Profitability of large companies

This article presents estimates of company profitability since 1985 derived from the published accounts of a fixed sample of the largest UK companies. Measures of capital gearing, interest cover and dividend payments are also shown. These estimates complement and supplement those based on national accounts data which were published in the August 1990 Bulletin.

The figures show that the return on net assets[1] of large non North Sea industrial and commercial companies declined slightly in 1989, reflecting the first effects of the slowdown in economic growth in the United Kingdom. The most notable feature was the divergence between manufacturing and non-manufacturing: whereas the profitability of the former rose slightly, that of the latter fell back to the level of 1987, suggesting that the initial impact of the tightening of monetary policy was mainly on non-manufacturing sectors. Overall, capital gearing rose in 1989, although for manufacturing companies this coincided with a rise in interest cover, whereas non-manufacturing companies experienced a fall in interest cover. Dividend payments, as a proportion of earnings, rose marginally in 1989.

Introduction

The figures which form the basis of this article are derived from the published accounts of a fixed sample of around one thousand of the largest UK companies. The sample includes only companies whose published results were available in each of the five years 1985–89: consequently, new companies, companies which have been taken over or ceased trading in the period under review, and companies whose 1989 accounts were not yet available, are excluded. The sample may not reflect the experience and behaviour of the whole of British industry but rather indicates the average position of a fixed group of established large companies. It is probable that, overall, the companies in the sample are likely to have been less vulnerable to the slowdown in the domestic economy than the company sector as a whole because of their greater diversification of both activities and markets and their access to cheaper sources of financing. Although the theme of the article is similar to that of previous articles in this series[2] the data source and sample have changed so that it would be inappropriate to make direct comparisons with figures reported in earlier years. A fuller description of the data sources and definitions is given at the end of the article.

Return on capital employed

Developments in latest year

In contrast to the previous upward trend, the average return on capital employed for the sample companies declined slightly in 1989,[3] edging down from a peak of 19.4% in 1988 to 19.2%. This downturn reflected the beginnings of the slowing of economic growth in the United Kingdom, with the rise in interest rates restraining demand and leading to increased competition which, together with higher interest payments and wage costs, put pressure on domestic margins. A notable feature of the fall was the differing experience of manufacturing and non-manufacturing companies. Whereas the average return on capital of manufacturing companies recorded a further, albeit more modest, increase in 1989, that of non-manufacturing companies fell back to around the level of 1987 (Chart 1). This is consistent with evidence from other sources that the initial impact of the tightening of

Return on capital employed[a]

Per cent

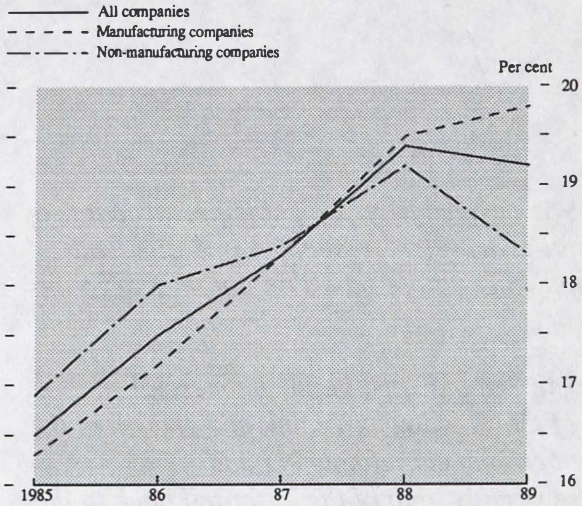
	1985	1986	1987	1988	1989
Manufacturing	**16.3**	**17.2**	**18.3**	**19.5**	**19.8**
Food, drink and tobacco	16.7	17.1	17.4	17.4	17.2
Chemicals and pharmaceuticals	17.7	19.8	21.1	25.8	26.5
Motor vehicles	11.1	14.6	13.7	17.1	18.6
Mechanical engineering	12.6	16.1	17.1	16.2	19.2
Electrical engineering (including aerospace)	17.8	16.6	19.2	19.8	20.9
Building materials	14.8	15.7	17.3	20.0	22.6
Textiles	16.1	19.1	19.2	21.1	16.4
Publishing, printing and paper	16.6	16.7	17.3	18.1	16.5
Household goods	12.9	15.0	18.4	22.0	19.0
Metallurgy and metal forming	12.1	16.1	18.9	20.7	20.7
Other manufacturing	12.4	14.8	15.8	17.6	17.6
Non-manufacturing	**16.9**	**18.0**	**18.4**	**19.2**	**18.3**
Civil engineering and construction	10.3	13.8	13.8	16.7	18.1
Retailing and distribution:					
Food	23.6	23.6	23.1	22.4	20.9
Stores	18.1	17.8	20.8	20.1	19.2
Other	15.5	16.1	18.4	21.7	21.8
Transport and freight	14.6	16.3	15.0	15.1	14.8
Other non-manufacturing	17.7	18.4	18.3	19.5	18.0
All companies	**16.5**	**17.5**	**18.3**	**19.4**	**19.2**
Number of companies analysed			987		

