Company profitability and finance

UK industrial and commercial companies' (ICCs) performance has differed markedly between the recent recession and that during the early 1980s. This article[1] compares how companies have performed in the two recessions, and reviews company performance in 1992 and the first quarter of 1993. The main points include:

- *ICCs took earlier and more active steps to adjust in the recent recession: labour costs in particular were contained earlier than in the previous cycle.*
- *Higher productivity, greater competitiveness and higher capacity utilisation have kept the return on capital in the non North Sea sector some three percentage points higher throughout this recession than the previous one.*
- *This helps to explain why, despite substantial falls in recent years, business investment as a share of GDP was nearly three percentage points higher in the early 1990s than in the early 1980s.*
- *But ICCs have been more indebted than in the previous recession, partly because their borrowing requirement averaged 7.4% of GDP in the five years to 1992, compared with 2.2% in the five years to 1982.*
- *Although there was little overall change in company profits, retained earnings or the financial deficit between 1991 and 1992, each of these indicators had improved significantly by the first quarter of 1993. But many firms, particularly smaller ones, still face strong financial pressures.*
- *The shift away from bank borrowing accelerated in the first quarter of 1993.*

The early 1980s and 1990s compared

The performance of industrial and commercial companies (ICCs) has differed markedly in the last two recessions. During the recent recession, company profitability and investment were much stronger than in the early 1980s; but companies have also been significantly more indebted this time around.

Table A compares various measures of ICCs' performance in the early 1980s and the early 1990s. It shows that ICCs' performance has on the whole been more robust during the recent recession. In particular, although ICCs' return on capital fell substantially in both recessions, firms have retained a large proportion of the gains in profitability made in the 1980s. In 1992, the return on capital was four percentage points higher than in 1981, its trough in the previous recession.

Companies' higher profitability during the early 1990s is attributable to three main factors:

Table A
Measures of ICCs' performance (1978–82 and 1988–92)

Per cent in italics

	Manufacturing productivity(a)	Relative unit labour costs(a)	Firms operating below capacity(b)	Return on capital(c)	Net income gearing(d)	Capital gearing(e)
1978	1.1	9.5	*64.0*	*7.4*	*14.7*	*8.7*
1979	0.4	15.8	*57.0*	*5.9*	*18.3*	*8.2*
1980	-3.9	20.4	*73.3*	*4.1*	*27.3*	*8.9*
1981	3.5	3.9	*80.3*	*3.0*	*23.7*	*7.4*
1982	6.6	-5.7	*76.3*	*4.2*	*22.6*	*9.6*
1988	5.8	6.7	*32.3*	*10.3*	*15.5*	*19.9*
1989	4.0	-0.2	*37.8*	*9.3*	*25.2*	*23.9*
1990	1.6	3.9	*48.5*	*8.1*	*26.7*	*25.0*
1991	1.5	3.2	*67.0*	*7.3*	*26.7*	*25.1*
1992	5.0	-4.3	*69.0*	*6.9*	*23.6*	*25.0*

Memo: levels of productivity and relative unit labour costs in 1970, 1980 and 1990 (1980=100)

	Manufacturing productivity	Relative unit labour costs
1970	85.1	68.6
1980	100.0	100.0
1990	159.8	86.1

(a) Percentage change on year earlier. Relative unit labour costs are in a common currency. A rise indicates poorer competitiveness.
(b) Source: CBI Quarterly Survey of manufacturing firms.
(c) Pre-tax rate of return on capital stock at replacement cost in the non North Sea sector.
(d) Net interest payments as a percentage of after-tax income.
(e) Outstanding borrowing (debt at nominal value) as a percentage of the capital stock at replacement cost.

(1) Prepared by Gabriel Sterne in the Bank's Economics Division.

- *Higher productivity*: Levels of and growth in productivity were much higher entering the 1990s recession than a decade earlier (see Table A). During the 1970s manufacturing productivity increased by only 18%, compared with 60% in the 1980s; in addition, productivity growth was stronger in the 1980s in construction, distribution and transport and communications. Manufacturing firms have also been quicker to adjust in this recession: in particular, the more flexible labour market allowed companies to contain labour costs much earlier than in the previous cycle. Whereas manufacturing productivity fell in 1980, as employment was slow to adjust to the fall in output, it increased consistently throughout the early 1990s. The financial pressures of substantially higher indebtedness at the beginning of this recession may have partly prompted this earlier adjustment.

- *Greater competitiveness*: UK industry has been more competitive during this recession than in the early 1980s, when profit margins were squeezed more. The real exchange rate (based on relative normalised unit labour costs) appreciated by over 20% in 1980 compared with 1989; and according to the same measure, manufacturing has been nearly 14% more competitive throughout this recession relative to the last.

- *Higher levels of capacity utilisation*: the return on capital is significantly affected by the rate at which capital is used. As Table B illustrates, the cumulative fall in domestic demand in the recent recession was slightly less severe than in the early 1980s, and UK export markets were stronger than in the previous recession. Reflecting this, the proportion of manufacturing firms reporting underutilised capacity to the CBI reached an average annual peak of 69% in 1992—much lower than the 1981 annual peak of 80% (see Table A).

Table B
Factors affecting UK companies

All percentage changes on a year earlier except interest rates

	GDP at factor cost	Domestic demand	World domestic demand(a)	Retail price inflation(b)	Short-term interest rates(c)	Effective exchange rate
1980	-2.0	-2.6	1.3	16.9	16.6	9.9
1981	-1.1	-1.4	-0.4	12.2	13.9	1.2
1982	1.7	2.3	-0.2	8.5	12.3	-4.5
1990	0.6	-0.5	3.2	8.1	14.8	-1.5
1991	-2.5	-3.1	1.5	6.7	11.5	0.5
1992	-0.5	0.5	1.3	4.7	9.6	-3.6
1993 Q1	0.9	0.4	0.2	3.4	6.4	-13.4

(a) Weighted average of domestic demand in the major seven industrialised countries excluding the United Kingdom.
(b) Excluding the effect of mortgage interest payments.
(c) Level of three-month interbank rate (period average).

Because of greater profitability, total post-tax income as a proportion of GDP has been on average 3.5 percentage points higher in the early 1990s (Table C). But the marked rise in dividend payments in the 1980s meant that, despite higher profitability in the recent recession, undistributed income (net income available for capital and other financial expenditures) was virtually the same percentage of GDP in both recessions.

Table C
Selected items from ICCs' accounts and financial transactions (1978–82 and 1988–92)

Percentage of GDP

	Total income(a)	Dividends	Undistributed income	Investment	Financial surplus(+)/deficit(-)	Borrowing requirement	Bank borrowing
1978	13.1	1.2	9.0	7.7	0.6	1.5	1.4
1979	13.0	1.8	7.8	7.7	-0.7	2.7	2.1
1980	11.3	1.5	5.8	7.1	—	2.4	2.8
1981	11.1	1.4	5.9	6.5	0.6	1.6	2.2
1982	11.8	1.6	6.5	6.2	1.1	2.6	2.4
1988	15.0	3.1	8.5	9.2	-1.6	10.6	6.7
1989	14.9	3.7	6.4	10.2	-4.4	10.5	6.6
1990	15.2	3.8	6.2	10.0	-3.6	6.7	3.6
1991	14.8	3.7	6.0	8.7	-1.9	4.5	-0.1
1992	14.6	4.2	6.0	8.1	-1.8	4.8	-0.5

(a) Post-tax income net of stock appreciation.

