Company profitability and finance

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As the recovery has become more firmly founded, the financial position of industrial and commercial companies (ICCs) has strengthened. This article compares the present recovery with that of 1982–84, and examines in detail how firms have performed in 1993 and the first quarter of 1994. The main points include:

- *Profitability is at a markedly higher level than at a similar stage in previous recoveries. In the first quarter of 1994, the pre-tax return on capital in the non North Sea sector increased to 9.5% from a trough of 6.3% in the first quarter of 1992. This return on capital is almost double that at the equivalent stage in the previous recovery.*

- *ICCs' retained earnings increased by over a third in 1993, when firms made unprecedented net repayments of bank debt. ICCs' net repayments to banks were equivalent to 1.8% of GDP in 1993, compared with total net borrowing equal to 2.4% of GDP in 1982, the comparable year in the last recovery.*

- *At the same time, firms have increasingly used the capital markets as a source of external finance. Gross capital issues by ICCs increased by 51% to £23.9 billion in 1993, representing 30.3% of total ICCs' funding.*

- *ICCs' dividend payments—which have been historically high since the mid-1980s—have grown further in the recovery; they increased 9.3% to £22.7 billion in 1993. But many firms with relatively weak profitability and high indebtedness have chosen to cut or pay no dividends in the recent cycle.*

- *Fixed investment has been higher as a share of GDP than in the previous recovery. This reflects a higher starting level of investment at the end of the recession; but to date, investment has not risen further as the recovery has picked up.*

Performance in the present and previous recoveries compared

Company performance in the present recovery so far has differed in a number of ways from the previous one in 1982–84. The differences have to some extent reflected the relative shallowness of the recent recession, and they have been seen in the profitability, investment and financial transactions of industrial and commercial companies (ICCs). The recent cycle has also had a different sectoral impact—with business failures in the service sector, for example, remaining high compared with the previous recovery.

Profitability

Excluding the North Sea sector, ICCs' pre-tax return on capital recovered to 8.3% in 1993—almost twice as high as in 1982, the similar stage in the last recovery (see Table A). The rise in profitability has occurred from a higher starting-point than both in the early 1980s and after the 1974–75 recession, but has not been significantly sharper than in those recoveries. The pre-tax rate of return on capital

Table A
Measures of ICCs' performance (1980–84 and 1990–93)

Per cent in italics

	Firms operating below capacity (a)	Return on capital (b)	Net income gearing (c)	Capital gearing (d)	Valuation ratio (e)
1980	*73*	*4.1*	*27.3*	*9.0*	0.4
1981	*80*	*3.0*	*23.7*	*7.5*	0.4
1982	*76*	*4.3*	*22.6*	*9.8*	0.4
1983	*70*	*5.1*	*18.1*	*9.2*	0.5
1984	*58*	*5.4*	*17.7*	*9.5*	0.5
1990	*49*	*7.5*	*31.2*	*24.9*	0.9
1991	*67*	*7.2*	*27.5*	*26.3*	1.0
1992	*69*	*6.9*	*25.2*	*27.1*	1.1
1993	*65*	*8.3*	*18.1*	*23.3*	1.2

(a) Source: CBI quarterly survey of manufacturing firms.
(b) Pre-tax rate of return on capital stock at replacement cost in the non North Sea sector.
(c) Net interest payments as a percentage of after-tax income.
(d) Outstanding borrowing (debt at nominal value) as a percentage of the capital stock at replacement cost.
(e) Ratio of ICCs' net financial liabilities to their capital base.

rose to 9.5% in the first quarter of 1994 from a trough of 6.3% in the first quarter of 1992. This compares with rises over a similar period of two percentage points from a trough of 2.3% in 1981 Q2, and of three percentage points from a trough of 3.5% in 1975 Q3.

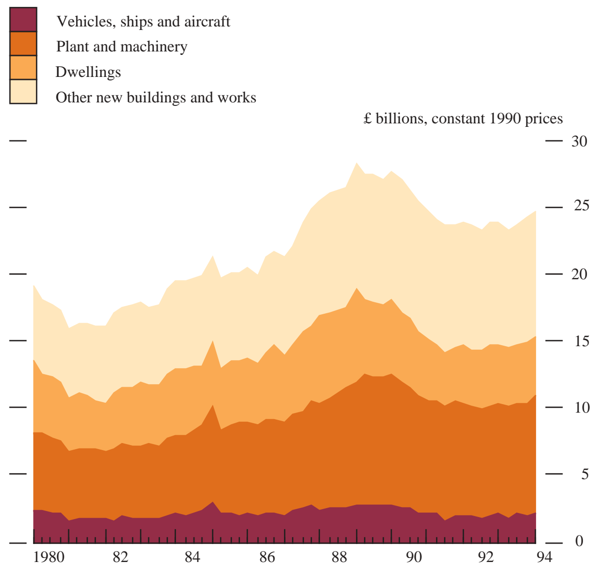
The higher level of profitability has reflected in particular the strong growth of labour productivity relative to the growth in real wages in the last decade or so. ICCs' labour productivity[(1)] increased by 36% between 1990 and 1993, compared with a rise of 9.4% in 1979–82.

In addition, the shallowness of the recent recession has meant that manufacturers' levels of capacity utilisation have remained higher than previously, helping to contain fixed costs per unit of output. As Table A shows, CBI survey evidence suggests that 65% of manufacturers were operating below capacity in 1993, compared with 76% in 1982.

