Company profitability and finance

This article reviews the performance of UK industrial and commercial companies during 1991. The main points include:

- *Total company income fell by 3% in 1991,*[1] *largely owing to a 12% decline in income from abroad.*
- *Gross trading profits*[1] *were 5% lower than a year earlier (or 0.6% lower if the newly privatised electricity companies are included); but profitability remained higher than in previous recessions.*
- *Despite the fall in income, industrial and commercial companies reduced their financial deficit from £24 billion in 1990 to £11 billion in 1991.*
- *This has been achieved through stringent cost control measures. Employment levels have been reduced and spending on investment and stockholdings has been cut back.*
- *Companies have also repaid bank borrowing and increasingly turned to the capital markets for finance.*
- *Consequently the net liquidity of the corporate sector has improved, reducing worries about financial fragility.*
- *Company insolvencies, however, have continued to rise, increasing by 45% in 1991.*

Introduction

Industrial and commercial companies (ICCs) have made considerable progress in adjusting to the downturn in the United Kingdom and overseas. Although trading profits have fallen, profitability has remained higher than in previous recessions. ICCs' financial deficit has also narrowed sharply. Wage settlements have been reduced and companies have shed labour, cut back spending on capital equipment and reduced holdings of inventories. The recession, however, has affected some companies more than others. The construction and property sectors, for example, have been particularly badly hit.

Profit margins and profitability

Encouragingly, manufacturers appear to have been able to maintain their domestic profit margins in 1991 at the previous year's level (Table A). This was largely made possible by a slowdown in the growth of labour costs during 1991 and a fall in input prices. Both manufacturing and service sector employment have fallen. This represents a continuation of a trend observable in manufacturing throughout the 1980s, but a partial reversal of the previously steady expansion of service sector employment.

It is somewhat surprising, nevertheless, that margins did not fall further and it may be that the output price series have not fully captured the price discounting which is likely to have taken place at this stage of the cycle. Consequently, prices, and therefore margins, may have been lower than official data suggest.

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 (c)	Margins (residual)(b)	Output prices
	1	*2*	*3=2-1*	*4*	*5*	*6=7-(3+4+5)*	*7*
1981	2.0	6.4	4.4	2.9	2.8	-2.7	7.5
1982	3.1	4.4	1.3	2.3	1.1	2.2	6.9
1983	3.6	3.7	0.1	2.6	0.9	1.8	5.4
1984	2.7	3.5	0.8	3.0	1.1	0.3	5.2
1985	1.6	3.5	1.9	1.0	1.1	1.7	5.7
1986	1.7	3.1	1.5	-3.4	0.8	5.3	4.1
1987	3.0	3.4	0.3	1.7	0.8	1.6	4.4
1988	2.7	3.6	0.8	1.6	2.0	0.4	4.8
1989	1.9	3.7	1.8	1.8	2.2	-0.4	5.4
1990	0.3	4.1	3.8	-0.3	2.3	0.2	6.0
1991	0.2	3.7	3.5	-0.7	2.2	0.0	5.0

(a) Excluding food, drink and tobacco.
(b) Figures may not add to totals because of rounding.
(c) Proxied by unit labour costs in the service sector.

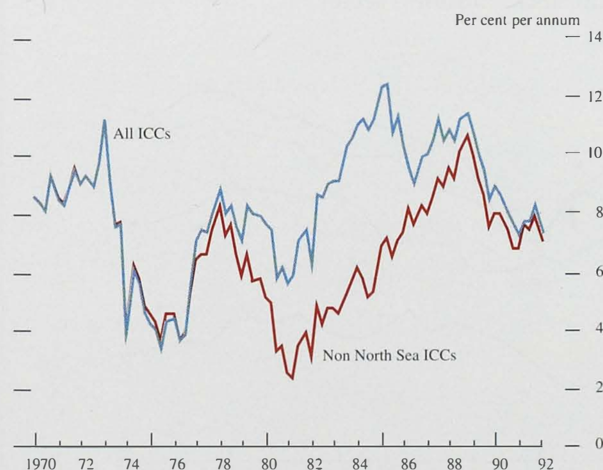
(1) Net of stock appreciation.

By comparison, manufacturers' export margins were pared back sharply during 1991 as firms strove to maintain price competitiveness and market share against a background of worsening labour cost competitiveness and weakening overseas demand.