Capital expenditures and the borrowing requirement

As in the last recession, companies have adjusted by cutting capital outlays. But, reflecting higher profitability, ICCs' investment entering the recent recession was higher as a proportion of GDP: between 1990 and 1992, company investment was on average 2.4 percentage points higher than a decade earlier (Table C). Since undistributed income was a similar proportion of GDP in both recessions, higher investment by ICCs in the recent recession translated into a significantly worse financial balance. Whereas ICCs ran a financial surplus which averaged 0.6% of GDP between 1980 and 1982, a decade later the financial deficit averaged 2.4% of GDP.

Table C also shows that ICCs ran a much larger borrowing requirement, both leading up to and during the recent recession, than a decade earlier. The larger borrowing requirement reflected both the financial deficit and ICCs' financial transactions, particularly spending on mergers and acquisitions. Retrenchment in ICCs' financial transactions was therefore much more pronounced in the recent downturn. Companies' borrowing requirement was £25.1 billion lower in 1992 than in 1989: the £12.1 billion reduction in the financial deficit was reinforced by a larger (£20.2 billion) reduction in largely debt-financed expenditures on domestic and foreign merger activity.

The financial counterpart to the fall in the net borrowing requirement was a sharp reduction in bank borrowing. In 1989, ICCs borrowed £34.0 billion from banks. In 1992 they repaid £2.7 billion, and repayments increased to £5.2 billion in the first quarter of 1993 alone. Capital issues have also fallen, but remain a much more important source of finance for ICCs than in the early 1980s. Such large reductions in borrowing were not as necessary in the early 1980s, when the borrowing requirement as a proportion of GDP averaged only 2.2% of GDP in the five years to 1982, compared with 7.4% of GDP in the five years to 1992.

The greater accumulation of debt in the recent cycle resulted in capital gearing[1] being around three times (or

(1) Net debt as a proportion of the capital stock at replacement cost.

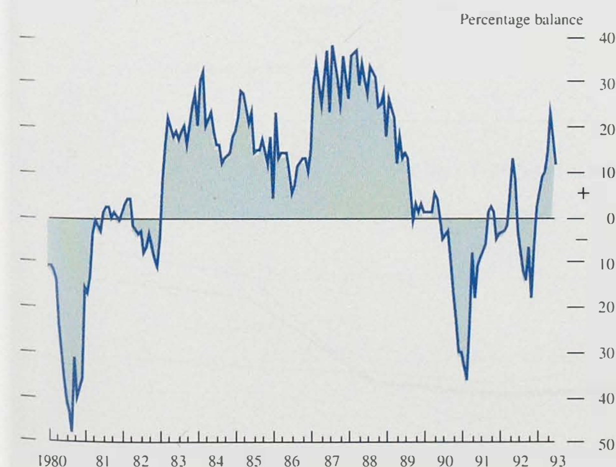
16 percentage points) higher in the recent recession than in the early 1980s (Table A). The sharp rise in interest rates from late 1988 and the subsequent recession substantially increased companies' debt service costs while also lowering their ability to service this by putting the brake on economic activity. Such financial pressures may have contributed directly to firms retrenching earlier in this cycle than the previous one.

The difference in income gearing[1] in the two recessions was not so marked. Although net debt was higher in the recent recession, this was offset by higher income (Table C), and lower interest rates (Table A).

Company performance in 1992 and 1993

Between 1991 and 1992, there was little overall change in company profits, retained earnings or the financial deficit. But each of these indicators improved significantly in the first quarter of 1993. The difficult trading conditions faced by companies eased in 1992 and in the first quarter of 1993. Domestic demand continued to recover slowly, and the fall in interest rates both before and after sterling's exit from the ERM contributed to improvements in company finances: by the first quarter of 1993, net income gearing had fallen to 18%, compared with 30% in the first quarter of 1991.

Chart 1
Expectations of the volume of output[a]



Source: CBI monthly trends

(a) Percentage of firms expecting increase in output over the next four months less percentage expecting decrease.

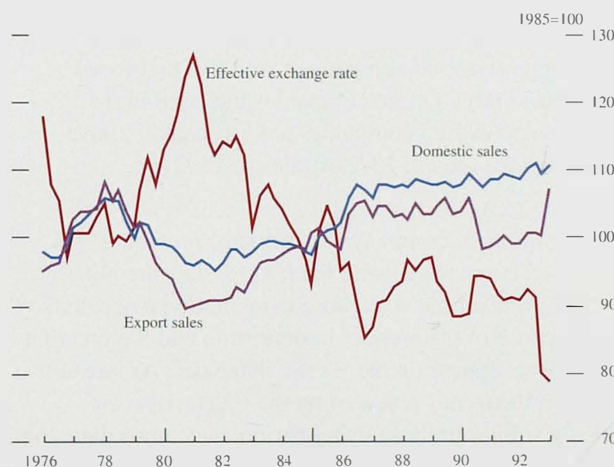
Business confidence in recovery has also strengthened since 1992. Chart 1 illustrates that increases in expected output earlier in the recession were partially reversed in the second half of 1992, but more recent increases have gone further, and are consistent with improvements in production, demand and company finances.

Yet certain sectors still face severe difficulties. The construction and property sectors were particularly hard hit by recession, and falls in property prices have eroded the collateral on which small firms often secure loans. Record levels of insolvencies were reached in the third quarter of 1992, and insolvencies still remain at high levels.

Margins and profitability

Manufacturers' domestic margins have continued to hold up well (Chart 2). In early 1993, margins remained historically high.[2] The performance of margins contrasts with the last recession, when much stronger growth in unit labour costs was a crucial part of the erosion of manufacturers' profitability, as was the increased competitiveness of imports, reflecting the appreciation of the exchange rate.

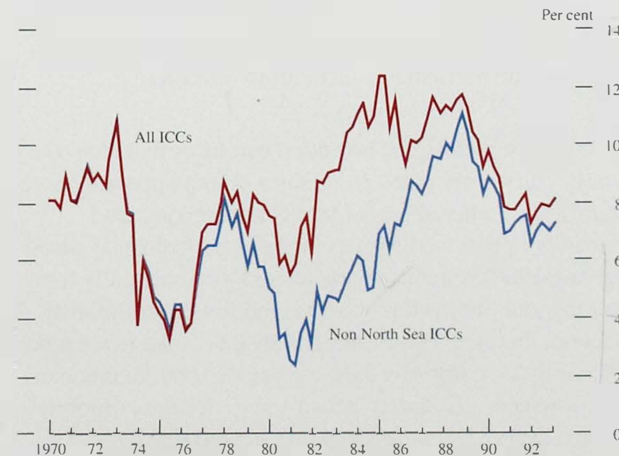
Chart 2
Manufacturers' price to cost ratios[a] and the exchange rate



(a) Calculated as output prices deflated by weighted average of unit labour costs (weight = 0.44), input prices (0.33) and bought-in services (0.23).