Investment

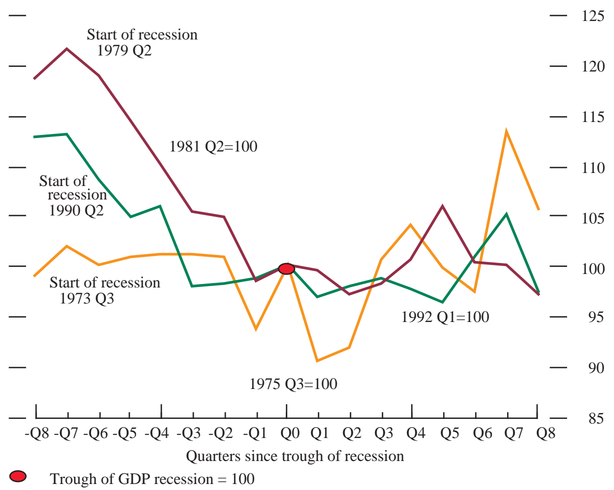
Investment by ICCs was 9.1% of GDP in 1993, compared with an average of 6.4% a year between 1982 and 1984.[(2)] Stronger investment in plant and machinery has been a notable feature—it represented 6.1% of GDP in 1992 and 1993, compared with an average of 5.1% a year between 1982 and 1984 (see Chart 1).[(3)] There has also been greater investment in 'other' new buildings and works—6.6% of GDP in 1993, compared with 5.6% in 1982.

Chart 1
Whole-economy investment—analysis by asset



So far, however, there has not been a strong upturn in ICCs' capital spending, and over the last year or so investment has contributed less to the growth of GDP than in the previous recovery. In real terms, ICCs' investment grew by 1.7% in 1993, compared with a rise of 2.4% in 1982 (see Chart 2). A possible explanation for this may be that firms have given priority to reducing their higher levels of debt this time rather than to new investment.

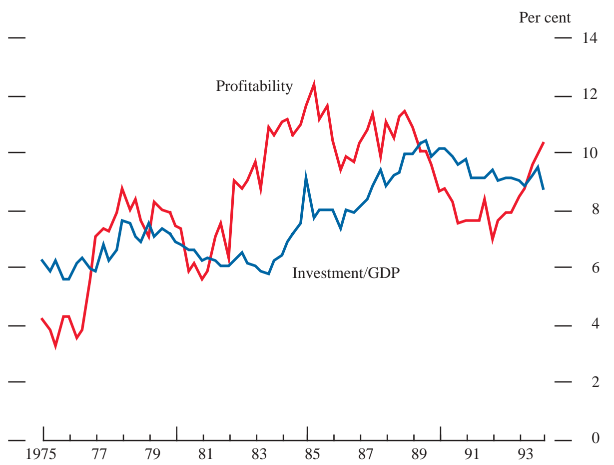
Chart 2
ICCs' investment in three recessions[(a)]



(a) Investment in 1990 prices.

Changes in profitability do, however, tend to precede changes in the investment to output ratio—as Chart 3 shows. In the previous recovery, ICCs' profitability started to increase in the first quarter of 1981, but the investment to output ratio did not grow until the third quarter of 1983. In the present recovery, profitability reached a trough in the first quarter of 1992, and the investment to output ratio is yet to show any sustained rise.

Chart 3
ICCs' return on capital[(a)] and ICCs' investment as a percentage of GDP[(b)]



(a) Pre-tax rate of return on capital stock at replacement cost.
(b) Investment and GDP at 1990 prices (GDP at market prices).

In an upturn, firms may postpone major investments until output shows definite signs of recovery and profitability begins to increase. In addition, the installation of plant and equipment is often a lengthy process. Nevertheless, the sharp rise in profitability in recent quarters should add

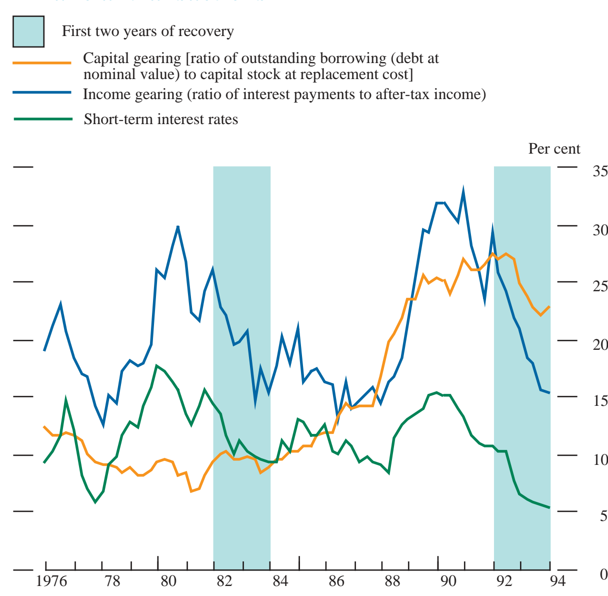
(1) The figures cover the mining and quarrying, manufacturing, utilities, construction, distribution and transport, and communication sectors. Sectors are weighted using the Central Statistical Office's 1990 weights.
(2) The higher corporate-sector investment to output ratio, however, partly reflects the effect of privatisations, which have widened the sector.
(3) The figures cover whole-economy investment in plant and machinery, and not just that by ICCs.

strength to the recovery in investment—a view which is supported by survey evidence (see below).

Financial transactions

ICCs' financial transactions have been very different in this recovery from that in the early 1980s. Firms have reduced their levels of bank debt significantly and turned increasingly to the capital markets for external finance; bank borrowing has been much lower than in the previous recovery. Nevertheless, capital gearing—outstanding borrowing at nominal value as a proportion of capital stock at replacement cost—remains high. Most of the improvement in ICCs' income gearing—the ratio of interest payments to after-tax income—reflects lower interest payments (Chart 4).[1]

Chart 4
Financial transactions



Although profits fell as the economy entered the recent recession, investment levels were maintained and this led to a significant worsening in companies' financial balance in 1990–92. The sharp improvement in retained earnings last year has enabled firms to improve their financial position: ICCs recorded a financial surplus of £2.8 billion (0.4% of GDP)—the first surplus for six years. In the previous recovery, ICCs recorded an average surplus of £4.1 billion a year (1.4% of GDP) between 1982 and 1984, as capital expenditures remained below retained earnings.