Source: Extel Financial Ltd.

(a) Weighted averages of the historical cost profit before interest and tax, including the profit from associated companies and investments in liquid and other non-trading assets, on closing capital employed.

(1) Weighted average of the historical cost profit before interest and tax, over the end-year book value of net assets.
(2) Previous articles were published in the September 1985, September 1986, November 1987, November 1988 and November 1989 *Bulletins.*
(3) Includes company results for financial years ending between April 1989 and March 1990.

Chart 1
Return on capital employed [(a)]



(a) Weighted average of profit before interest and tax, on closing capital employed.

monetary policy from 1988 was on consumption rather than investment which, in general, would have had a more marked effect on non-manufacturing sectors. In addition, manufacturing companies were on average less vulnerable to the slowdown in the UK economy because more of their income was derived from exports, which benefited in 1989 from generally buoyant world markets and a weakening exchange rate. More than a quarter of the turnover of manufacturing companies in the sample was in overseas markets in 1989, compared with around 15% for non-manufacturing companies.

Within the manufacturing group, however, as the table shows, there were wide differences between sectors. The largest increases in profitability in 1989 were recorded by mechanical engineering companies and manufacturers of building materials. In contrast, textile manufacturers and producers of household goods experienced significant declines in profitability. Textile companies suffered both from the weakening of domestic demand in 1989 and from strong import competition, while the slowdown in the housing market particularly affected manufacturers of household goods such as furniture and carpets. Most sectors within the non-manufacturing group showed declines in their return on capital in 1989. The only non-manufacturing group which significantly increased profitability in 1989 was civil engineering and construction which, in common with the manufacture of building materials, was still benefiting from the tail end of the property boom. Results for the current year, however, are likely to show a sharp decline in profitability, reflecting the general weakness in both the residential and the commercial property market.