In contrast with domestic margins, exporters' margins were quite heavily squeezed in the recent recession. But the depreciation last year enabled exporters to increase prices by 9.5% between the third quarter of 1992 and the first quarter of 1993, resulting in margins increasing by 6.2%. This parallels behaviour in the last recovery, when depreciation allowed exporters to improve margins.

Chart 3
Return on capital[a]



(a) Pre-tax rate of return on capital stock at replacement cost.

(1) Interest payments as a proportion of post-tax income.
(2) An assessment of recent developments and contributions to manufacturers' margins is contained in the *Inflation Report* page 319.

The effect of privatisations on measures of company performance

The aggregate national accounts data on Industrial and Commercial Companies (ICCs) do not include information on the financial performance of public sector companies. So when companies move from the public sector to the private sector on privatisation[1] the underlying trends in corporate sector performance become more difficult to discern from the aggregate data.

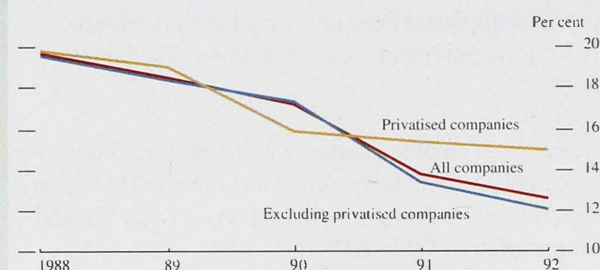
Work in the Bank has used the EXTEL database of disaggregated company accounts to construct indicators which isolate the effect of the privatised companies. The charts opposite show aggregate indicators, constructed from the EXTEL database, of the financial performance of (i) ICCs including privatised companies; (ii) ICCs excluding privatised companies; and (iii) privatised companies only. Of the companies included in the database, privatised companies are estimated to have accounted for around 13% of sales in 1992.

The measures of company performance *including* privatised companies using the EXTEL data are not directly comparable with those using national accounts data because of differences in definition and the fact that fewer firms appear on the EXTEL database. As a result, although the trends revealed by the EXTEL data are broadly similar to those using national accounts data, the absolute *levels* of indicators differ. For example, the rate of return on the capital stock in 1992 was 12.5% on the EXTEL measure, compared with 7.6% using national accounts data.

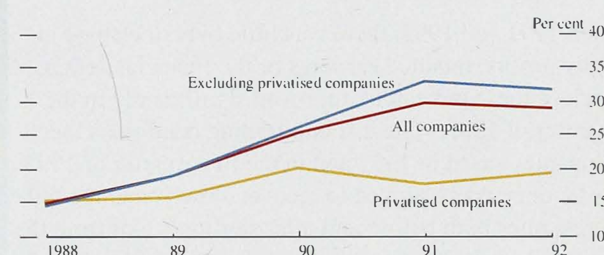
All the EXTEL measures reflect yearly changes in the sample, as well as fluctuations in year-by-year performance. This is particularly so for the measures of privatised companies only, whose sample size increased from 4 in 1987, to 36 in 1992. For example, major fluctuations in the capital gearing ratio of privatised companies occurred in 1990 and 1991; the sample size more than doubled in each of these years. Measures of the financial performance of privatised companies only are therefore particularly difficult to interpret.

Two main conclusions, however, can be drawn from the charts. First, privatised companies do not appear to have significantly altered recent trends in company data. *Excluding* privatised firms, company performance since the late 1980s remains characterised by historically high gearing and dividend payments, and lower profitability. Second, the inclusion of the privatised companies would appear to have improved the aggregate trend in company performance. *Excluding* privatised firms, the corporate sector, by 1992, was more highly geared (by 2.8 percentage points for income gearing, and 0.2 percentage points for capital gearing) and earned a lower rate of return on capital (by 0.6 percentage points).

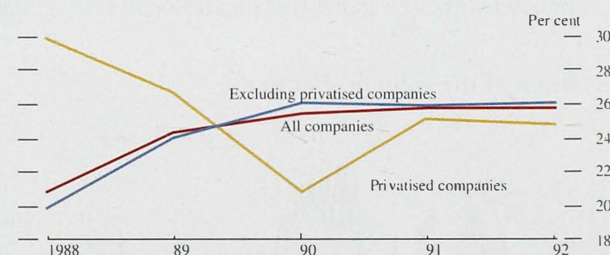
Rate of return on capital stock[a]



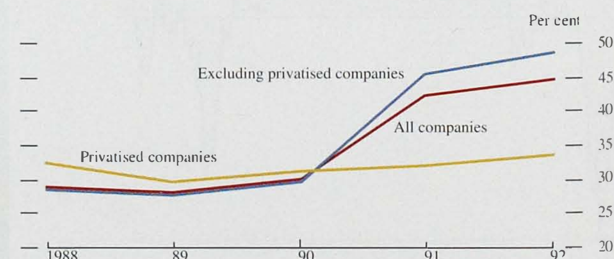
Income gearing[b]



Capital gearing[c]



Dividend payout ratio[d]



Source: EXTEL.

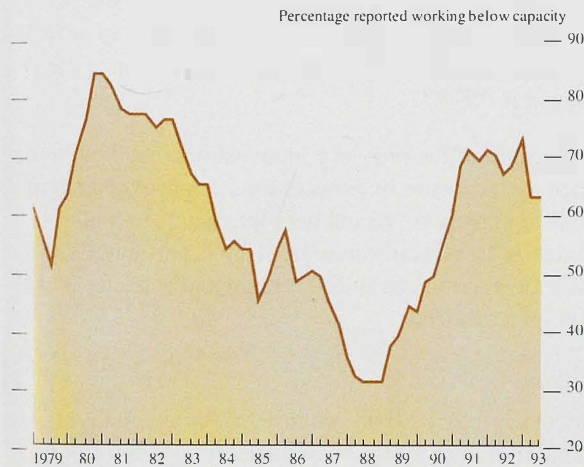
(a) Pre-tax income as a percentage of financial capital employed at nominal cost.
(b) Interest payments as a percentage of pre-tax income.
(c) Total loans as a percentage of total assets.
(d) Dividends paid as a percentage of post-tax income.

A particularly striking result is the stability of the dividend payout ratio of privatised companies; this contrasts with the sharp rise in the ratio of other private sector companies. (For possible explanations of the latter see page 367.)

(1) Privatisations during the 1980s include British Telecom with effect from 28 November 1984, British Gas from 3 December 1986, British Airways from 6 February 1987, Royal Ordnance from 22 April 1987, BAA from 16 July 1987, British Steel from 2 December 1988, water companies from 12 December 1989, electricity distribution companies from 11 December 1990, electricity generating companies from 12 March 1991 and Scottish electricity companies from 18 June 1991.

The better performance of manufacturers' domestic margins in this recession helped to stabilise the rate of return on capital of non North Sea ICCs at an average of 7% in 1992, much higher than its 1981 trough of 3% (Chart 3). The containment of labour costs earlier in this recession played an important part in this. Furthermore, the number of firms working below capacity is markedly lower than the last recession, and fell significantly in the first quarter (Chart 4).

Chart 4
Capacity utilisation



Source: CBI Quarterly Survey of manufacturing firms.