After a high net borrowing requirement—boosted by mergers and acquisition activity—in the years leading up to the last recession, there has been a large fall in ICCs' net borrowing requirement, though it remains above the levels seen in the previous recovery. It fell from £28.6 billion to £14.3 billion in the year to end-1993, compared with an average of £3.7 billion between 1982 to 1984. Although the borrowing requirement has been higher in this recovery, bank borrowing has actually been lower. Instead, ICCs have made significant net *repayments* to banks. In 1993 alone, companies repaid £11.4 billion to banks (£2.3 billion in 1992), compared with average borrowing of £5.1 billion a year between 1982 and 1984 (see Table B). The emphasis that firms have placed on reducing gearing levels by repaying bank debt may be partly the result of low inflation. Capital gearing levels were similarly high in the mid-1970s, but with strongly negative real interest rates following that recession, real debt values were rapidly eroded; it is unlikely that firms expect debt to be eroded by inflation in such a way in this recovery.

Table B
Selected items from ICCs' accounts and financial transactions (1980–84 and 1990–93)

Percentage of GDP (a)

	Total income (b)	Undistributed income	Investment	Financial surplus(+)/ deficit(-)	Borrowing requirement	Bank borrowing
1980	15.5	8.1	7.1	—	2.4	2.7
1981	15.5	7.8	6.4	0.6	1.7	2.2
1982	16.4	7.8	6.2	1.1	2.5	2.4
1983	17.6	8.8	5.8	1.7	0.3	0.5
1984	19.2	9.7	6.8	1.3	1.0	2.2
1990	19.5	6.7	9.9	-4.1	6.7	3.6
1991	18.6	7.0	8.7	-1.4	4.7	-0.2
1992	17.5	6.8	8.0	-1.3	4.8	-0.4
1993	18.3	8.6	7.8	0.4	2.3	-1.8

(a) GDP at current market prices.
(b) Net of stock appreciation.

There has been increased recourse to the capital market, with ICCs' net capital issues totalling £17.3 billion in 1993. There was a significant rise in the volume of equities issued; this was partly a consequence of the rise in share prices in 1993, which contributed to the relative attractiveness of the capital market.

There has also been a tendency since the early 1980s for the corporate sector to issue a greater amount of fixed, rather than floating-rate, finance: only about 60% of the stock of corporate sector debt is now closely linked to short-term market rates, compared with over 90% in 1982.[2] A consequence of the large debt repayments by ICCs has been that their capital gearing has fallen, although it remains at historically a high level. ICCs therefore remain sensitive to changes in nominal interest rates, but the tendency to issue more fixed-rate finance may reduce that sensitivity in the short term.

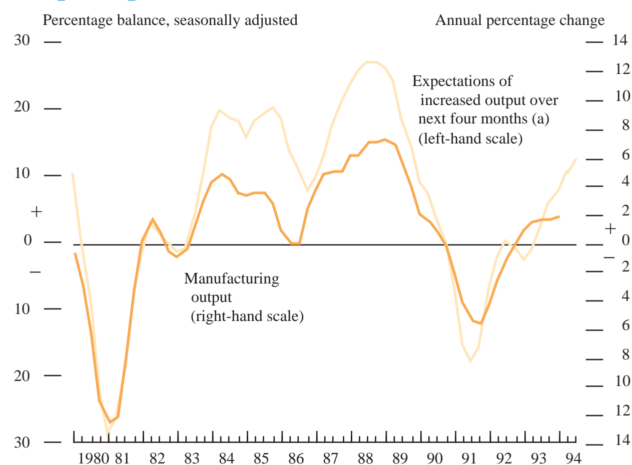
Company performance in 1993 and 1994

The cash flow of firms has improved significantly over the last year, as consumer demand has strengthened and sales have recovered. In 1993, output grew across all sectors except construction; growth in this sector resumed in the last quarter of 1993. Chart 5 shows the annual change in manufacturing output and the balance of manufacturers expecting an increase in output (as reported by the CBI). The rate of output growth is expected to continue increasing in 1994, albeit moderately. Improved trading conditions

(1) For a disaggregated analysis of corporate sector debt, see the article on personal and corporate sector debt in the May 1994 *Quarterly Bulletin*, pages 144–55.
(2) See the article, 'Fixed and floating-rate finance in the United Kingdom and abroad', in February 1994 *Quarterly Bulletin*, pages 34–45.

have also led to a sharp decline in business failures in the recovery so far.

Chart 5
Output expectations

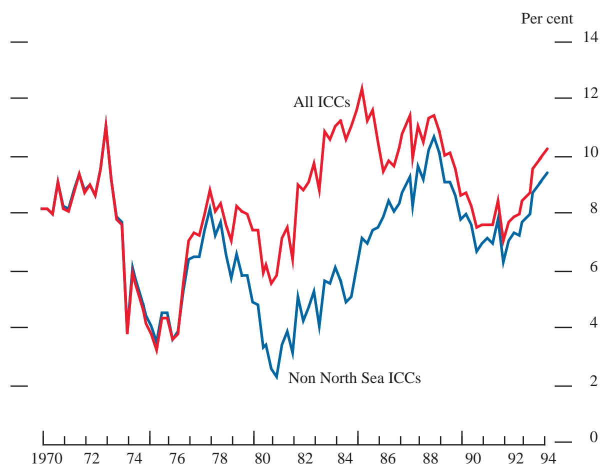


(a) Source: CBI Industrial Trends survey.

Profitability

Cost containment and sustained productivity growth have contributed to the continued rise in profitability. Non North Sea ICCs' pre-tax rate of return increased sharply from the third quarter of 1993, and by the first quarter of 1994 was only 1.2 percentage points below its peak in the fourth quarter of 1988 (Chart 6). The return on capital of these

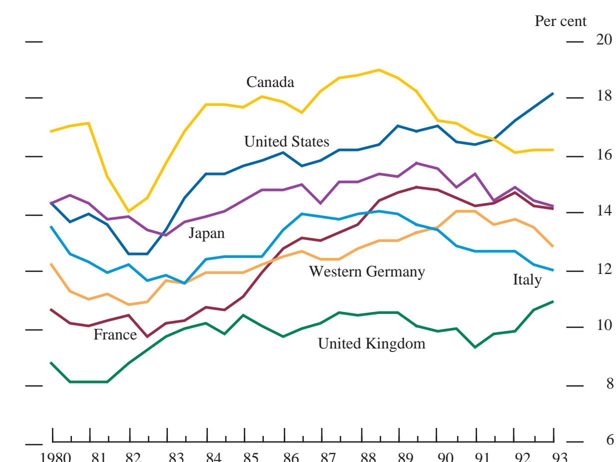
Chart 6
Return on capital(a)



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

ICCs is now 3.2 percentage points higher than its trough in the first quarter of 1992. Chart 7 shows that the gap between the profitability of the UK business sector and those of other G7 economies narrowed sharply in the first half of the 1980s, but that the improvement was not sustained later in the decade.[1] Recently, UK profitability has improved once more, particularly relative to other European economies.

