Profitability of large companies

Introduction

The figures which form the basis of this article are derived from the published accounts of a sample of around 1,400 of the largest UK companies. Although the theme of the article is the same as that of previous articles in this series,[1] it is not possible to make direct comparisons with figures published in earlier years because of significant changes to the sample of companies. A fuller description of the data sources and definitions is given at the end of the article. It is intended that in future years this article will be amalgamated with that analysing company profitability and finance which appears in the August *Bulletin*.

Return on capital employed

Against the background of a sharp slowdown in domestic demand and output growth, the average return on capital employed[2] for the sample companies, based on historical costs, declined to 15.1% in1990,[3] although the fall was less steep than in 1989 (Table A). The return on capital employed declined for the third successive year from a recent peak of 18.7% in 1987. Profits (before interest and tax) grew by 8% in 1990, which was much lower than in recent years (Table B). The growth of operating profit in 1990 was even lower, at 5.6%, reflecting lower sales growth and a reduction in gross margins from 9.8% to 9.0%. Exports, which accounted for nearly a quarter of total sales in 1990, continued to show stronger growth than domestic sales.

Table A
Return on capital employed[a]

Per cent

	1986	1987	1988	1989	1990
Manufacturing:	**18.1**	**19.4**	**19.5**	**17.1**	**16.2**
Food, drink and tobacco	17.4	17.3	16.9	12.5	12.5
Chemicals and pharmaceuticals	20.7	24.8	25.3	24.8	23.3
Motor vehicles and components	12.2	16.6	18.2	18.1	16.1
Mechanical engineering	16.0	15.9	18.8	19.3	18.7
Electrical engineering	19.7	22.3	21.8	20.5	21.1
Building materials	17.7	20.6	23.6	20.0	14.7
Textiles	18.8	20.6	15.6	14.6	13.5
Publishing and printing	20.1	22.0	17.0	17.9	17.9
Packaging and paper	16.0	16.7	17.2	16.5	14.8
Household goods	18.7	22.7	10.6	16.7	10.8
Metallurgy	13.9	16.3	17.7	15.1	9.1
Aerospace	14.4	8.0	13.4	14.2	16.4
Other manufacturing	21.0	22.5	23.4	23.0	21.1
Non-manufacturing:	**17.7**	**18.0**	**16.9**	**14.9**	**13.8**
Civil engineering and construction	12.7	14.3	14.0	11.3	6.6
Retailing and distribution:					
Food	24.8	22.0	21.1	20.5	20.0
Stores	19.9	19.3	18.3	16.2	16.0
Other	18.1	20.9	19.6	16.7	14.5
Transport and freight	14.0	12.7	12.5	12.4	9.9
Hotels and caterers	9.7	8.9	8.1	7.8	7.2
Industrial conglomerates	14.7	19.0	17.6	16.3	15.1
Broadcasting and leisure	16.3	16.4	14.8	14.3	13.1
Support services	22.4	19.6	21.0	26.8	23.7
Telecommunications	21.1	21.7	20.6	18.6	21.5
Media agencies	29.5	30.9	22.0	12.3	14.6
Water	10.2	10.7	11.4	10.1	11.6
Other non-manufacturing	21.8	23.0	21.7	18.8	13.0
All companies	**17.9**	**18.7**	**18.2**	**16.1**	**15.1**
Number of companies analysed			*1,437*		

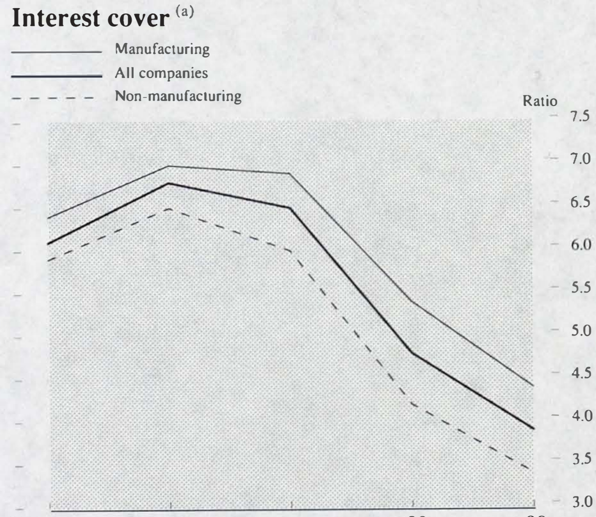
(a) Weighted average of the historical cost profit before interest and tax, including the profit from associated companies and investments in liquid and other non-trading assets, over the end-year book value of net assets.

Table B
Average growth rates and ratios

Percentage changes

	1986	1987	1988	1989	1990
Profit & loss account					
Sales	-3.9	5.1	12.2	23.1	15.1
United Kingdom	-0.7	2.0	11.8	23.1	13.7
Overseas	-15.2	17.6	13.6	23.2	19.9
Operating profit	8.7	13.7	18.4	25.1	5.6
Operating profit margin	8.4	9.1	9.6	9.8	9.0
Non-trading income	2.2	6.5	16.3	29.8	18.9
Profits before interest and tax	7.4	12.6	17.7	26.1	8.0
Interest charge	-12.2	2.8	21.6	66.7	32.0
Interest cover	6.1	6.8	6.5	4.8	3.9
Earnings	14.4	16.2	18.2	19.4	1.4
Ordinary dividends	13.5	16.7	20.4	33.9	20.3
Payout ratio	33.8	34.3	34.5	39.1	46.6
Balance sheet					
Equity	2.3	10.8	18.6	24.7	14.5
Total loans	5.8	4.4	29.1	52.9	17.6
Short-term	1.7	1.6	23.2	51.3	17.6
Long- and medium-term	8.1	5.9	31.6	53.8	17.8
Net assets	2.9	8.0	20.6	43.1	15.4
Net capital gearing(per cent)	21.6	19.7	22.6	25.6	25.6
Memorandum item					
Producer output prices	4.3	3.9	4.5	5.1	5.9

Chart 1
Interest cover [(a)]



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

(1) Previous articles were published in the September 1984, September 1985, September 1986, November 1987, November 1988, November 1989 and November 1990 *Bulletins*.