The aggregate picture for margins and profitability conceals significant differences across industrial sectors: for example, profitability in the construction industry has fallen much further than the average (Table D). In line with construction being hard hit, building materials has shown one of the largest falls in manufacturing. Diversity in experience is particularly striking in non-manufacturing, where the strong rate of return in the telecommunications, water and electric industries contrasts with weakness in the civil engineering, construction and mineral extraction industries. The performance of this latter group of industries has tended to be more cyclical. The rate of return in the financial services sector also declined sharply in 1991, but bounced back in 1992.(1)

Table D
Return on sales(a) by industrial sector(b)

Reporting year	1987	1988	1989	1990	1991	1992
All manufacturers	**8.9**	**9.8**	**10.1**	**9.2**	**7.7**	**7.5**
Food, drink and tobacco	8.3	9.0	10.0	9.4	9.1	10.5
Chemicals and pharmaceuticals	12.6	13.4	13.5	12.6	13.4	10.1
Engineering	7.6	9.1	8.4	7.4	5.9	4.0
Building materials	11.5	12.9	13.0	10.0	6.7	6.4
All non-manufacturers	**8.2**	**9.4**	**9.8**	**8.9**	**7.6**	**7.7**
Civil engineering and construction	7.2	8.6	7.9	5.2	—	0.5
Mining, oil and gas	9.4	10.7	11.8	10.9	8.1	3.7
Telecommunications	22.9	23.4	23.6	21.7	24.9	23.6
Utilities(c)	...	...	...	23.5	12.8	15.3
Financial services	6.7	6.2	5.5	5.8	3.1	6.5

Source: EXTEL.

(a) Operating profit as a percentage of sales.
(b) The sub-sectors do not represent an exhaustive set of firms in either manufacturing or non-manufacturing.
(c) Utilities only included from 1990 because the sample was too small before privatisations.

Income and appropriations

Gross trading profits (net of stock appreciation) increased marginally in 1992, though by less than inflation (see Table E). Profits are now showing signs of recovery: in the year to the first quarter of 1993 they increased by 8.4% in nominal terms. Total post-tax income growth over the same period, at 6.4%, was slower because of lower interest receipts.

Table E
ICCs' income and appropriation accounts

£ billions

	1989	1990	1991	1992	1993 Q1
Income					
Gross trading profits(a)	74.4	77.6	77.8	78.4	20.4
North Sea	6.8	7.0	6.4	6.6	1.8
Non North Sea	67.7	70.6	71.3	71.7	18.5
Rent and non-trading income	12.5	14.9	13.7	12.4	2.6
Income from abroad	18.1	18.4	15.0	15.5	4.1
Total income(a)	**105.1**	**111.0**	**106.4**	**106.2**	**27.1**
Allocation of income					
Dividends on ordinary and preference shares	19.0	20.7	21.5	25.1	5.9
Interest and other payments	25.2	29.7	29.1	26.3	5.2
Profits due abroad	8.6	7.6	5.4	5.2	1.7
UK taxes	19.3	19.0	15.7	13.7	3.4
Undistributed income(a)	**32.8**	**34.0**	**34.7**	**35.9**	**10.7**
Capital transfers	-0.5	-0.5	-0.4	-0.2	-0.1
Fixed investment	52.3	54.9	49.9	48.3	12.0
Physical increase in stocks	2.7	-1.4	-5.0	-2.0	-1.2
Financial balance (surplus+)	**-22.7**	**-19.9**	**-10.6**	**-10.6**	**-0.1**

(a) Net of stock appreciation.

The proportion of ICCs' net income taken in tax has fallen sharply in recent years, from a peak of 20.7% in 1989 to 14.7% in 1992. Tax payments are very sensitive to the cycle; but they have also been affected by changes in tax rules in the 1991 budget, which cut the corporation tax rate to 33%, and extended the carry-back period for losses (to three years) and for advance corporation tax (to six years). The extent to which investment has held up during the cycle has generated allowances which have also reduced corporation tax payments. In contrast, dividend payments increased sharply in the 1980s, as discussed in the box on page 367.

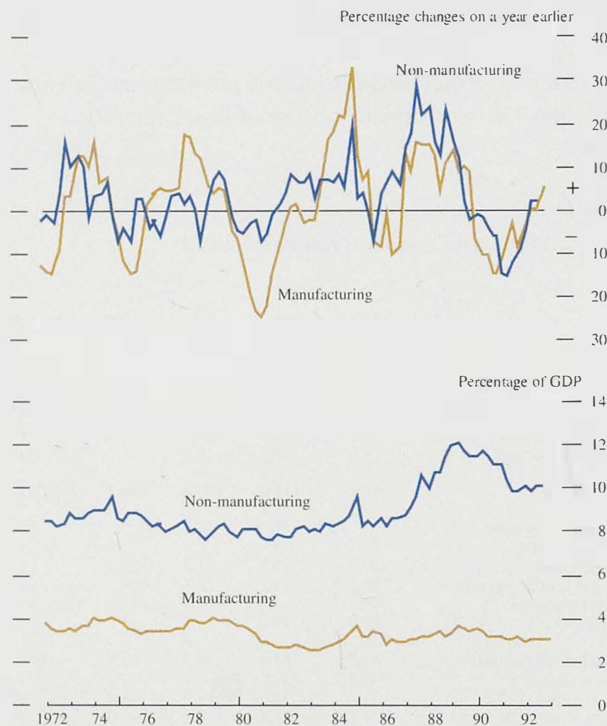
In 1992, rising dividend payments did not offset the effect of lower tax and interest payments, so that undistributed income increased by 3.5%. There was, also, a sharp increase of £1.4 billion in undistributed income in the first quarter of 1993, as total income increased and dividend, tax and interest payments all declined.

Capital expenditure

Business investment(2) stabilised during 1992, after two years of significant decline. In spite of modest increases in each quarter of 1992, business investment fell by 1.5% in the year as a whole, following an average fall of 5.4% in the previous two years. But investment remains at an historically high proportion of GDP following the late 1980s investment boom, partly reflecting companies' success in maintaining

(1) The effect of privatisations on aggregate measures of ICCs' performance is discussed in a box on page 364.
(2) Business investment includes public as well as private corporations, and is therefore not affected by privatisations.

Chart 5
Business[a] investment in manufacturing and non-manufacturing[b]

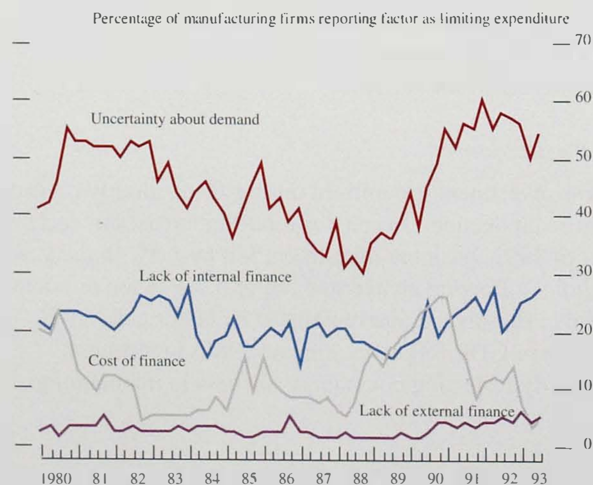


(a) Non-oil business investment.
(b) Figures include public corporations and are therefore not affected by privatisations.

rates of return at higher levels than the last recession. In 1992, business investment was 14.3% of GDP, close to the 1988 figure of 14.4%, and much higher than its previous trough of 11.4% in 1983. In contrast to previous cycles, when manufacturing investment has been more volatile, Chart 5 illustrates that the large increases in investment as a percentage of GDP in the 1980s were dominated by rapid increases in non-manufacturing, as were the subsequent declines in the recent recession.