Chart 7
Cross-country profitability



Source: OECD.

Income and appropriations

As Table C shows, gross trading profits (net of stock appreciation) increased markedly in 1993; they were 14.4% higher than in the previous year. In the year to the first quarter of 1994, they increased by 16.6%. ICCs' profits

Table C
ICCs' income and appropriation accounts

£ billions

	1990	1991	1992	1993	1994 Q1
Income					
Gross trading profits (a)	74.4	78.1	77.8	89.0	24.3
Rent and non-trading income	15.4	13.9	12.0	9.9	2.6
Income from abroad	18.0	15.0	14.6	16.2	4.0
Total income (a)	**107.8**	**106.9**	**104.3**	**115.1**	**30.9**
Allocation of income					
Dividends on ordinary and preference shares	17.6	18.4	20.8	22.7	5.1
Interest and other payments	32.1	29.8	26.8	21.1	4.9
Profits due abroad	7.7	5.4	5.0	6.3	2.0
UK taxes	18.7	15.4	13.4	13.0	3.1
Undistributed income (a)	**31.7**	**37.9**	**38.2**	**51.9**	**15.8**
Capital transfers	-0.5	-0.5	-0.5	-0.4	-0.2
Fixed investment	54.7	50.0	47.8	48.7	11.8
Physical increase in stocks	-1.1	-4.8	-2.1	0.2	-0.3
Financial balance (surplus +)	**-22.8**	**-7.8**	**-7.6**	**2.8**	**4.3**

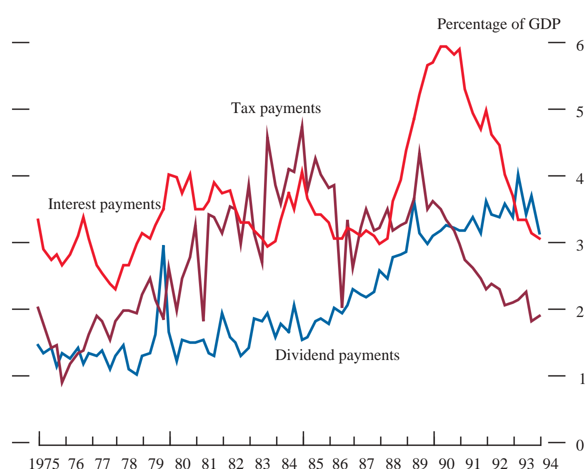
(a) Net of stock appreciation.

have now increased in every quarter since their trough in the first quarter of 1992, rising a total of 33.2%. ICCs' tax payments declined marginally in 1993, reflecting the increase in capital allowances between November 1992 and October 1993, and the stability of profits in the previous year.

Dividend payments rose by 9.3% in 1993—more slowly than the growth in profits—but fell by 1.3% in the year to the first quarter of 1994. Over the last ten years, dividend payments by ICCs have doubled as a percentage of GDP—to 3.1% in the first quarter of 1994 (Chart 8). The path of the

(1) Profitability is measured here by the pre-tax operating surplus net of depreciation as a percentage of the capital stock net of cumulative depreciation. Differences in estimates of asset lives mean that the levels of profitability are not directly comparable across countries.

Chart 8
Selected items from ICCs' balance sheets(a)



(a) Tax, interest and dividend payments at current prices; GDP at current market prices.

dividend payout ratio—dividends as a proportion of post-tax income—has been similar during the early 1990s' cycle to that in the early 1980s, but from a higher starting-point.(1)

The ratio remained above 30% between 1990 and 1993—high by the standards of the last 20 years (though not as high as in the late 1960s). A possible explanation for this is that the long-term profit growth of firms has been expected to be higher and this optimism has influenced dividend behaviour. It may also reflect the provision for tax-exempt shareholders to reclaim advance corporation tax on dividends. For companies paying mainstream corporation tax, there is a higher charge on retained than on distributed profits when shareholders are exempt from tax on dividends. As profitability increased in the 1980s, a greater proportion of firms paid mainstream corporation tax, and so dividend behaviour was more influenced by the difference in effective tax rates. As profits have increased in the recovery, this difference may have provided an incentive to increase dividends.

In addition, firms have continued to restructure their balance sheets by increasing their use of the capital market and lessening their reliance on bank borrowing (see below). The resulting greater proportion of equity has contributed to the rise in dividend payments. Reduced bank borrowing and lower nominal interest rates led interest payments to fall by 21.4% in 1993; they continued to fall in the first quarter of 1994. ICCs' undistributed income rose 33.7% in nominal terms in 1993, primarily reflecting higher profits. Company performance continued to strengthen in the first quarter of 1994, when undistributed income rose to £16.3 billion. The level of ICCs' undistributed income as a proportion of GDP has in fact been similar to that seen in the previous recovery, because dividend payments have been higher—ICCs' dividend payments were 3.6% of GDP in 1993, compared with 1.6% in 1982.

Capital expenditure

In real terms, ICCs' fixed investment grew in the third and fourth quarters of 1993, but fell back in the first quarter of 1994, when it was 0.2% lower than a year earlier. The fall was greatest in the manufacturing sector, where investment was 3.7% down on 1993 Q1.

According to CBI survey evidence, however, investment intentions have increased in the manufacturing sector. The balance of manufacturing firms expecting investment to increase in the following 12 months improved from -13% in 1992 to -5% in 1993. In the first two surveys of 1994, there was a positive average balance of +6%.

