Company profitability and finance

By Mark Cornelius and Kieren Wright of the Bank's Structural Economic Analysis Division.

This article looks at the performance of companies in 1994 and the first quarter of 1995. Its main points include:

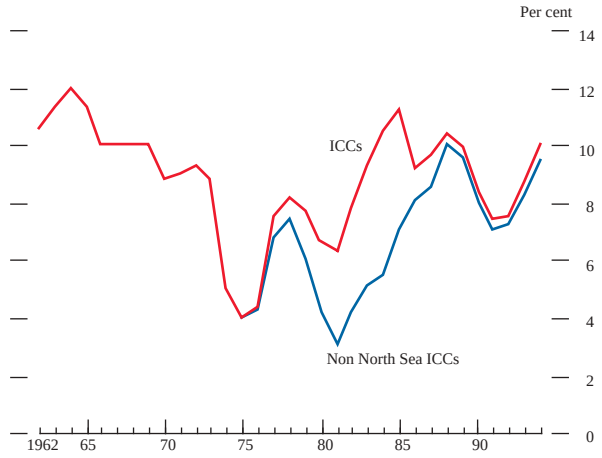
- *Company profitability outside the North Sea sector continued to improve rapidly in 1994. But figures for the first quarter of 1995 suggest that nominal profits fell compared with a quarter earlier.*
- *Industrial and commercial companies' investment fell in 1994. Investment varied markedly between industrial sectors, however. In the oil and gas and utilities sectors it fell sharply, whereas service-sector and manufacturing investment grew quite strongly. Growth in overall investment has been subdued in this recovery to date, particularly in new buildings. But most economic commentators predict that investment will strengthen this year.*
- *Spare capacity, uncertainty and the need to restructure balance sheets are possible reasons for companies' cautious expenditure on fixed assets so far.*
- *Companies increased stock levels in 1994 and at the beginning of 1995. This may have reflected a mixture of involuntary and voluntary stockbuilding.*
- *Despite large repayments of bank borrowings by companies, corporate debt has remained at relatively high levels because of continued growth in the stock of other liabilities. But income gearing is low. Recent recourse to bank borrowing may have reflected a number of factors: including the need for working capital, plans to invest and the desire to finance acquisition activity.*

Profits and profitability

The profitability of industrial and commercial companies (ICCs) outside the North Sea sector(1) continued to rise in 1994 (see Chart 1). Profitability measures the real rate of return on capital or, in other words, profits expressed as a percentage of the capital stock. Underlying these figures, nominal profit growth was higher in 1994 than in 1993 (see Table A). But data indicate that these companies' profits fell sharply in the first quarter of 1995 compared with the previous quarter.

Official data for manufacturing companies suggest that profits in that sector grew by 11% in 1994.(2) Bank estimates suggest that manufacturers' profit margins(3) on domestic sales rose in 1994 compared with a year earlier. Material costs—including semi and finished manufactured imports used in the production process—rose more quickly than domestic output prices. But unit labour costs, which account for a larger proportion of manufacturers' costs, were

Chart 1
ICCs' profitability(a)



Source: CSO.

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

(1) The usual term 'North Sea sector' is used in this article; but strictly, the sector is defined to include those companies involved in the development of new oil fields in the Atlantic.
(2) The Central Statistical Office publishes annual data for the gross operating surplus of manufacturing companies, which is gross trading profits plus rent less stock appreciation.
(3) Measured as profits per unit of output.

Table A
ICCs' income and appropriation account

£ billions (seasonally adjusted)

	1993	1994					1995
	Year	Year	Q1	Q2	Q3	Q4	Q1
Income							
Gross trading profits (a)	85.1	98.5	23.3	24.9	25.0	25.4	24.6
of which:							
non North Sea (a)	*77.0*	*88.8*	*21.3*	*21.9*	*22.6*	*23.0*	*21.8*
Rent and non-trading income (b)	12.5	13.0	3.2	3.2	3.3	3.4	3.5
Income from abroad (c)	15.7	20.2	4.2	5.2	5.5	5.4	5.0
Total income (d)	**115.8**	**135.3**	**30.8**	**33.8**	**34.9**	**35.7**	**34.5**
Allocation of income							
Dividends on ordinary and preference shares	21.8	23.4	5.0	5.8	6.1	6.5	6.8
Interest payments	21.3	20.7	5.1	5.1	5.2	5.2	5.4
Profits due abroad	5.9	8.8	1.8	2.2	2.3	2.4	2.2
UK taxes on income	12.7	13.9	2.9	3.5	3.6	3.9	3.7
Undistributed income	**54.0**	**68.5**	**16.0**	**17.2**	**17.6**	**17.7**	**16.4**

Source: CSO.