The main factors behind the fall in investment during the recession were demand uncertainties and the cost of finance. The proportion of manufacturing firms citing lack of availability of external finance as a factor limiting investment remained relatively low in CBI surveys throughout the recession.

Chart 6
Factors limiting capital expenditure: CBI quarterly survey results



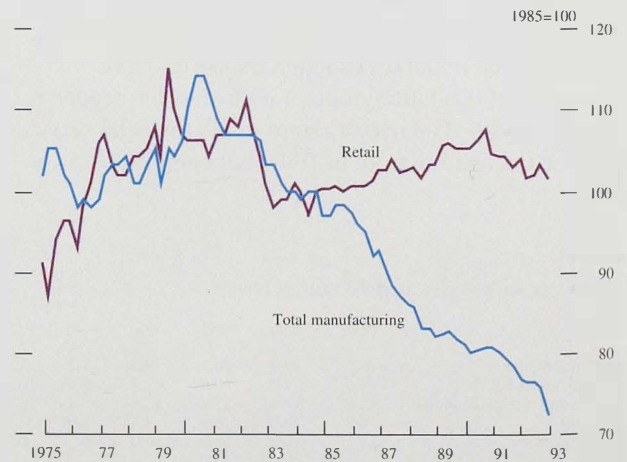
CBI survey evidence points to two improvements in investment conditions in recent quarters (Chart 6). First, the balance of firms citing uncertainty about demand as an obstacle to investment fell by six percentage points in the second quarter of 1993 and, despite an increase in the July survey, lack of demand is considerably less important than at its peak in 1992. Second, the proportion of firms citing the cost of finance as a constraint has fallen far more sharply, from the peak of 26% in the first quarter of 1991, to only 3% in the second quarter of 1993, the lowest figure since the series began in 1979.

But the strength of the recovery in investment is likely to be dampened by the desire of firms to retain improvements in their financial position; recent net repayments to banks suggest that ICCs remain cautious. This is particularly the case while demand uncertainties remain and capacity is still generally underutilised.

Stockbuilding

ICCs' stocks fell by £2.0 billion in 1992, compared with a fall of £5.0 billion in 1991. Manufacturers' stocks fell by £1.2 billion in 1992. Improved inventory control methods have enabled manufacturers to operate at lower stock to output ratios (Chart 7), encouraged by high real short-term interest rates. Since the last quarter of 1989, the value of stocks held by ICCs has decreased by £10.8 billion. But the fall in manufacturers' stock to output ratio has not yet been shared by retailers.

Chart 7
Ratio of stock to output



Destocking accelerated in the first quarter of 1993, when ICCs reduced stocks by £1.2 billion. Both manufacturers' and distributors' stocks fell significantly: firms chose to meet some of the stronger demand through destocking rather than immediate increases in production and purchases.

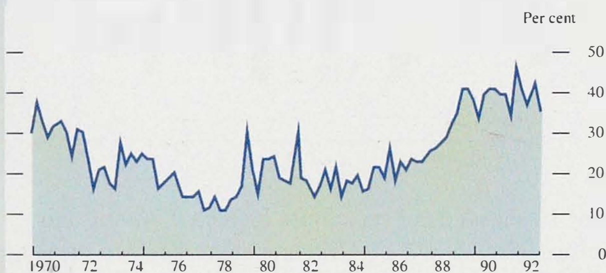
Financial transactions

ICCs had a record financial deficit in 1989 of 4.4% of GDP. The borrowing requirement peaked a year earlier at 10.6% of

Dividend payments

During the 1980s, ICCs' dividend payout ratio roughly doubled (see Chart A). Between 1990 and 1992, dividend payments increased a further 21.5%, despite a stagnation in company profits, though the 10.9% cut in dividend payments in the first quarter has partially offset previous increases. One explanation for dividends holding up is that firms may have remained optimistic about long-term profit growth even in recession, and that this optimism has influenced dividend behaviour. The importance of

Chart A
Dividend payout ratio [(a)]



(a) Dividend payments as a percentage of post-tax income.

long-term profit growth is illustrated by 3i's recent survey of 178 finance directors of larger companies (with a turnover of more than £200 million).[1] Some of the results from this survey are set out in Table 1 and suggest that the single most important determinant of dividend policy is long-term profit growth. The need to retain cash in the company is listed by less than one sixth of finance directors as the most important factor in determining dividend behaviour, and is most important for companies with liquidity problems. The expectations of shareholders are seen as relatively important, perhaps because a cut in a firm's dividends relative to its competitors may be taken as a signal of the relative prospects of a company.

Table 1
The most important factor influencing dividend policy

	Per cent
Internal	
Long-term profit growth (historical)	10.7
Long term profit growth (prospective)	42.9
Need to retain cash	14.8
External	
Expectations of shareholders	18.9
Expectations of analysts	2.6
Need to maintain access to sources of capital	10.2
	100.0

Source: *3i Survey of Finance Directors* April 1993.

Over 55% of finance directors in the 3i survey agreed with the statement: 'Any cut in dividend payout sends adverse signals to markets and should be avoided'. This corresponds with EXTEL data, which show that 63% of firms either maintained or increased dividends in 1992. Although this is a significant decrease compared with 84% in 1988, it

Table 2
The proportion of firms not paying or cutting dividends

Per cent

Account year	Firms not paying dividends in consecutive years	Firms cutting dividends	Firms maintaining or increasing dividends
1988	10	6	84
1989	9	10	81
1990	9	20	71
1991	14	27	59
1992(a)	14	23	63

Source: EXTEL.

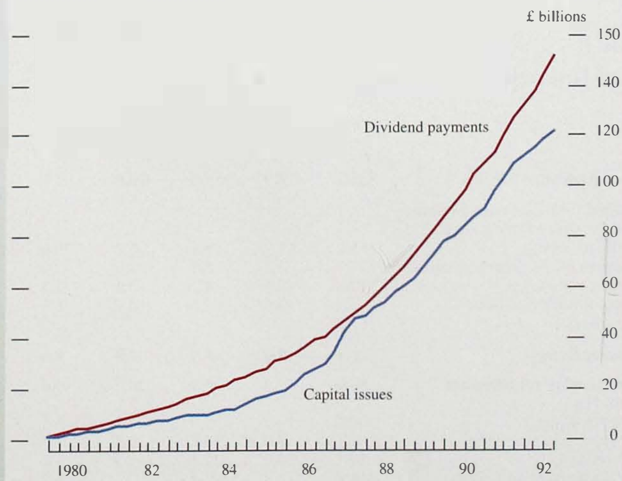
(a) Preliminary: only 80% of accounts are currently available.

illustrates that even in recession the majority of firms prefer not to cut dividend payments.