CBI surveys have also shown that an increasing proportion of firms are investing to increase capacity—27% in the April 1994 survey, compared with 19% in 1992 (see Table D). These indications are consistent with the rise in the CBI capacity utilisation balance (see Table A above), but that balance also suggests that capacity pressures are not significant. At this stage, firms' priority when investing seems to be to improve efficiency—a view supported by the contacts of the Bank's regional agents. The number of firms reporting the cost of finance as a factor limiting investment has fallen markedly in the recent recovery, from 12% in 1992 to 2% in the April survey. Uncertainty about demand has remained the major limiting factor, with 55% of firms mentioning it in April, compared with a peak of 60% in January 1992.

Table D
CBI survey evidence on investment (percentage of manufacturing firms)

Reasons for capital expenditure:

	Expand capacity	Increase efficiency	For replacement	Other
1991	18	71	53	11
1992	19	70	50	11
1993	23	70	52	10
1994 Q1	25	75	52	8
1994 Q2	27	76	47	7
Mean 1979 Q4–1994 Q1	*23*	*72*	*50*	*7*

Factors limiting capital expenditure:

	Cost of finance	Inadequate net return	Uncertainty about demand	Lack of internal finance	Lack of external finance
1991	17	42	55	24	4
1992	12	44	58	23	4
1993	5	46	54	26	5
1994 Q1	2	46	44	24	3
1994 Q2	2	44	55	23	3
Mean 1979 Q4–1994 Q1	*11*	*41*	*46*	*21*	*3*

There is also some evidence that firms have continued to be deterred from investing by inadequate rates of return; a balance of 46% reported this as a limiting factor in 1993. One reason for it might be that firms have not yet adjusted their required rates of return to take account of lower and less variable inflation.(2)

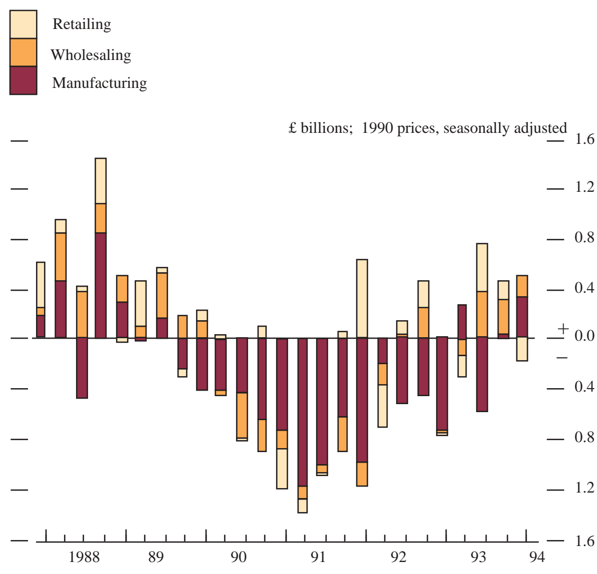
(1) See the box on the cross-sectional analysis of dividend payments on page 247.
(2) The article on pages 250–4 looks at companies' criteria for investment appraisal and the implications of a return to sustained low levels of inflation.

It seems likely that investment will show stronger signs of recovery in the near future, as firms' financial positions improve further. Anecdotal evidence suggests, however, that rates of scrapping were lower in the recent recession than in 1981–82; if so, there is likely to be significant spare capacity in the economy—particularly in sectors such as construction—and this may weaken the growth in investment in the short term.

Stockbuilding

Whole economy stocks rose by £335 million in 1993, compared with a fall of £1.8 billion in 1992 (see Chart 9). There was, however, significant destocking in the manufacturing sector: stocks there fell by £1 billion in 1993, though they recovered by £334 million in the first quarter of this year. The latter was in line with CBI survey data which suggest expectations of reduced destocking: the April survey showed a balance of -14% of firms expecting to increase stocks, compared with a trough of -26% in July 1991.

Chart 9
Stockbuilding in the manufacturing and distribution industries

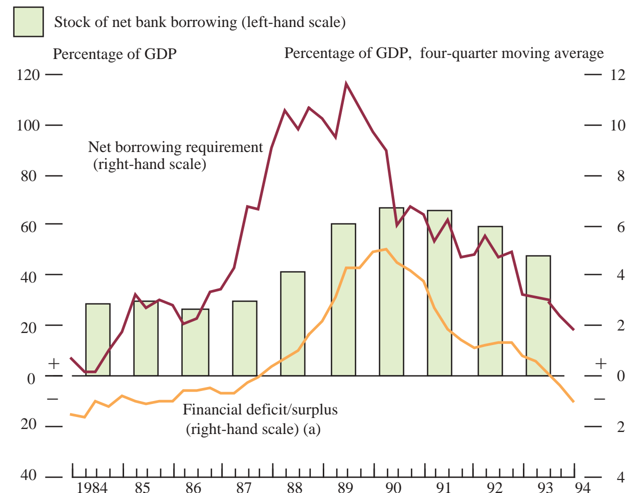


Overall in the first quarter of 1994, total stocks fell by £449 million.[1] Manufacturing and wholesaling stocks increased—the latter by £158 million—but in the retailing sector, there was a fall of £184 million, perhaps because firms underestimated demand prior to announced tax changes. Firms may be inclined to increase rather than reduce stocks in the near term, as they become more confident about the strength of demand, and with the incentive provided by low inflation and low nominal interest rates.

Financial transactions

ICCs recorded a financial surplus of £2.8 billion (0.4% of GDP) in 1993—the first surplus for six years; in the previous five years, their financial deficit had averaged 2.5% of GDP (Chart 10). The dramatic turnaround in financial position seems to have resulted from the emphasis firms have placed on reducing debt levels, with their large growth in profits enabling them to do so. Firms' net borrowing requirement began to fall in 1989, at an earlier stage of the downturn than in the previous recession. In 1993, the borrowing requirement was 2.3% of GDP, compared with the 1988 peak of 10.6%. The financial balance of firms took longer to adjust, as capital expenditures remained high by historical standards, so that firms did not record a surplus until last year. The trend continued in the first quarter of 1994, when ICCs' financial surplus of £4.3 billion was the largest on record.