In spite of a moderation in unit wage cost growth in the rest of the economy during 1991, many non-manufacturing sectors are likely to have reduced their profit margins in response to the fall in domestic demand. In particular, there has been widespread evidence of extended sales periods and sharp price discounting, especially in the clothing and durable goods sectors.

The impact of the recession has been especially acute on the construction and property sectors. The volume of construction output declined sharply last year, and is now 14% below its peak in the first quarter of 1990. The resulting increase in competition for orders has led to substantial price cutting—a recent Financial Times survey suggested that prices may have fallen by up to 30% since 1989, with contractors in some cases operating at a loss.

Chart 1
ICCs' profitability (a)



(a) Pre-tax real rate of return.

As can be seen in Chart 1, ICCs' profitability (or real rate of return) fell from a peak of 11.5% in 1988 to 7.3% in the first quarter of 1991 and has subsequently remained around this level. This overall reduction in profitability has been at least as severe as seen in the previous recession when profitability fell from a peak of 8.9% to a trough of 5.6%. Profitability in aggregate has, nevertheless, remained high by historical standards. For the non North Sea sector the fall in profitability has not been as extreme as during the previous recession. By the second quarter of 1981 profitability had fallen by six percentage points in just over three years to 2.4%, compared with a fall of four percentage points to 6.7% between the fourth quarter of 1988 and the first quarter of 1991. The box on page 300 makes cross-country comparisons of the rate of return to capital in the 1980s.

Income and appropriations

If the electricity companies which were privatised in December 1990, March 1991 and June 1991 are excluded, ICCs' gross trading profits (net of stock appreciation) fell by 5% in 1991 (see Table B)—or by only 0.6% if the privatised companies are included. From a trough in the first quarter they improved steadily during the year and, even after falling significantly in the first quarter of this year, they were still higher than a year previously. Gross trading profits of North Sea oil companies fell by 10% last year as maintenance work closed a number of oil fields over the summer period.

Table B
ICCs' income and appropriation accounts (a)

£ billions

	1988	1989	1990	1991
Total income (b)	**92.7**	**102.7**	**107.3**	**104.0**
Gross trading profits (b)	69.7	72.7	74.8	74.3
Non North Sea (b)	62.9	66.2	67.7	68.0
North Sea (b)	6.9	6.6	7.0	6.3
Rent and non-trading income	9.1	11.9	14.6	13.9
Income from abroad	13.8	18.1	17.9	15.8
Allocation of income				
Dividends on ordinary and preference shares	14.9	19.0	20.7	22.1
Interest and other payments	15.5	24.7	30.0	28.2
Profits due abroad	7.4	8.2	7.5	6.6
UK taxes	15.4	19.2	18.3	14.8
Undistributed income (b)	**39.4**	**31.7**	**30.8**	**32.3**
Capital transfers	-0.2	0.4	0.4	0.2
Fixed investment	43.1	51.9	55.0	48.3
Physical increase in stocks	4.5	2.7	-0.7	-4.9
Financial balance (surplus +)	**-7.9**	**-23.4**	**-24.0**	**-11.3**

Source: Central Statistical Office.

(a) Including newly privatised companies.
(b) Net of stock appreciation.

In contrast to the previous few years, ICCs' total income was not boosted by a rise in income from other domestic sources in 1991. Rent and non-trading income eased back slightly from its level in 1990 as nominal interest rates declined and the property market weakened. On average, the rate on three-month money was more than three percentage points lower in 1991 than in 1990, so that the contribution of non-trading income to the growth of total income was smaller than it had been in the previous two years. Income from abroad fell more markedly in 1991 by 12%—as the United Kingdom's overseas markets witnessed a pronounced slowdown.

Despite a £3 billion fall in total income (net of stock appreciation), ICCs raised their aggregate dividend payments in 1991 by 7% with a further strong rise in the first quarter of this year. This represents a further moderation in the growth of dividend payments which increased by 9% in 1990, having risen strongly in the late 1980s, but was nevertheless surprising against a background of severely restrained profitability.