(a) Net of stock appreciation.
(b) Consists mainly of ICCs' interest receipts and rent received by property companies.
(c) Consists of income from direct investment abroad and from other overseas assets.
(d) Including stock appreciation.

unchanged on a year earlier. Domestic margins may have been squeezed in the first quarter of this year, as unit labour costs recovered and the pressure from material prices increased. Margins on exported manufactures may also have increased in 1994 compared with 1993. But in contrast to the margins on domestic sales, exporters' margins almost certainly rose in 1995 Q1, as export prices increased by almost 7% compared with the previous quarter.

Bank estimates suggest that in 1994 goods retailers' margins continued the downward trend begun in 1992. Retailers' unit labour costs have grown more slowly than retail goods inflation since 1992. But bought-in goods account for the bulk of their costs; and retailers have been unable or unwilling to pass on all of the price increases made by their suppliers.

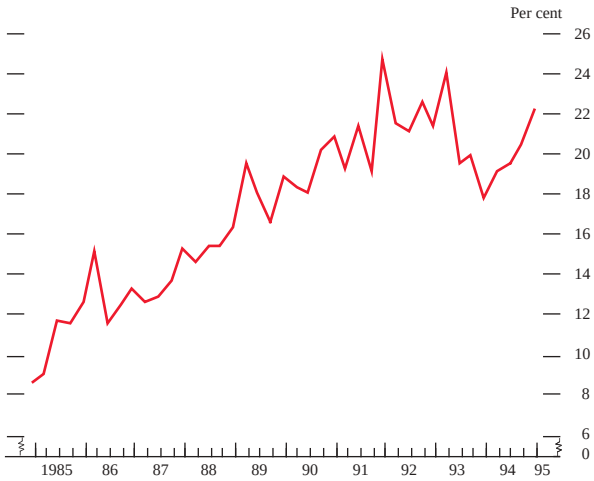
Profits from oil and gas extraction rose by 20% in 1994, some five percentage points faster than those of other ICCs. Average Brent oil prices were lower in 1994 than 1993; but oil and gas output volumes rose by 24% in 1994. This reflected the ending of maintenance programmes, which had stopped some production, and the coming on-stream of new fields. There was a further strong rise in North Sea companies' profits in 1995 Q1: output rose by 5% on the previous quarter and Brent prices also rose, by around 2%.

Income and appropriation

Gross trading profits are the largest component of ICCs' income, accounting for around three quarters in 1994 (see Table A). And profits growth was the main reason for the 17% increase in ICCs' income in 1994. But income from abroad also made an important contribution, accounting for around a quarter of total income growth. Income from abroad itself grew by about 30%; this seems to have been largely a result of stronger growth in the world economy in 1994. GDP in the major six overseas economies grew by close to 3% last year, compared with less than 1% in 1993.

Looking at the allocation of income, dividends constituted the largest item in 1994. Although in 1994 as a whole there was a fall in dividends as a proportion of ICCs' post-tax income—the dividend payout ratio—this largely reflected a particularly low first-quarter dividend figure (see Chart 2). Over the course of 1994, dividends grew extremely strongly: they were around 30% higher in the fourth quarter than at the beginning of the year. This strong growth continued in 1995 Q1: dividends increased by almost 5% compared with the previous quarter.

Chart 2
ICCs' dividend payout ratio(a)



Source: CSO.

(a) Dividends as a proportion of post-tax income.

Interest payments by ICCs fell slightly in 1994. ICCs' total annual interest paid has fallen by £11 billion since 1990; this has been largely the result of falling payments to the banking sector. It has reflected the fall in base rates; but in addition companies have been net repayers of bank lending since 1991 (see below).