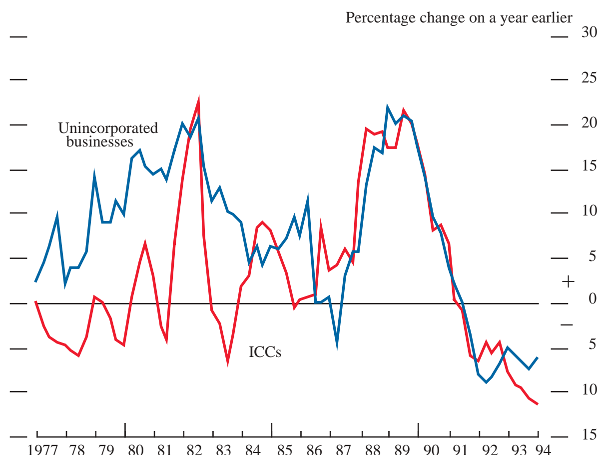
Chart 10
Financial deficit/surplus, net borrowing requirement and stock of net bank borrowing



(a) + = deficit, - = surplus

ICCs repaid £11.4 billion to banks in 1993 (1.8% of GDP) continuing the trend seen since 1991 (see Chart 11); this has

Chart 11
Real(a) stock of bank lending(b) to ICCs and unincorporated businesses



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

(1) This was in large part the result of significant destocking in the 'other industries' category.

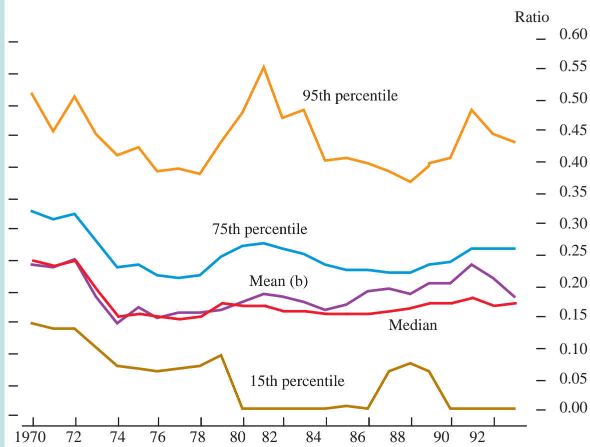
A cross-sectional analysis of dividend payments

Since the late 1970s, firms as a whole have increased their dividend payout ratio—the proportion of post-tax income they distribute in dividends. This box investigates whether the increase has been a feature across the corporate sector or has been confined to a relatively small number of firms.[1]

Some commentators have suggested that the dividend payout ratio remained at historically high levels in the recent recession because firms did not wish to give an adverse signal to shareholders. If so, such behaviour would mean that one commonly-perceived difference between equity and debt finance—that interest payments are less contingent on company performance than dividends—was in practice less clear cut. To explore this, the box also examines the proportion of firms that cut dividends, and compares the performance of those firms that cut and those that raised dividends.

In order to examine whether the increase over time in the mean dividend payout ratio is a feature shared by firms generally, Chart A shows a cross-sectional distribution of dividend payout ratios. The lines show the ratio for representative firms at various points in the distribution; for example, the line showing the 95th percentile gives the payout ratio of the firm with a ratio higher than 95% of the firms in the sample.

Chart A
Dividend payout ratio:[(a)] cross-sectional distribution and mean

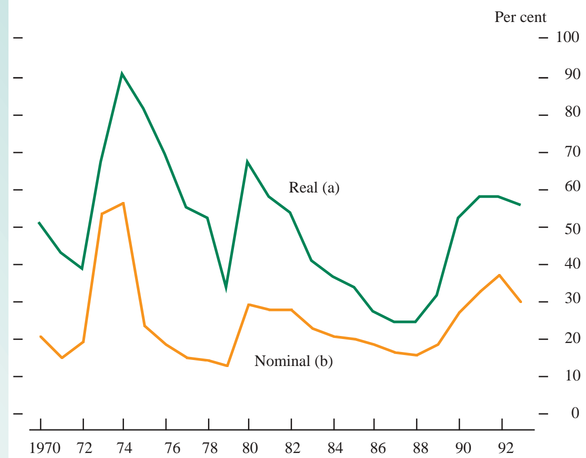


(a) Dividend payments as a proportion of total income net of tax and interest payments.
(b) The mean dividend payout ratio increased from 13.9% in 1974 to 23.4% in 1991.

Chart A shows that although the mean dividend payout ratio increased steadily from the mid-1970s to 1991, it did not increase across all firms. In the late 1980s, it increased sharply for firms in the upper tail of the distribution, but by 1990 at least 15% of firms paid no dividends. So the rise in the average ratio may reflect a minority of firms paying higher levels rather than low-income firms being resistant to cutting dividends.

Chart B reinforces the view that some firms did choose to cut dividends (or pay no dividends) in the recent recession. A greater proportion of firms cut their nominal dividends in the recent recession than in the early 1980s. Indeed, the proportion of firms cutting the real dividends they paid rose to 58% in 1992: 22% of the firms included paid no real dividends and a

Chart B
Percentage of firms cutting and/or paying no dividends

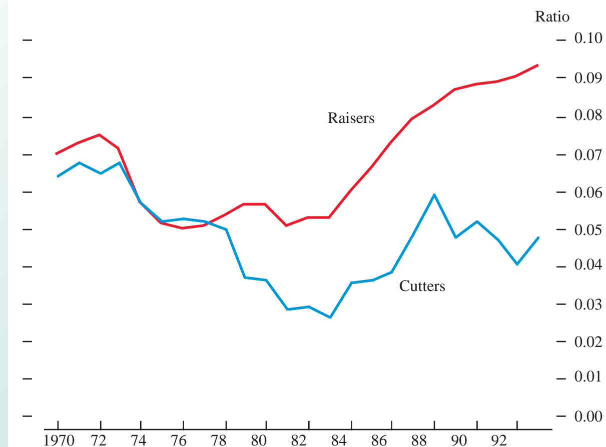


(a) Dividend payments expressed in real terms (deflated by the GDP deflator).
(b) Dividend payments expressed in current values.

further 36% of firms paid lower (real) dividends. This was, however, rather less than in the early 1980s.