The dividend payout ratio, defined as the ratio of dividend payments to total corporate income after deducting tax and interest payments, fell during the year but on average was

International comparisons of the rate of return to capital

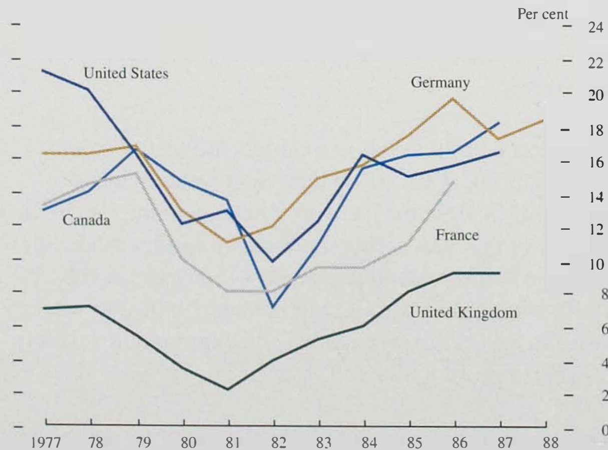
Most measures of the rate of return to capital (defined as the ratio of profits to capital employed) show a general improvement in performance among the major economies over the 1980s. This has been particularly marked in manufacturing, but rather less so in broader definitions of enterprise.

Limited data make it more difficult to establish the *relative* rate of return across countries. This would give an indication of the relative incentive to invest in different economies. But, although data exist for most of the major economies, both for manufacturing and more broadly defined business sectors, the divergent assumptions in any measure of the rate of return to capital mean that cross-country comparisons are subject to a degree of uncertainty. Furthermore, new investors in any economy may be able to achieve a return which deviates from the average measures assessed here.

Problems in data arise both in defining profits and capital stock. This box uses figures for the net rate of return, so that profits are defined net of capital consumption, and the capital stock net of cumulative capital consumption. Of the various sources of data inconsistency, one of the most important is the widely differing assumptions each country makes as to the life of its capital stock. For example, the United Kingdom's capital stock is assumed to have a service life of 28 years, the longest of the major economies and compared with 11 years in Japan, the shortest. It is unlikely that such widely diverging assumptions are entirely justified. It can be shown that, as long as gross profits exceed gross investment, then assuming a capital life which is longer than is actually the case will bias downwards the rate of return. Being the county with the longest assumed capital life, this source of bias may be more important for the United Kingdom than other countries.

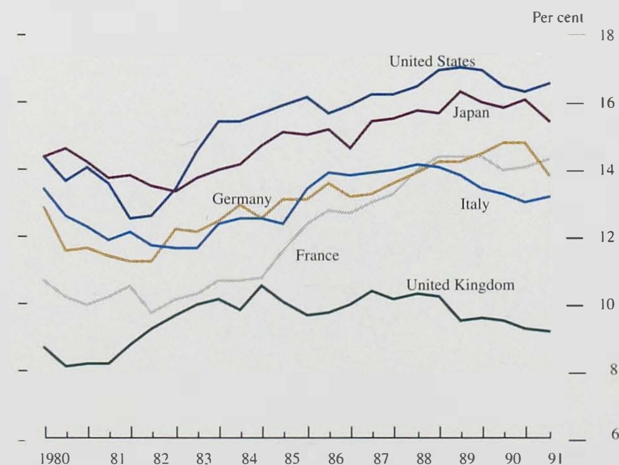
Chart A shows the rate of return in manufacturing in the G5 countries, as measured in the OECD 'National Accounts'. Although the estimated rates are subject to a number of uncertainties, they are not as sensitive as is the *relative* rate of return to the assumptions discussed above. As the chart shows, manufacturers' rate of return in the major industrialised counties improved markedly in the 1980s. Although the *measured level* of the UK manufacturing sector's rate of return has remained the lowest of the major economies, it improved sharply over the 1980s, increasing by 5.8 percentage points between 1980 and 1987, more than any of the other major economies for which data are available. This reflected strong increases in UK profit margins during the 1980s, supported by sustained economic growth and rising capacity utilisation.

Chart A
Net operating surplus as a proportion of the net capital stock: manufacturing



Source: OECD National Accounts.