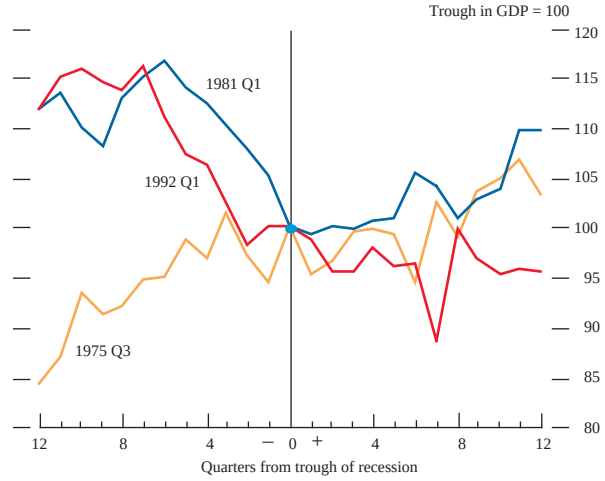
ICCs' tax payments (largely mainstream and advanced corporation tax) increased by close to 10% in 1994. There was a substantial rise in tax payments over the course of the year, which partly reflected the sharp pick-up in profits in 1993. Increases in tax payments tend to lag recoveries in profits, partly because mainstream corporation tax is payable nine months after the end of a company's accounting period. But also some firms have been able to use losses accumulated during the recession to reduce their tax liabilities in the initial phase of the upturn.

The 48% rise in profits due abroad in 1994 partly reflected the continuing rise in the stock of direct inward investment. But this accounted for only a small proportion of the increase: the stock of inward investment into the ICCs sector has only grown by about 6% in each of the past two years. The key driving force would appear to have been the performance of the underlying assets.

Capital expenditure

Measured in current prices, ICCs' investment fell by 2.6% in 1994. Indeed, it has yet to show a sustained rise during this

Chart 3
Business investment in three recoveries(a)(b)



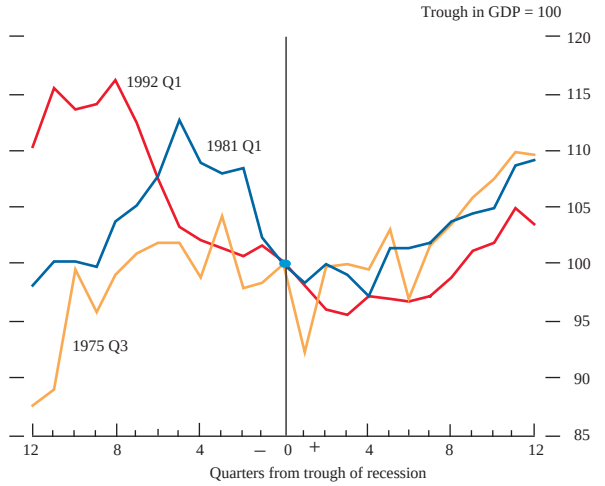
(a) At constant prices.
(b) Dates shown indicate the quarter in which the trough in output was reached.

recovery. Chart 3 shows the behaviour of business investment in the past three recoveries;(1) in each case, investment has been set equal to 100 at the trough in output. It shows that each downturn and recovery in investment has been different. But one feature of the present recovery to date is that business investment has recovered slowly and hesitantly.

Looking at non-residential investment overall, Charts 4, 5 and 6 show that although plant and machinery investment has been relatively slow to recover, investment in new buildings and works has been particularly subdued.