Firms which deviate most from shareholder objectives may have a lower market valuation. In the late 1980s this made them vulnerable to hostile takeover bids.[2] But firms have remained sensitive to market valuation even after the takeover boom ended, in part because a low share price makes capital issues more expensive. This may explain why the need to maintain access to sources of capital was the most important factor determining dividend payments for over 10% of finance directors.

The increase in the dividends paid during the 1980s was closely paralled by an increase in capital issues (see Chart B). The rise in the dividend payout ratio may in part reflect the provision for tax-exempt shareholders (including pension funds) to reclaim advance corporation tax on dividends. For companies paying mainstream corporation tax, there is a higher charge on retained than distributed profits. As profitability increased in the 1980s, it is likely that a greater proportion of firms paid mainstream corporation tax, and hence were able to take advantage of the difference in effective tax rates.

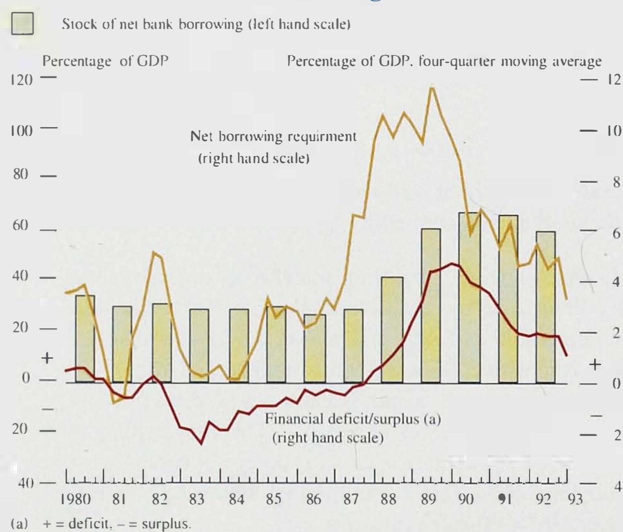
Chart B
Cumulative dividend payments and capital issues since 1980



(1) Dividend Policy, 3i plc, April 1993.
(2) *Bank of England Quarterly Bulletin*, August 1990, page 355.

GDP. The borrowing was largely debt-financed and the stock of bank borrowing increased sharply up to 1990 (Chart 8). Adjustment to this, and to the sharp rise in base rates from the second half of 1988, initially came in retrenchment in financial outflows, in particular the very sharp fall in debt-financed merger activity in 1990 (see Table F). Improvement in the financial deficit has taken longer—the initial halving between 1989 and 1991 was not maintained last year, as profits failed to recover significantly. But in the first quarter of 1993 the financial deficit approached balance for the first time in over five years (Table F).

Chart 8
Financial deficit/surplus, net borrowing requirement and stock of net bank borrowing



(a) + = deficit, – = surplus.

ICCs' reduced need to borrow has largely shown up in reduced recourse to the banking system. ICCs borrowed £34 billion from the banks in 1989, but repaid bank debt in 1991 and 1992. In the first quarter of 1993, repayments increased sharply, to £5.2 billion. The switch away from bank finance in part represents an attempt to reduce income gearing by restructuring balance sheets. (Table F and Chart 9.)

Table F
ICCs' financial transactions

£ billions

	1989	1990	1991	1992	1993 Q1
Financial balance (surplus +)	**-22.7**	**-19.9**	**-10.6**	**-10.6**	**-0.1**
Identified financial transactions (outflow/acquisition of assets -)					
Unremitted profits	-5.2	-5.9	-5.3	-4.7	-1.8
Investment in UK company securities	-17.9	-2.3	-5.1	-1.7	-0.9
Investment abroad(a)	-10.4	-0.5	-4.2	-3.1	-2.4
Balance of trade and other credit/given	1.3	-0.3	0.2	-0.9	1.6
Balancing item(b)	**1.1**	**-8.0**	**-0.9**	**-7.8**	**3.0**
Net borrowing requirement	**53.8**	**37.0**	**25.9**	**28.7**	**0.6**
Financed by:					
Bank borrowing	34.0	19.9	-0.9	-2.7	-5.2
Other loans and mortgages	9.1	8.0	3.6	2.5	1.2
Capital issues	15.7	14.0	21.1	13.7	4.7
Overseas investment (other)	11.2	11.7	9.3	7.1	0.8
Financial assets: liquid	-11.6	-8.2	-5.6	2.7	-1.8
other	-4.6	-8.6	-1.7	4.7	0.4

(a) Includes direct and portfolio investment.
(b) Figures may not add to total because of rounding.

Chart 9
Estimated total quarterly sterling borrowing by ICCs

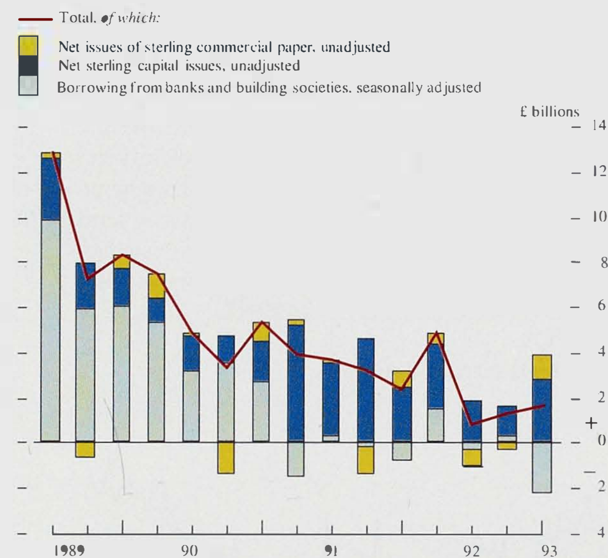


Chart 10 shows that expenditure on both domestic and overseas acquisitions by UK companies declined further in 1992. The reductions in ICCs' investment in UK and overseas securities between the annual peak in 1989 and 1992 amounts to £20.2 billion, equivalent to two thirds of the fall in ICCs' net borrowing requirement over this period. An increasing proportion of domestic mergers and acquisitions has been financed through share issues rather than cash: 63% were financed by cash in 1992, compared with 82% in 1989. Reductions in merger activity are the main counterpart to reductions in bank borrowing over this period.