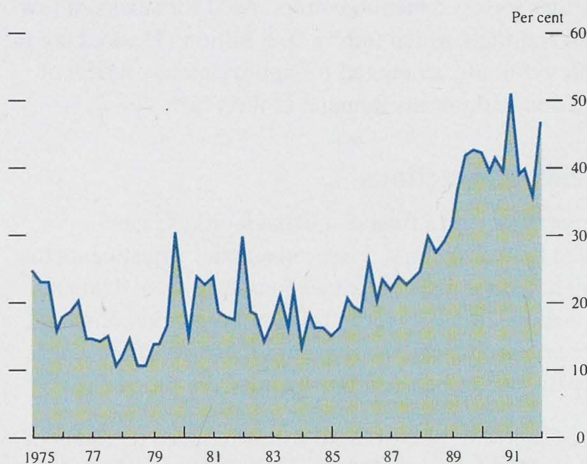
Chart B
Net operating surplus as a proportion of the net capital stock: business sector



Source: OECD Economic Outlook.

Chart B shows the OECD 'Economic Outlook' measure for the business sector rate of return in the G7 countries. This sector is more broadly defined than manufacturing and the data are more timely. The levels of the rates of return began the 1980s higher than in manufacturing, but remained flatter. This was therefore a period in which manufacturing performance improved faster than other sectors. The measured UK business sector rate of return is lower than those of other major economies and is broadly flat, varying between a minimum of 8.2% in 1981 and a peak of 10.3% in 1985. However, as in manufacturing, the measured rate of return for the United Kingdom may be biased downwards relative to other countries.

Chart 2
ICCs' dividend payout ratio (a)



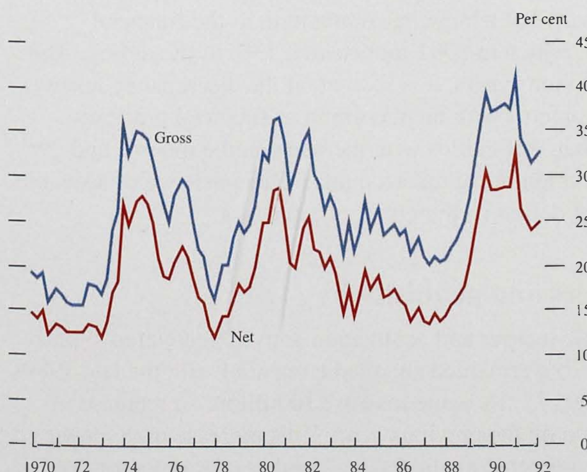
(a) Dividend payments on ordinary shares as percentage of income after deducting tax and interest payments.

still slightly up on 1990 (see Chart 2). A large rise in dividends in the first quarter of 1992 reversed this gradual decline but may have partly reflected a shift in the timing of payments compared with a year earlier. The dividend payout ratio remains high by historical standards. This suggests that, even at the current stage in the economic cycle, managers may feel obliged to continue a consistent dividend policy in order to provide shareholders with a constant income stream and also minimise the threat of takeover.

The relative strength of the ratio, however, masks a diverse industrial picture. From a sample of 1,000 large companies from the Extel database it appears that over 12% of the sample paid no dividend at all in 1991 and a further 27% cut their dividend compared with a year earlier. The most severely constrained sectors were those connected with the construction and property markets and those related to the investment sector, although evidence of dividend cuts appeared across a broad industrial spectrum.

Although ICCs' income fell by 3% in 1991 (net of stock appreciation), their tax payments were almost one-fifth lower than a year earlier. Tax changes announced in the 1991 budget will have been the reason behind some, albeit a minor part, of the fall. The main rate of corporation tax was reduced to 34% in the 1990/91 financial year and the period for which trading losses could be carried back was extended from one to three years. In addition, corporation tax payments tend to be very sensitive to the cycle. The strong rate of investment growth enjoyed in the late 1980s and in early 1990 will have generated a large amount of allowances to be offset against a weakening profits trend. Petroleum revenue tax payments also fell sharply in 1991.