The cross-sectional analysis can be used to examine the characteristics of firms that cut their real dividend payments. For most of the 1970s, there was little difference between the profit to output ratio of firms cutting and those raising dividends, but from the late 1970s a widening wedge developed between the two groups—see Chart C. A similar picture

Chart C
Profit-output ratios[(a)] of real[(b)] dividend-cutting and dividend-raising companies



(a) Post-tax income net of interest payments as a proportion of turnover. The lines represent the median profit to output ratio of the group in each year. The composition of the groups changes in each year.
(b) Deflated by the GDP deflator.

emerges from looking at the capital gearing of dividend-cutting and dividend-raising firms: the cross-sectional analysis therefore confirms that firms with relatively low profitability and high indebtedness *were* prepared to cut or pay no dividends in the recent recession. This may have sent a signal of their relatively poor performance to shareholders, but it helped to relieve their cash-flow difficulties.

(1) It uses company accounts data compiled by Datastream International. The accounts of, on average, 1,200 quoted companies are used for each year. 1993 data are provisional, as only around half of the data have been collected to date.

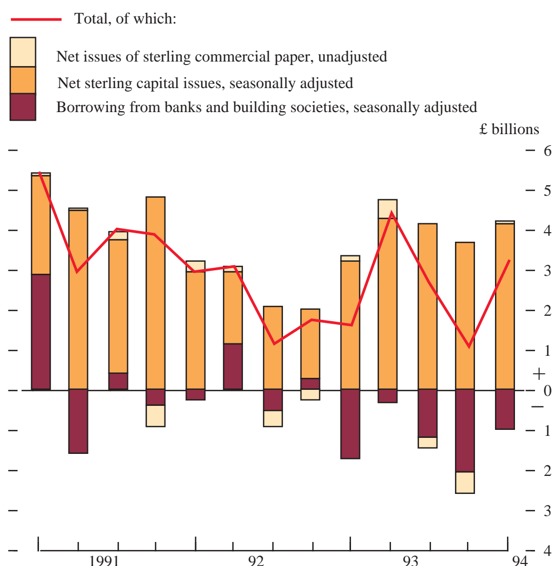
been followed by a further £2.8 billion repayment in 1994 Q1. The switch away from bank borrowing partly reflects the desire of firms to reduce their income and capital gearing. There have been significant differences in the rates at which different sectors have reduced their borrowing. Table E shows that the reductions have been greatest in the construction industry—where firms borrowed 15.7% less in 1993 than in the previous year—and in the manufacturing and distribution sectors. Bank lending to the utilities increased by 17.6% over the course of 1993, reflecting strong investment in that sector.

Table E
Stock of sterling bank lending across UK industrial sectors

	Utilities	Construction	Transport	Manufacturing	Distribution
£ billions, constant 1990 prices, levels:					
End-1993 Q4	6.4	11.3	6.2	34.3	33.7
Percentage change on a year earlier:					
End-1990	34.0	15.0	12.1	10.9	13.6
End-1991	27.4	-8.1	7.2	-4.5	-0.1
End-1992	46.8	-7.3	-3.6	-1.1	-0.2
End-1993	17.6	-15.7	7.2	-7.2	-7.9
Percentage change on previous quarter:					
End-1993 Q1	1.4	-4.8	1.1	-3.2	-2.1
End-1993 Q2	-6.1	-3.5	0.9	-3.2	-0.3
End-1993 Q3	10.3	-2.9	-1.4	1.9	-3.0
End-1993 Q4	11.9	-5.6	6.6	1.0	-2.7

Reduced recourse to the banking system was to some extent counterbalanced by an increase in capital issues in 1993 (Chart 12). ICCs' sterling capital issues (net of redemptions) totalled £15.2 billion in 1993, which was followed by net

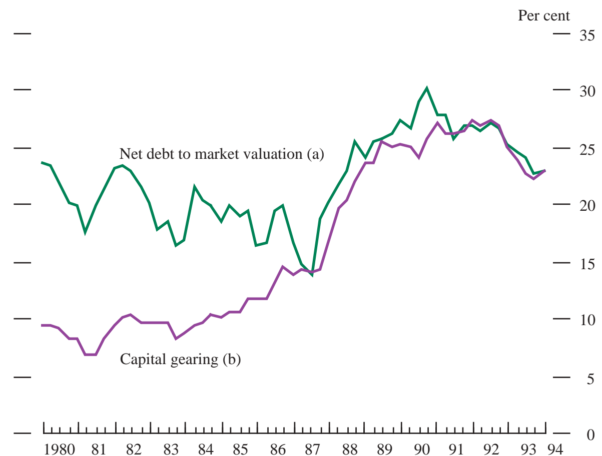
Chart 12
Estimated total quarterly sterling borrowing by ICCs



issues of £4.1 billion in 1994 Q1 on a seasonally adjusted basis. The increase was the result of a sharp rise in net issues of ordinary shares by ICCs: in 1993, ordinary share issues totalled £12.3 billion, a 134% increase on the previous year; in 1994 Q1, £2.4 billion worth of shares were issued.

Chart 13 shows the ratio of ICCs' net debt to net financial wealth (or market valuation).[1] The fall in the stock of ICCs' net debt combined with the rise in their market valuation led to the ratio falling to 24.1% in 1993, from a peak of 28.1% in 1990. The capital gearing ratio—net debt as a proportion of the physical capital stock—also fell in

Chart 13
Measures of gearing



(a) Ratio of ICCs' net debt at market value to the market value of ICCs' firms.
(b) Ratio of outstanding borrowing (debt at nominal value) to capital stock at replacement cost.