Chart 10
Merger activity involving UK ICCs

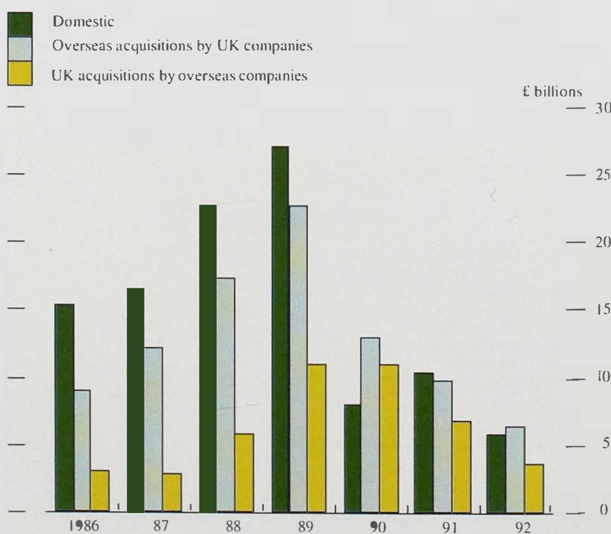
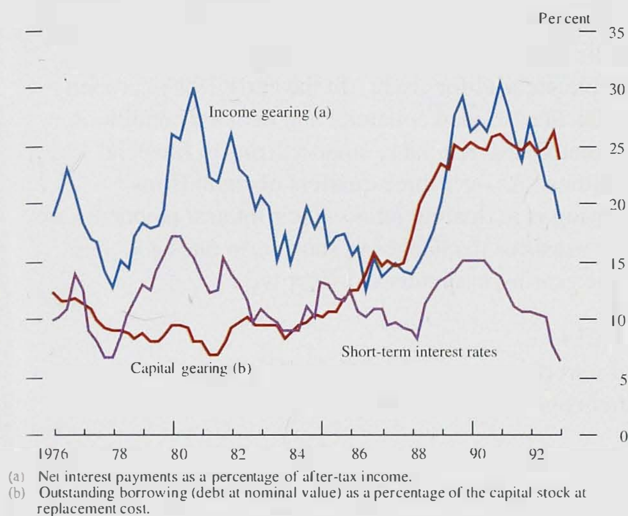


Chart 11 shows the gearing of ICCs. High income gearing was the product of a rapid growth in capital gearing and the rise in interest rates from late 1988. As discussed above, capital gearing rose markedly as strong growth in investment and acquisition expenditures were financed to a large extent by debt. It is likely that many firms took on such debt on the

Chart 11
Net income and capital gearing



(a) Net interest payments as a percentage of after-tax income.
(b) Outstanding borrowing (debt at nominal value) as a percentage of the capital stock at replacement cost.

basis of eventually unfulfilled expectations about income growth and interest payments. Recent falls in bank debt represent adjustment to this, and have occurred in spite of lower interest rates.

Disaggregated company accounts data illustrate the marked differences in experience across different sectors. Table G shows that income gearing deteriorated more in the non-manufacturing sector than in manufacturing during the recent recession. In 1992 income gearing in the manufacturing sector ranged between 18.4% (chemicals) and 37.0% (motor vehicles); in non-manufacturing the range was far greater. According to accounts reported in 1992 (which refer partly to activity in 1991) the construction, transport and hotel sectors all had gearing levels which suggest the need for considerable further adjustment.

Table G
Income gearing[a] by industrial sector[b]

Per cent

Reporting year	1987	1988	1989	1990	1991	1992
All manufacturers	**14.6**	**13.8**	**17.7**	**21.6**	**25.0**	**24.3**
Chemicals and pharmaceuticals	11.7	11.0	14.1	16.1	16.5	18.4
Motor vehicle and parts	19.0	16.9	19.4	24.3	42.1	37.0
Engineering	14.6	13.4	16.9	22.5	26.1	34.1
All non-manufacturers	**15.2**	**15.2**	**19.3**	**28.0**	**32.4**	**31.7**
Civil engineering and construction	15.2	12.8	19.7	34.1	. . .(c)	. . .(c)
Transport and freight	17.3	19.4	29.5	43.0	60.2	71.7
Hotels and catering	33.6	29.8	44.6	41.4	56.6	67.6
Telecommunications	5.7	14.2	14.6	17.7	14.2	13.4
Utilities (d)	. . .	. . .	. . .	40.0	13.4	14.7

Source: EXTEL.

(a) Ratio of gross interest payments to pre-tax income.
(b) The sub-sectors do not represent an exhaustive set of firms in either manufacturing or non-manufacturing.
(c) Used when number is greater than 100.
(d) Utilities only included after 1990 because the sample was too small before privatisations.

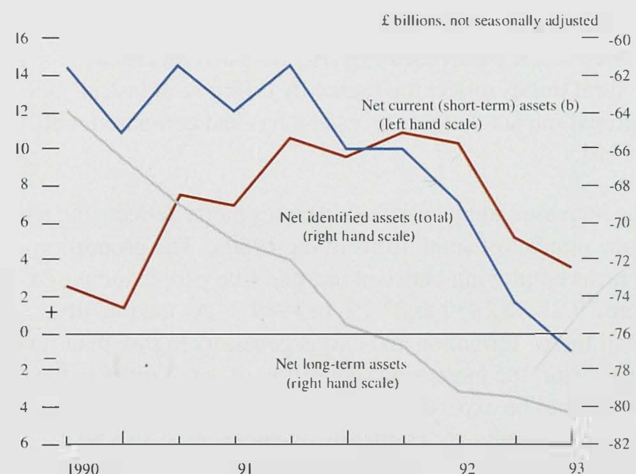
Although total capital issues declined in 1992—to £13.0 billion compared with £20.7 billion in 1991—the decline was not so marked as with bank debt (see Chart 9). Chart 9 shows, too, that equity issues have grown considerably in the first quarter of the year. The relatively greater use of equity rather than debt finance has had a stabilising effect on capital gearing, in addition to the reduction in the net borrowing requirement which has reduced reliance on external funds generally.

Company liquidity

ICCs chose to increase liquid assets in the recent recession, in addition to reducing their borrowing requirement (Table F). In the three years to 1991 ICCs increased liquid assets by £26 billion. Not until 1992 did ICCs as a whole run down liquid assets (by £2.5 billion) as a means of financing the deficit—and even then they partly reversed this rundown in the first quarter of 1993.

The data are consistent with the Large Companies Liquidity Survey, which illustrates that in reaction to recession large companies increased short-term assets as a percentage of the total. Chart 12 shows that throughout 1991 and in the first half of 1992 large companies moved out of long-term assets into liquid assets. This is consistent with firms attempting to build up short-term balances in a period of financial

Chart 12
Net current and long-term assets of large companies[a]



(a) Data from CSO's *Financial Assets and Liabilities Survey*. This is not a complete balance sheet, so total assets are not equal to total liabilities. Large companies are defined as those with total net assets exceeding £40 million.
(b) Current assets (liabilities) are defined as those maturing (realisable) in less than one year.

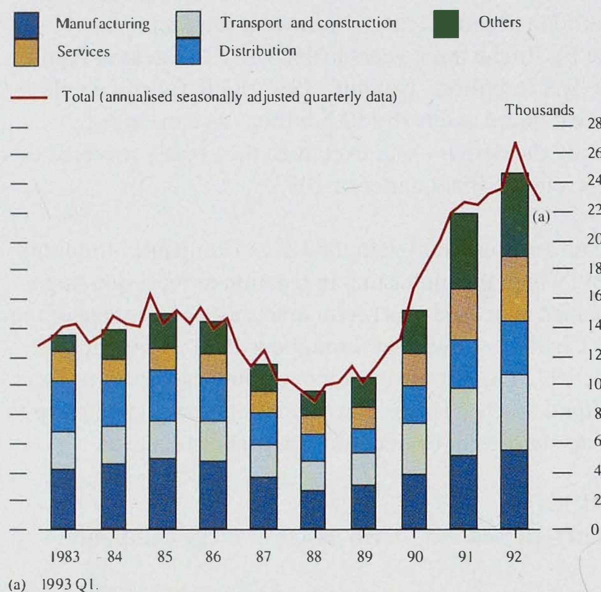
difficulties, and may also reflect the shape of the yield curve; long-term interest rates were lower than short rates between 1989 and the first half of 1992. Since the second half of 1992, the yield curve has been positively sloped and the chart shows that short-term assets of large companies have fallen while net long-term assets have flattened.