Chart 3
ICCs' income gearing (a)



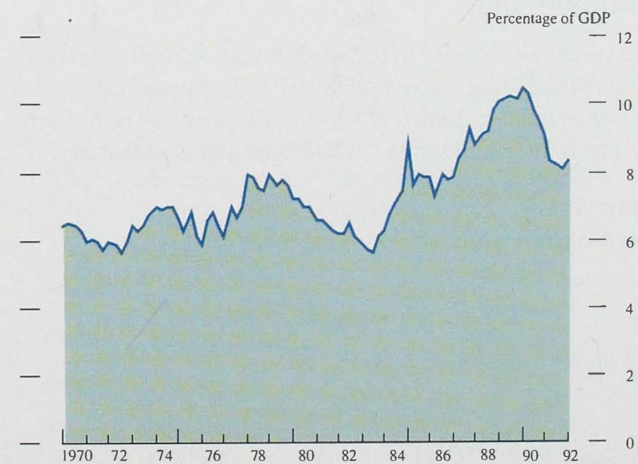
(a) Ratio of interest payments to income.

The fall in ICCs' stock of outstanding bank borrowing and lower nominal interest rates led to a reduction in ICCs' interest payments to £28 billion, almost £2 billion lower than in 1990. As a result, as Chart 3 shows, income gearing declined during the year from its historically high level in 1990.

Capital expenditure

Many firms have reacted to weaker demand by cutting back capital expenditure. Gross domestic fixed capital formation by the corporate sector fell last year by 16% in nominal terms compared with 1990 (and by 12% if the privatised electricity companies are included).

Chart 4
ICCs' gross domestic fixed capital formation

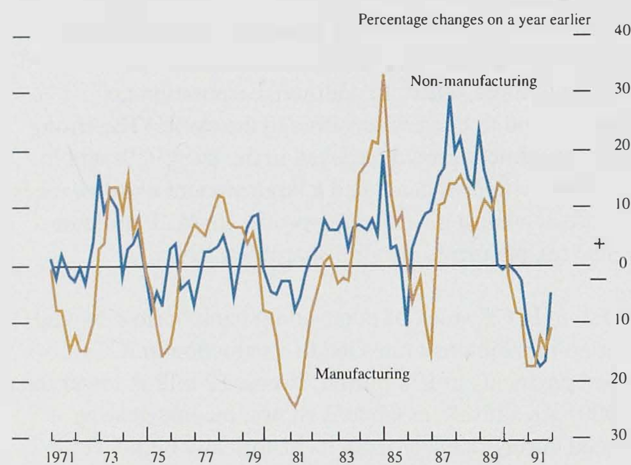


One reason for such a large fall may simply have been continued adjustment from previously very strong rates of investment. As can be seen in Chart 4, although the fall in investment has been steeper than in previous recessions, as a proportion of GDP investment is not at a historically low level, and remains higher than in the early and mid-1980s.

There was an increase in investment in the first quarter of this year, although survey evidence, including from the CBI, suggests that investment is still being inhibited by uncertainty over the timing of the recovery.

In contrast to previous recessions when manufacturing suffered most from weakening demand, it is notable that non-manufacturing investment has fallen equally sharply

Chart 5
Investment in manufacturing and non-manufacturing

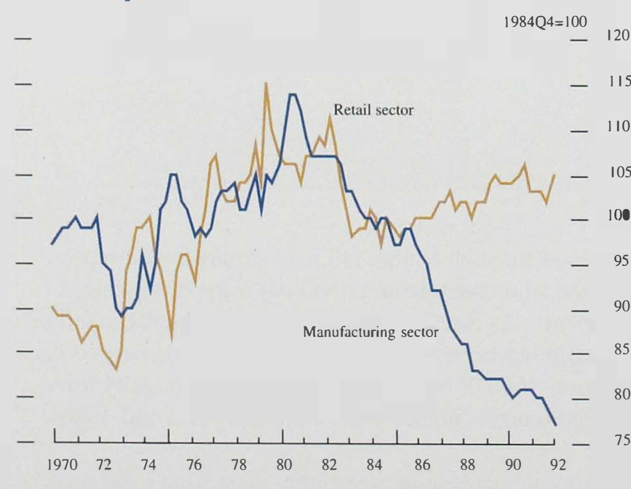


(see Chart 5). The sample of 1,000 large companies mentioned above provides a more disaggregated view of sectoral performance and shows that investment by construction and property companies, which generally tends to be highly cyclical, has fallen very sharply in this recession. Those sectors connected with the production and sale of consumer durables have also made substantial reductions in investment. By contrast, investment by food retailers in 1991 fell less markedly and remains well above 1988 levels.