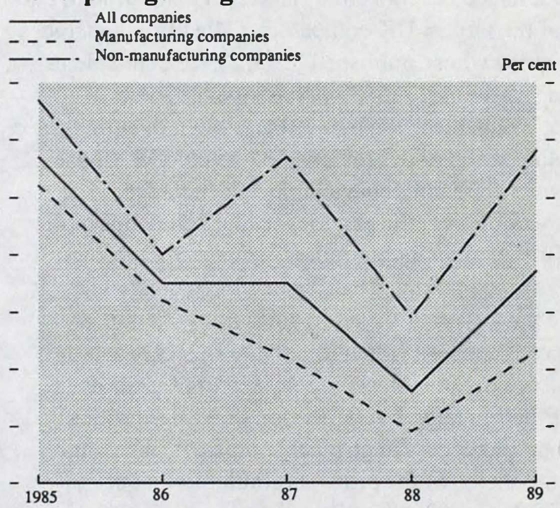
Changes since 1985

The average rate of return on capital employed for non-oil industrial companies rose steadily between 1985 and 1988 but edged back in 1989. During the five years to 1989, the average profitability of manufacturing companies has grown faster than that of non-manufacturing groups, a trend which was particularly pronounced in 1989, although there was a wide diversity between sectors within these two main groupings. Sectors which have shown the strongest growth in profitability include civil engineering and construction; metallurgy and metal forming; manufacture of motor vehicles; manufacture of building materials; and mechanical engineering. Sectors where the growth of profitability has been well below the average include food retailing; publishing, printing and paper; transport and freight; textiles; and food, drink and tobacco.

Capital gearing

Capital gearing[(1)] increased sharply in 1989 to 21.7%, reversing the fall recorded in the previous year (Chart 2). The rise reflected growth of 37% in total net debt during 1989, compared with an increase of 24% in total capital. The sharp increase in borrowing can in part be explained by continued strong growth in investment expenditure and also by a record value of acquisitions, most of which were cash financed, requiring either borrowing or a rundown in liquid assets. It is notable that whereas for manufacturing companies the rise in capital gearing in 1989 was accompanied by increased profitability and interest cover, non-manufacturing companies, whose gearing increased more sharply, experienced a fall in profitability and interest cover.

Chart 2
Net capital gearing [(a)]

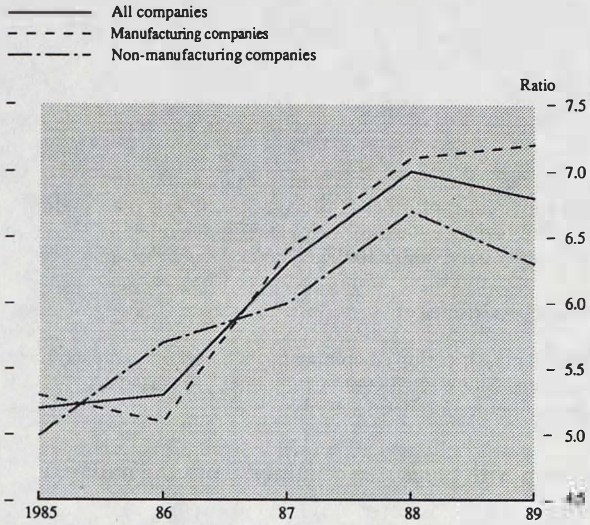


Interest cover

After rising in each of the previous three years the average interest cover[(2)] of companies in the sample declined from 7.0 in 1988 to 6.8 in 1989 (Chart 3). Interest payments increased by an average of 25% in 1989. The large increase in borrowing noted above suggests that the rise in interest charges was mainly due to a higher debt burden rather than a significant rise in the average cost of borrowing. Indeed,

(1) Weighted average of end-year net debt (total debt *less* cash) over end-year net capital employed (total capital employed *less* cash).
(2) Weighted average of profits before interest and tax divided by gross interest payments (excluding capitalised interest).

Chart 3
Interest cover[(a)]



(a) Weighted average of profits before interest and tax, divided by gross interest payments.

larger companies may have been less affected than smaller companies by the rise in UK interest payments because the former are likely to have greater access to a wider range of sources and types of borrowing, including fixed-rate and foreign currency loans.