1993, to 23.3% compared with 27.1% in 1992; it was 22.8% in the first quarter of 1994. Since 1990, the ratio of net debt to market valuation has fallen more than the capital gearing ratio, as net financial wealth has increased more than the physical stock of capital. Firms continued the reduction in income gearing seen since 1990: average income gearing fell by more than 7 percentage points to 18.1% in 1993. It fell further to 15.2% in the first quarter of this year.

Mergers and acquisitions in the corporate sector have showed some signs of recovery in the last year. In 1993, the number of domestic acquisitions in the United Kingdom totalled 526, an increase of 22% on the previous year, but still a third below their peak in 1987. In the year to the first quarter of 1994, the number of acquisitions increased by 71%. Spending by ICCs on mergers totalled £2.7 billion in 1994 Q1—a 69% increase (in nominal terms) on a year earlier. An increasing proportion of domestic mergers have been financed by cash rather than through share issues: 80% in 1993, compared with 64% in 1992. The first quarter of 1994 showed a sharp fall in cash-financed mergers, however—down to 46% from 87% in the last quarter of 1993.

Insolvencies

Company insolvencies peaked much earlier in the present recovery than in the previous upturn, but the number of

(1) This is an alternative measure of capital gearing to the one commonly used: the major difference is that the denominator is the market valuation of firms rather than the replacement value of the physical capital stock.

insolvencies remains higher—see Chart 14. Since the peak in 1992 Q3, company failures have fallen sharply; they were 14.7% lower in 1993 than in the previous year. Company failures continued to fall in the first quarter of 1994—by 2.6% on the previous quarter and 21.6% on the same quarter of 1993—and now stand at their lowest level since the third quarter of 1990. The improvement partly reflects the fact that firms took active steps early on in this recovery to reduce indebtedness, which was a major factor in many insolvencies in the recent recession.

Chart 14
Company insolvencies

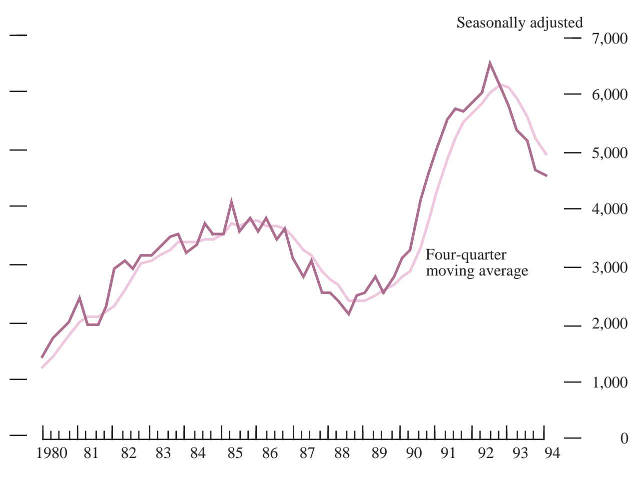


Table F shows that a higher proportion of the business failures during the recent recession were in the financial and business service and construction sectors; in the early 1980s' recession, insolvencies increased most in the manufacturing, and retailing and wholesaling sectors. This sectoral difference has had a regional element. Firms in the financial and business service sector, for example, tend to be concentrated in the south of England, which was affected relatively severely in the recent recession because the debt burden was greatest there.[1] Manufacturing industry is more concentrated in the North and Midlands, which were less affected by the recent recession.

Table F
Company insolvencies by sector

	Total insolvencies ('000s)	'Other' ('000s)	Insolvencies by sector, as a percentage of total insolvencies excluding 'other'(a)			
			Manufact-uring	Construct-ion	Retailing and wholesaling	Financial and business services
1981	8,596	2,341	42.8	15.8	24.4	17.0
1982	12,067	3,059	45.0	15.8	25.7	13.5
1991	21,827	7,249	34.5	23.1	23.3	19.1
1992	24,425	8,072	33.3	23.4	22.8	20.5
1993	20,825	7,193	33.7	23.4	22.1	20.8
1993 Q1	6,235	2,142	35.4	23.7	20.9	20.0
1993 Q2	5,318	1,845	33.0	24.4	21.4	21.2
1993 Q3	4,356	1,425	35.1	22.1	22.7	20.2
1993 Q4	4,916	1,781	30.9	23.2	24.0	21.9
1994 Q1	4,887	. .	. .	. .	. .	. .

. . not available.

(a) Not seasonally adjusted; source: Department of Trade and Industry.

Manufacturing company failures have fallen sharply during the recovery—by 15.8% in 1993. They still account for more than 30% of total insolvencies in England and Wales (excluding 'others'), however. In the construction sector, failures fell by 16.7% in 1993, but activity in the sector has remained depressed. Company insolvencies are also falling in the financial and business service sector, though at a slower rate than elsewhere, so that the sector's *share* of insolvencies has been rising, accounting for 20.8% of the total in 1993 compared with 19.1% in 1991. The downward trend is likely to continue as the recovery becomes more established and the financial position of firms becomes even stronger. At the same time, a significant minority of firms remain highly indebted, so that in the short to medium term business failures are likely to remain above levels seen in the previous recovery.

Summary

There has been a marked turnaround in the financial performance of ICCs in the recent cycle. The rise in profits since 1992 has led to a reduction in ICCs' financial deficit: indeed, they have recorded surpluses in the last three quarters, with an unprecedented surplus in the first quarter of 1994. Lower costs, higher productivity and higher capacity utilisation have meant that profitability has been increasing from a higher starting-point than in the previous recovery. The combination of strong profitability and increased recourse to the capital market has enabled firms to make significant net repayments of bank debt. This, together with the fall in interest rates, has contributed to a fall in their income gearing to levels similar to those in the previous recovery. Capital gearing has also fallen in aggregate, but the debt overhang from the late 1980s remains a constraining factor on the spending of a number of firms.

Capital expenditures have been maintained—rather than increased significantly—so far in the recovery, but the outlook for investment growth is favourable. As debt levels are reduced further, firms are likely to become more confident about their financial position. The growth in retained earnings is likely to continue, enabling more investment to be financed internally; the need for such investment is likely to rise as firms approach capacity constraints.

(1) See the personal sector section of the article in the May 1994 *Quarterly Bulletin*, pages 144–55.