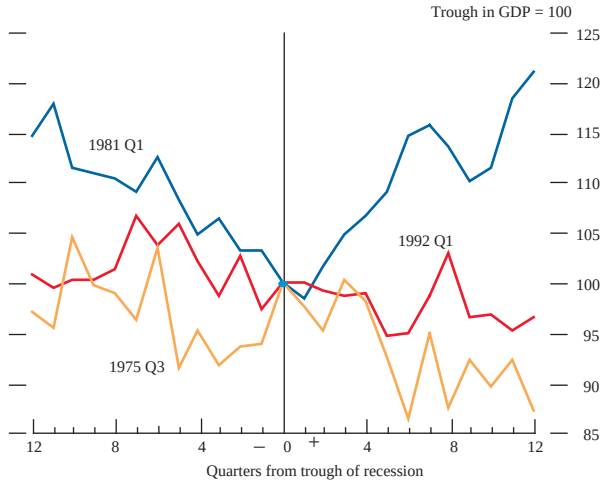
In sectoral terms too, there has been a wide diversity of behaviour. Investment growth last year was highest in 'other

Chart 4
Investment in plant and machinery in three recoveries(a)(b)



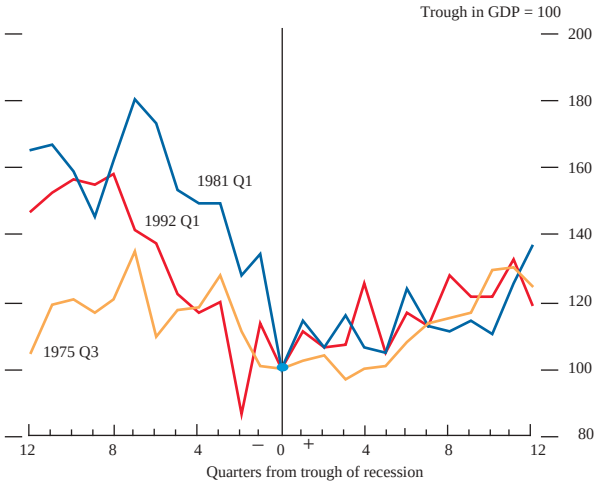
(a) At constant prices.
(b) Dates shown indicate the quarter in which the trough in output was reached.

Chart 5
Investment in new buildings and works(a) in three recoveries(b)(c)



(a) Including transfer costs of land and existing buildings.
(b) At constant prices.
(c) Dates shown indicate the quarter in which the trough in output was reached.

Chart 6
Investment in vehicles, ships and aircraft in three recoveries(a)(b)



(a) At constant prices.
(b) Dates shown indicate the quarter in which the trough in output was reached.

industries' (mostly services),(2) where it rose by about 8%; however, a key growth area in this sector was financial services. Manufacturing investment also grew by around 7% last year. The largest fall, of around 23%, was seen in the mining and quarrying industry. Utilities' investment also fell sharply—by around 13%.

About 90% of investment in mining and quarrying is accounted for by oil extraction. Offshore investment experienced something of a boom in the early 1990s, caused by the coincident development of several large fields. These have now come on stream; consequently investment has fallen.

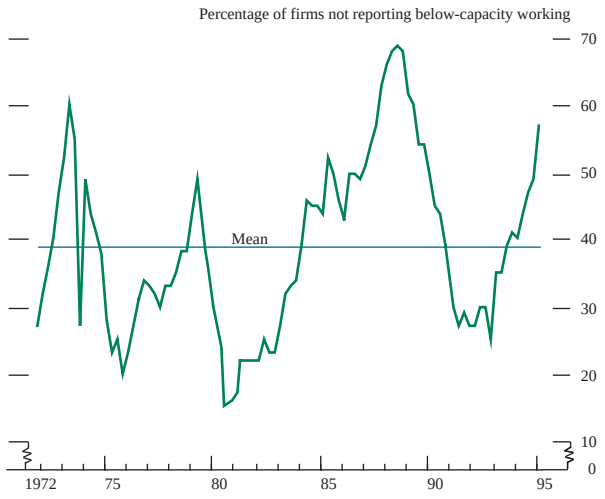
(1) Business investment is defined as total investment less investment in private sector dwellings, private sector and public corporations purchases of land and existing buildings, general government investment and investment by NHS Trusts. Broadly, it is investment by ICCs, financial companies and public corporations. Although the measure is wider than ICCs' investment, its advantages are that it is not affected by privatisations and is calculated by the Central Statistical Office at constant prices.
(2) The term 'other industries', as used by the Central Statistical Office, refers essentially to non-residential investment outside the extraction, manufacturing and utility industries.