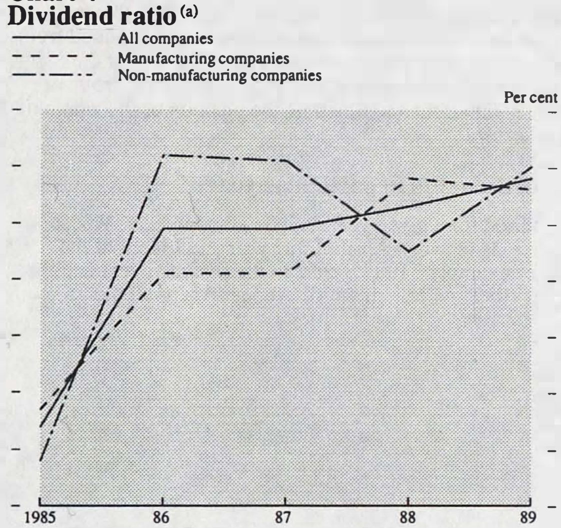
As already noted, the picture for manufacturing and non-manufacturing companies was somewhat different in 1989. Whereas manufacturing companies increased their interest cover, for non-manufacturing companies the rise in interest payments exceeded the growth in earnings, providing further evidence that non-manufacturing sectors have been hardest hit by the tightening of monetary policy. Retailing stores and, to a lesser extent, manufacturers of household goods and textiles suffered the sharpest declines in interest cover in 1989.

Although the average figure for interest cover in 1989 appears high at 6.8 and may suggest that companies could easily service their borrowing, it should be stressed that these figures reflect averages for large and continuing companies. Furthermore, the figure represents an average over the company's financial year and it is likely that interest cover weakened during the year. National accounts data, for example, suggest that, for the non North Sea industrial and commercial company sector as a whole, interest cover fell sharply during 1989 from around 5 to around 3 by the end of the year.

Dividend ratio

In 1989 the dividend payout ratio[(1)] increased marginally from 35.3% to 35.8%, following a similar increase in the previous year. The small increase in the dividend ratio occurred despite a fall in profitability which suggests that companies strive to increase, or at least maintain, dividends as a demonstration of future financial wealth. Within the total, the behaviour of manufacturing and non-manufacturing companies was sharply different, as it had been in the previous year (Chart 4). Whereas manufacturing companies reduced the proportion of their earnings paid in dividends, there was an increase in the ratio for non-manufacturing companies. This pattern probably reflects the general practice of companies to maintain even and steady growth of dividends, whereas earnings may be variable from year to year. (Recent movements in the dividend payout ratio reported here are markedly different from those obtained from the national accounts which were analysed in the August *Bulletin.* This is because of differences of both coverage and definitions between the national accounts and the sample of companies derived from Extel.)

Chart 4
Dividend ratio[(a)]



(a) Weighted average of ordinary dividends, over earnings after interest, tax and preference shares.

(1) Weighted average of the ratio of ordinary dividends to earnings (after preference dividends).

Notes and definitions

Sample of companies

The estimates of profitability and gearing presented in this article are derived from the published accounts of a fixed sample of 987 of the largest UK industrial and commercial companies, which are made available in a computerised form by Extel Financial Limited. Companies included on the Extel database are either quoted on the International Stock Exchange or private companies included in the Times 1000. Companies whose accounts were unavailable for one or more of the years 1985–89 were omitted. The sample therefore excludes companies that failed, companies that were taken over, companies that obtained a listing during the period, and companies whose 1989 accounts were not yet available. Although this may create a bias in the results when compared with those obtained from national accounts data for the sector as a whole, the aim of the exercise has been to examine the position of a particular group of large companies rather than to illustrate the position of the whole of the company sector.

Allocation of accounts to particular years

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, '1989' refers to the financial year ending between April 1989 and March 1990. About 40% of all the companies in the sample have accounting years ending in December and around a further 15% have accounting years ending in March. The 'average' year to which the figures relate is therefore broadly comparable to the calendar year 1989.

Industrial classification

The industrial classification of companies is based on that used by the International Stock Exchange. Companies are classified according to their predominant activity.

Comparison with measures obtained from the national accounts

Apart from differences in coverage mentioned above, results obtained from company data will differ from those obtained from the national accounts because of definitional differences in underlying data. Probably the most important of these is that measures of profitability derived from national accounts typically cover just the domestic activities of UK companies, that is, they cover only the income derived from the UK capital stock, whereas those derived from company accounts cover overseas as well as domestic activities.