Stockbuilding

Chart 6 shows changes in the stock-output ratio in the retail and manufacturing sectors since 1970. The sustained decline of manufacturers' stocks in this recession is in sharp contrast to the retail sector. It had been assumed that the scope for destocking in this recession would be limited. The decline in manufacturers' stock to output ratio throughout the 1980s had been widely interpreted as an improvement in methods of stock management based on greater security of supply. Though this indeed occurred, there was still clearly scope for further cuts as the economy moved into recession.

Chart 6
Stock-output ratio



Manufacturers' holdings of finished goods fell by £1.1 billion in 1991. The decline in manufacturing output in 1991 further lessened manufacturers' need for stocks of raw materials and fuels which fell by £0.8 billion. Destocking in the whole economy accounted for approximately a fifth of the reduction in domestic demand in the year.

Financial transactions

The corporate sector's financial behaviour has been dominated by two factors. First, substantial adjustments to spending have enabled companies to reduce their financial deficit. Second, the recovery of the equity market and high real interest rates have led companies increasingly to resort to equity finance rather than borrowing from the banks.

As Table C shows, the corporate sector reduced its financial deficit from £24 billion in 1990 (4% of GDP) to £11 billion in 1991 (2% of GDP). Much of the adjustment was made through cuts in investment spending and destocking, although lower tax and interest payments also contributed.

Table C
ICCs' financial transactions

£ billions

	1988	1989	1990	1991
Financial balance (surplus +)	**-7.9**	**-23.4**	**-24.0**	**-11.3**
Identified financial transactions (outflow/acquisitions of assets -)				
Investment in UK company securities	-12.1	-18.5	-1.9	-4.8
Investment abroad	-12.6	-10.3	-0.1	-3.0
Balance of import and export credit	-0.8	0.9	-0.6	0.2
Financial assets:				
Liquid	-4.2	-11.0	-8.1	-4.8
Other	1.2	-4.3	-8.5	-0.5
Other loans and mortgages	6.0	9.2	8.4	3.3
Bank borrowing	31.8	33.1	18.8	-3.5
Ordinary share issues	4.4	1.9	2.9	9.7
Other capital market issues (a)	6.1	13.4	11.0	11.4
Overseas investment (other)	3.3	9.3	9.8	7.6
Changes in tax balances and other accruals adjustment, including net unremitted profits	-5.1	-4.2	-4.1	1.5
Balancing item (b)	**-10.0**	**3.9**	**-3.6**	**-6.0**

Source: Central Statistical Office.

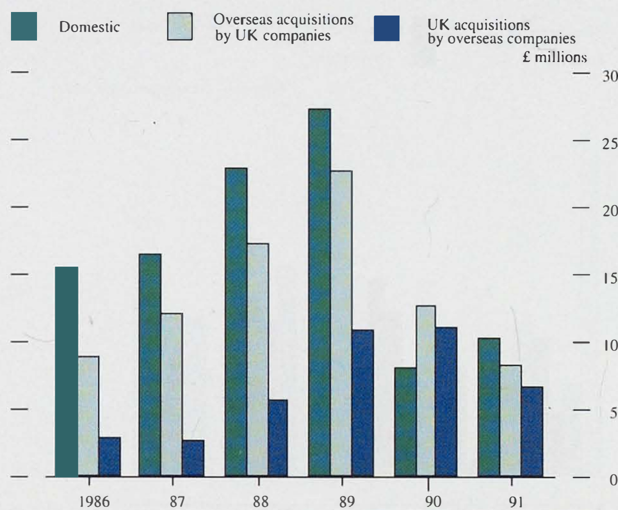
(a) Debenture, preference shares and capital issues overseas (including eurosterling).
(b) Figures may not add to totals because of rounding.

Assessing the size of the financial deficit is complicated by the presence of a large balancing item in the financial account, which in 1991 represented 53% of the deficit. But, as in previous years, it is likely that the discrepancy results from problems with the recording of financial outflows rather than difficulties with the items in the income and appropriation or capital accounts. The existence of a sizable financial deficit is, therefore, not in doubt.

