability and gearing for ICCs as a whole, it is evident that the effect has varied substantially between firms, depending on sector and size. The response to tighter conditions has also not been uniform. Key differences affecting a firm's vulnerability or response include its closeness to the housing market, its access to export markets, its financial structure and the extent to which it experienced rapid adjustment in the early 1980s.

Given these factors it would appear that the non-manufacturing sector has been most severely affected by the recent tightening of monetary policy. Construction companies and retailers of durable goods have been directly affected by the slowdown in the housing market. Non-food retailers in general have also been affected by much reduced retail sales growth. Furthermore, many non-manufacturers, by the very nature of their business, are less able to direct production into export markets. However, it is notable that so far it is the manufacturing sector that has adjusted most. Employment in manufacturing, having risen between 1987 and the end of 1988, has fallen since, particularly in early 1990. Meanwhile, employment in services continued to rise throughout 1989. Similarly, recorded stocks in manufacturing fell sharply in the fourth quarter of last year while retailers and wholesaling recorded just a slight fall. It may be that this disparity reflects the caution of managers in manufacturing who, unlike their counterparts elsewhere, experienced severe retrenchment in the early 1980s and, as a consequence, have developed means of reacting rapidly to a changing economic climate.

Table D
Diversity of experience[(a)]

		1987	1988	1989
Operating profit	Small	32.9	14.0	6.2
(Percentage changes)	Medium	28.0	33.8	21.0
	Large	6.6	22.0	28.8
Overseas sales	Small	4.3	8.3	19.2
(Percentage changes)	Medium	13.9	15.0	32.2
	Large	6.2	14.2	36.3
Income gearing(b)	Small	10	18	33
(Per cent)	Medium	11	11	16
	Large	10	9	14
Net trade credit	Small	-5	-5	-6
obtained(c)	Medium	6	3	—
(Days)	Large	7	8	12

(a) Data from Extel. Sample consists of 286 companies, each of which reported in every year 1985-89. Small companies had a market valuation in June 1990 less than or equal to £20 million. Large companies had a June 1990 market valuation greater than or equal to £1 billion.
(b) This measure of income gearing is not directly comparable with that obtained from national accounts data, owing to differences in definition between these and company accounts.
(c) Defined as the ratio of creditors and bills to total sales minus the ratio of debtors and bills to total sales.

Firms of differing size have also had notably differing experiences in the past eighteen months. Table D, which is produced from company accounts data, shows key variables for three groups of companies whose reporting year ends on 31 December. It is noteworthy that large companies were the sole group to see operating profits grow faster in 1989 than in 1988. This group (which relies on overseas sales for a greater proportion of its earnings than any other) also saw the most rapid growth in overseas sales. In the meantime income gearing rose rapidly for all three groups. For the smallest, this is most likely to have reflected their relative dependence on bank finance, combined with some distress borrowing. These companies are likely to have cut investment expenditure sharply, although they were unable to increase the trade credit extended to them. For large companies, much borrowing was associated with takeover activity and substantial investment expenditure. The largest companies also increased their net trade debts.

Prospects

Despite some fall during 1989, ICCs' profitability remained healthy, particularly when compared with the recessionary periods of 1974–75 and 1980–81. Companies therefore responded by maintaining 'strategic expenditure' at high levels. Fixed investment and dividend payments each rose significantly, and cash expenditure on mergers and acquisitions was very high. As a result both the sector's financial deficit and its net borrowing requirement reached record levels. By the end of 1989 this had caused a marked rise in ICCs' financial exposure. Both income gearing and net liquidity had deteriorated sharply, and were at levels unusual for a period of reasonably healthy profitability. Given the voluntary nature of much expenditure, it is evident that many companies remain well able to manage in a tighter economic environment. This includes, in particular, those with good access to export markets. However, others have found themselves suffering from the combination of slowing demand and rising labour costs. Some indication of this is given in the liquidation figures for the first quarter of 1990 which show a 19% increase when compared with the previous quarter. For these sectors significant adjustment seems likely in 1990. Others, who are currently less affected, may nevertheless also retrench in order to reduce their exposure to any further tightening of monetary policy.

There are already some signs of adjustment, although not necessarily in sectors which have apparently been most affected by recent policy tightening. Perhaps as a result of experience in the early 1980s, manufacturing companies have reacted quickly, cutting stocks and shedding labour. More generally, although investment expenditure and dividend payments continued to be strong, domestic takeover activity was minimal in the first quarter of this year. It seems likely that many firms will also curtail investment and distributions somewhat this year, in order to reduce their borrowing requirement. However, as the recent DTI investment intentions survey suggests, adjustment is still expected to be much more modest than that seen in the early 1980s.