(2) Weighted average of the historical cost profit before interest and tax, over the end-year book value of net assets. Historical cost accounts are taken to include modified historical cost accounts which include the revaluation of certain assets, mainly land and buildings.

(3) Includes company results for financial years ending between April 1990 and March 1991.

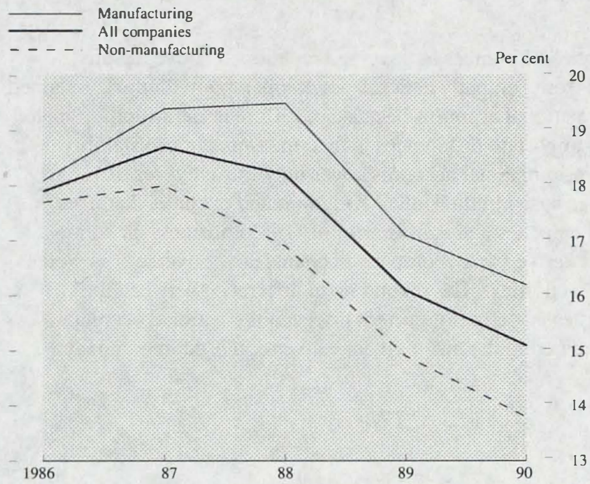
After interest and tax charges, earnings growth slumped to only 1.4% in 1990 compared with average growth of 17% in the previous four years. Despite the marked slowdown in profits, dividend payments increased by 20% in 1990. Consequently, the dividend payout ratio[1] rose to 47%, from 39% in 1989.

Within capital employed, debt continued to grow faster than equity. Since 1987, average bank borrowing has more than doubled and, because of higher interest rates, interest payments have increased even faster. Interest cover[2] fell from 4.8 to 3.9 in 1990, compared with 6.8 in 1987 (Chart 1).

Sector profitability

The average return on capital employed of both manufacturing and non-manufacturing companies in the sample declined in 1990 owing to the onset of recession, which affected most sectors (Chart 2). The sectors recording the most significant decreases in 1990 were metallurgy, household goods, building materials, and civil engineering and construction. The sharp fall in the average return on capital in the metallurgy sector probably reflects a significant slackening of demand as production of cars and white goods declined in 1990, together with a more widespread destocking of steel. The falls in the estimates of profitability for manufacturers of building materials and the civil engineering and construction sector are linked to the sharp drop in housebuilding. In addition, competition increased as the volume of total construction work declined in 1990, resulting in further pressure on margins. Manufacturers of household goods suffered from the collapse of consumer demand, particularly for electrical goods and furnishings, as a result of high interest rates and the slump in the housing market.

Chart 2
Return on capital employed [(a)]



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

In the period under review, rates of return on capital for most sectors peaked in 1987–88. The decline in profitability since then occurred first among non-manufacturing companies. Sectors showing the largest declines in profitability since 1987–88 include media agencies, household goods, building materials, metallurgy, civil engineering and construction, and textiles. A combination of factors, including intense overseas competition and the recent downturn in consumer demand, which particularly affected the carpet industry, have led to a decline in the average profitability of textile companies.

A number of sectors have shown a continuous downward trend in return on capital since 1986—namely, food, drink and tobacco, food retailing, stores, and transport and freight. In contrast, a few sectors, namely, aerospace, water, and telecommunications, have not followed the general trend and have maintained or increased their return on capital.

(1) Ordinary dividends expressed as a percentage of profits after tax, interest and preference dividends.
(2) Weighted average of profits before interest and tax, divided by gross interest payments.

Notes and definitions

Sample of companies

The estimates of profitability presented in this article are derived from the published accounts of a sample of 1,437 of the largest UK industrial and commercial companies, which are made available in a computerised form by Extel Financial Limited. The average sales of the sample companies is around £370 million and the average number of employees around 5,700. Companies included on the Extel data base are either quoted on the International Stock Exchange or private companies included in the Times 1000.

Only the consolidated accounts of parent companies are included in the sample: subsidiaries are excluded to avoid double counting. The sample also excludes companies which are not actively trading. Consequently, companies in receivership or liquidation or which have been taken over since 1986 are excluded. The composition and number of companies will vary from year to year as new companies join the sample. Estimates for 1990 should be regarded as more tentative than earlier years because the latest year's accounts for around 200 companies were not yet available.

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, '1990' refers to the financial year ending between April 1990 and March 1991. About 40% of all the companies in the sample have accounting years ending in December and around a further 25% have accounting years ending between December and March. The 'average' year to which the figures relate is therefore broadly comparable to the calendar year 1990.

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 are not comparable with those obtained from the national accounts because of different definitions. One of the most important differences is that measures of profitability derived from national accounts cover only the activities of companies based in the United Kingdom and exclude, therefore, overseas branches and subsidiaries of UK companies. In contrast, estimates derived from company accounts cover overseas as well as domestic activities. The second main difference between the two data sources is the use of current prices in the national accounts data compared to the historic cost convention used in company accounts.