Mergers and acquisitions

Domestic merger and acquisition activity recovered slightly in 1991, but remained subdued compared with the late 1980s (see Chart 7). Its value rose to £10 billion, an increase of £2 billion on the previous year. This increase in domestic activity reflected an increasing number of acquisitions of independent companies, rather than the sale of subsidiaries

Chart 7
Merger activity involving UK ICCs

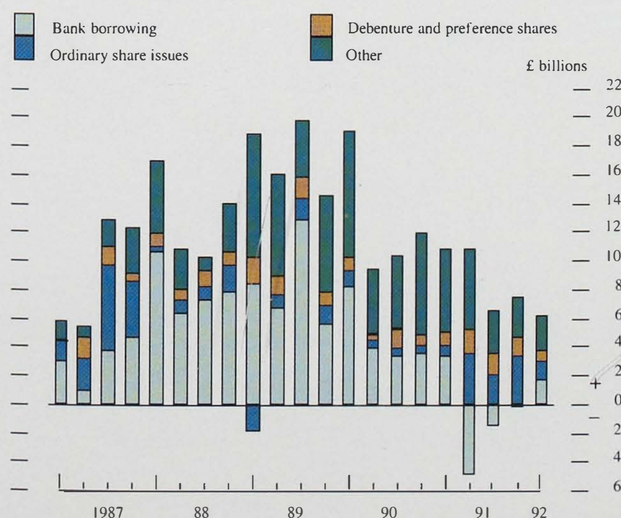


between groups. This suggests that the corporate sector did not adjust to any great extent last year by selling non-core businesses.

Of total expenditure on independent companies in 1991, 60% was in the form of cash compared with almost 70% in 1990. Almost all of the remainder was financed by issues of ordinary shares. The increasing use of share issues may reflect the strength of equity markets and a possible increase in banks' margins which would have reduced the comparative attractiveness of financing through cash.

Cross-border acquisitions by UK companies (including financial companies) continued to decline in 1991 to reach £8.3 billion, compared with the 1989 peak of £22.6 billion. Companies seem to have been choosing to concentrate their limited resources on acquiring companies in EC countries, (which accounted for 41% of the value of transactions in 1991, compared with 32% in the previous year). The increase in interest in EC companies may reflect preparations for the European single market and the reduction in uncertainty of foreign earnings following the United Kingdom's entry into the ERM. By contrast, the importance of the United States has continued to decline. Net inward acquisitions declined by £4 billion in 1991, to £7 billion from £11 billion a year earlier. These consisted mainly of non-EC companies buying British companies, possibly again in preparation for the single European market. The value of acquisitions of UK companies by companies in EC countries was less than the value of UK acquisitions in the rest of the European Community.

Chart 8
ICCs' external borrowing

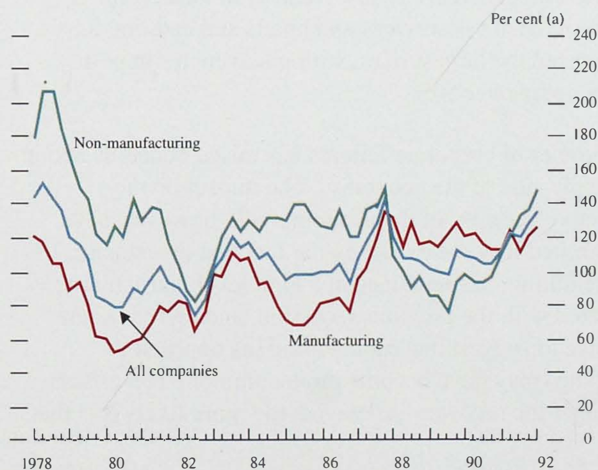


Company borrowing and liquidity

During 1991, ICCs repaid £3 billion of bank borrowing (see Chart 8); borrowing through other loans and mortgages also decreased from £8 billion to £3 billion in 1991. By contrast, net issues of ordinary shares rose over threefold in the year. This may have reflected the recovery of the stock market and the possible widening of bank margins. Issues of debenture and preference shares also rose in 1991, from £3.3 billion in the previous year to £5.1 billion.

The repayment of bank borrowing and an increase in financial assets enabled companies to improve their net liquidity last year. This has been particularly apparent for larger companies who may have ready access to alternative sources of finance (see Chart 9).

Chart 9
Liquidity of large companies



(a) Total current assets as a percentage of total liabilities.