Insolvencies

The diversity in experience discussed above is reflected in the high number of insolvencies. During this recession a much greater proportion of companies have become insolvent: 2.9% of active companies became insolvent in 1992 Q3, whereas following the previous recession the ratio did not peak until 1985 Q4, when 2.1% of active firms became insolvent.

As can be seen from Chart 13, the sectoral distribution of insolvencies has changed markedly since the previous peak in 1985. In 1992 insolvencies in manufacturing were 13% higher than in 1985, whereas construction sector insolvencies increased by 94% over the same period and

Chart 13
Insolvencies by industrial sector



(a) 1993 Q1.

service sector insolvencies by 197%. Such divergent sectoral trends reflect the markedly different industrial and regional impact that this recession has had compared with the last.

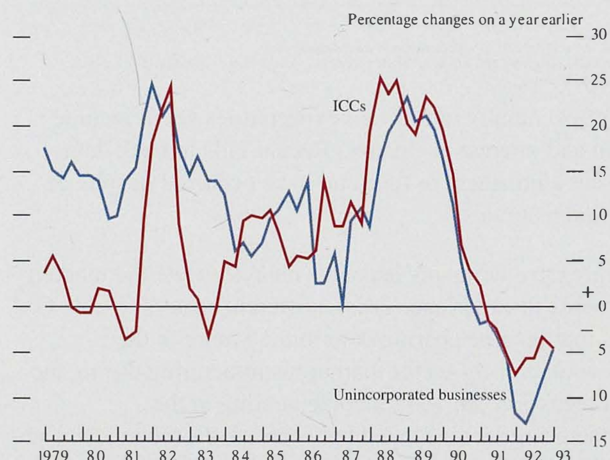
The increased number of insolvencies partly reflects the rise in the number of small firms in the 1980s. The proportion of firms employing between one and five people increased from 79.2% in 1979 to 87.7% in 1989.[1] As the rate of small firms' formation and exit is generally higher than for large firms, the increasing proportion of small firms in the total would be expected to raise the proportion of companies becoming insolvent. Higher insolvencies may also be a consequence of the 1986 Insolvency Act. In particular the wrongful trading provisions aimed at protecting creditors may have led some firms to opt for insolvency earlier than in the previous recession.

More encouragingly, the number of insolvencies fell significantly in the two quarters to 1993 Q1, perhaps suggesting a much earlier peak than the previous recession, when insolvencies continued increasing until 1985. If so, it would tie in with the view that the painful effects of recession, including employment and insolvencies, have occurred earlier in this cycle than in previous cycles.

The experience of smaller firms

The contrast between the financial performance of smaller and large firms has been very marked in the recent recession. Many small firms started or expanded rapidly in the 1980s, and have more recently experienced severe difficulties. Chart 14 shows that strong increases in bank lending to ICCs and unincorporated businesses[2] (a proxy for small businesses) in the 1980s came to an abrupt end by the end of 1990. The early 1990s has been a period in which bank lending to small businesses has contracted sharply. By this time many small firms had already taken advantage of the improved access to credit afforded to them by financial liberalisation and the rise in property prices which made available security for credit. In the early 1990s, property price declines eroded collateral and demand conditions deteriorated, leaving many smaller firms in financial difficulties. As over three quarters of small firms' borrowing is at floating rates,[3] their interest payments are highly sensitive to changes in short-term rates and their income gearing has increased sharply.

Chart 14
Real[a] sterling bank[b] lending to ICCs and unincorporated businesses



(a) Deflated by GDP deflator.
(b) Includes building societies.

Table H contrasts the performance of smaller[4] firms with those of all firms within the sample of EXTEL firms.[5] There is a sharp contrast in the performance of smaller firms from those of the entire sample. In 1988, smaller firms exhibited a strong financial performance relative to large ones. Profitability was strong and gearing levels modest.

Table H
The performance of smaller[a] and large companies[b]

Per cent

Reporting year	1988	1989	1990	1991	1992
Return on sales(c)					
Smaller firms	8.9	7.5	2.4	0.3	-1.8
All firms	9.6	10.0	9.1	7.6	7.6
Income gearing(d)					
Smaller firms	11.5	17.6	48.3	. . .(e)	. . .(e)
All firms	14.5	18.5	24.8	28.8	27.9
Capital gearing(f)					
Smaller firms	4.3	9.7	10.5	17.9	25.6
All firms	20.9	25.3	25.3	25.9	25.7

(a) Smaller companies companies are defined as those which satisfy each of the following criterion: (i) sales less than £25 million (ii) net assets less than £12.5 million (both at constant 1992 prices) and (iii) employees less than 350. In each year the sample comprises over 200 firms.
(b) Data are taken from EXTEL. The definitions are not directly comparable with those used in the national accounts.
(c) Pre-tax operating profit as a percentage of sales.
(d) Gross interest payment as a percentage of pre-tax income.
(e) Used when number is greater than 100.
(f) Total loans as a percentage of total assets.

(1) 'How Many Small Firms?', *Employment Gazette*, February 1992.
(2) Source: Bank of England survey of firms with turnover of less than £10 million.
(3) 'Bank lending to smaller businesses', Bank of England, January 1993. The survey covers firms with turnover of less than £10 million.
(4) Defined as firms who are 'smaller' in the year in question according to the criteria defined in Table H.
(5) The year used refers to the year in which the accounting period ended. Thus the results for a firm whose accounting year ends in March would depend on performance from April of the previous year.

But the financial position of smaller firms deteriorated substantially over the remainder of the period, and the 1992 results show that, as operating profits were negative for the sample of smaller firms, profitability was also negative. Income gearing for this group continued to rise in 1992, in contrast to the whole sample of firms, whose performance generally stabilised by the end of the period.

Prospects

ICCs have retrenched considerably, improving their current and prospective financial performance. Profitability and investment have stabilised at much higher levels than in either of the two previous recessions, and manufacturers are more competitive than in the early 1980s. This provides a better platform than in the early 1980s for firms to respond to recovery, though the difficulties facing many smaller firms and parts of the non-manufacturing sector meanthat these firms are some way from reaching such a position.

Although the financial pressures which contributed to recession have subsided, the effects of prolonged periods of large financial deficits and borrowing requirements may continue to affect company behaviour for some time, partly because considerable diversity remains in recent financial performance.

The experience of the recent recession, when many firms' debt service ratios rose shaply, may limit firms' willingness to finance expenditures through debt in this recovery. ICCs are presently showing very little inclination towards debt finance, even though the CBI survey evidence suggests that excessive cost of finance is not an important obstacle to investment. Although larger ICCs have recently turned increasingly to the capital markets for finance, this is not an option for many smaller firms who have faced the most acute financial pressures in the recent recession. For these firms the effects of financial overcommitment may take some time to unwind.