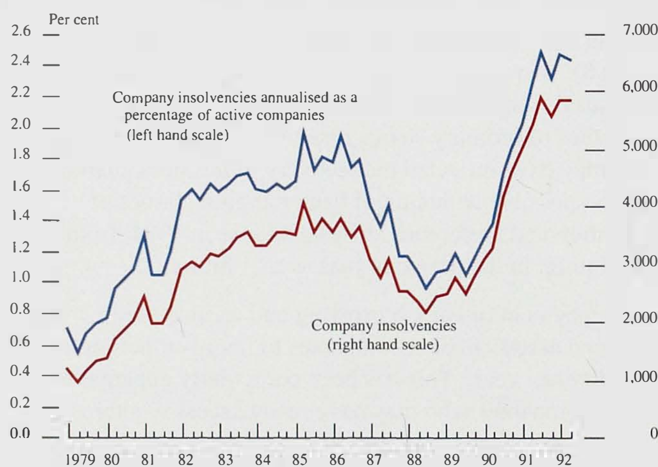
The reaction of companies to the recession, in particular the repayment of debt, suggests that, having borrowed heavily during the 1980s, companies have sought in the past year to restructure their balance sheets. At the same time, they have continued to acquire liquid assets. During the recession, there was considerable concern that companies' heavy indebtedness would make them especially vulnerable. Although still historically high, capital gearing has declined, and the improvement in liquidity has allowed companies to reduce income gearing levels.

Insolvencies

Despite the overall improvements in liquidity and income gearing in 1991, company performance was varied.

Insolvencies increased by almost 50% for the second year in succession, and represented 2.3% of companies. This increase in corporate insolvencies has been even greater than in the previous recession and has shown a different industrial pattern (see Charts 10 and 11). While in 1980 manufacturing insolvencies rose by over 100%—double the rise for all companies—in 1991 manufacturing insolvencies were only up 31%, two thirds of the increase for all

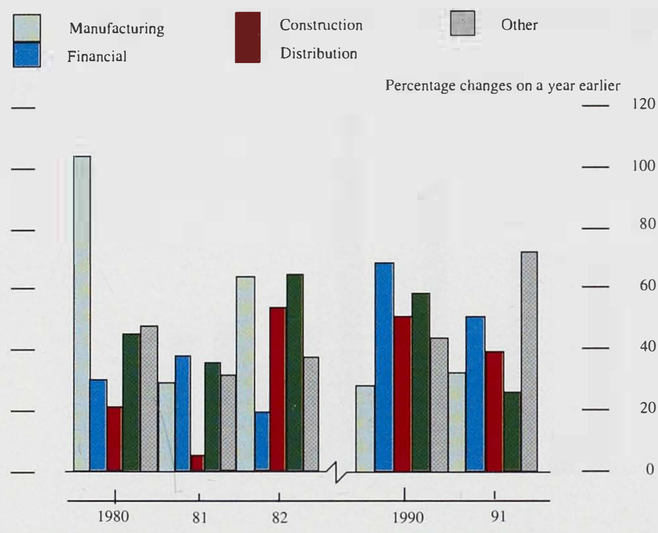
Chart 10
Company insolvencies



companies. By contrast, the service sector has suffered an above average increase in insolvencies in the current downturn: business services and hotels and catering have experienced the largest rises, with insolvencies in both sectors up by over 50%.

The number of corporate failures has raised concerns about the supply side of the economy. The impact on the productive capacity of the economy will, however, have been limited to some extent by the fact that investment, despite falling, has remained at a high level, particularly compared with the previous recession, and there is some evidence to suggest that mothballing (as opposed to scrapping) may have become more common. Nevertheless, the longer the recovery is delayed, the more likely it is that

Chart 11
Growth of insolvency in different sectors



capital equipment will be scrapped, and therefore the greater the damage to the real economy.

Prospects

There has been considerable corporate adjustment over the past year, with costs constrained sufficiently to reduce by more than half the financial deficit. Even so, ICCs have been able to maintain 'stategic' expenditure on investment, and dividend payments have remained high for the stage of the cycle as domestic merger and acquisition expenditure has risen.

As output recovers, a cyclical improvement in productivity is likely, enabling companies to widen profit margins and strengthen profitability. But capital gearing is still high and many sectors remain in a fragile position. Although the overall improvement in income gearing and liquidity will be beneficial when working capital requirements increase, concerns remain for the more indebted enterprises. Indeed, as has happened in previous recoveries, insolvencies may continue to rise after output has started to grow.