Investment in the utilities sector has followed a broadly similar pattern: it grew strongly in the early 1990s and has since declined. The strong earlier growth seems, to some extent, to have reflected the bunching of several one-off projects. For example, investment in the electricity industries(1) in the early 1990s was boosted by the construction of gas-fired power stations, the fitting of equipment to reduce emissions from coal-powered stations, and the construction of the Sizewell B nuclear power station. It is also possible that there was a privatisation effect; the water and electricity industries were privatised between December 1989 to June 1991. The removal of public sector limits on borrowing might have allowed a backlog of projects to be cleared.

Specific sectoral developments aside, there are a number of possible factors that may have been constraining companies' investment growth in this recovery so far. One is the level of capacity. The investment boom in the late 1980s added greatly to capacity. The recession in the early 1990s was deep and long-lasting, and as a result created large amounts of spare capacity. The service sector suffered particularly in the last recession: services output contracted in 1991 and 1992—the only recorded fall in services output in two consecutive years since 1949. In asset terms, there was a significant boom in building work at the end of the 1980s, which has clearly been a factor in the weak expenditure on these assets in the past three years.

Although the experience has not been uniform across the economy, capacity utilisation has recovered. Rapid growth in financial services' investment suggests that spare capacity has not been a major factor in this industry. Moreover, capacity utilisation in manufacturing, on one measure,(2) exceeded its long-term average in 1993 Q4 and has continued to rise (see Chart 7).

Chart 7
Capacity utilisation in manufacturing

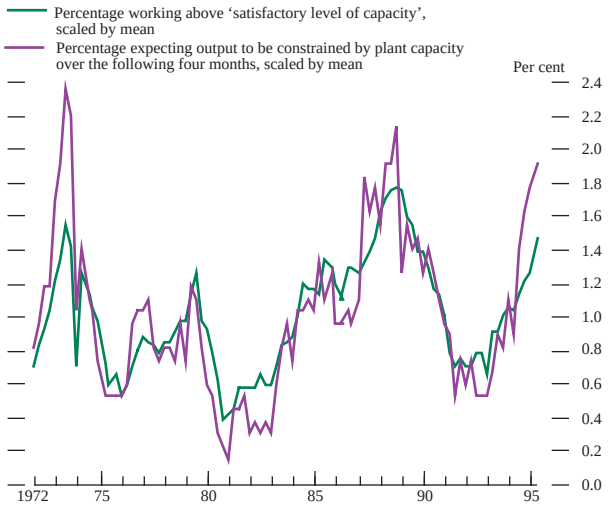


Source: CBI.

A second factor constraining investment growth has been uncertainty. An article in last August's *Bulletin* suggested that companies may have set high target nominal and real rates of return for investment projects in the 1980s to reflect the risks associated with high and volatile inflation.(3) Firms have been slow to adjust these rates of return downwards in the 1990s, because they have remained unconvinced that the new stable and low inflationary environment will persist.

The recent impact of uncertainty on investment may also be inferred from two CBI Industrial Trends Survey responses.(4) Chart 8 shows two series from the survey scaled by their respective means. One line is the measure of capacity utilisation, as in Chart 7; the other shows the proportion of firms that identify plant capacity as likely to constrain output over the following four months. Although other interpretations are possible, the diverging paths of the two series in the recent past could indicate that a greater proportion of respondents have viewed a potential capacity constraint on output over the following four months as 'satisfactory'. In turn, this may reflect firms' uncertainty about the durability of the current economic recovery. In other words, firms have perhaps been willing to risk losing future output and perhaps sales, because they have believed that the sunk costs of investing represented too big a gamble. This explanation is lent some weight by the export-led nature of the recent recovery. Exports tend to be more volatile than domestic demand and this may have added to producers' uncertainty.

Chart 8
Capacity utilisation and uncertainty



Source: CBI.

The structure of companies' balance sheets at the time of the recovery initially held investment back. The investment and take-over boom at the end of the 1980s led to companies borrowing heavily, mainly from banks. This left many with high levels of debt. The recovery has seen companies using

(1) This accounted for some 60% of utility investment in 1993.
(2) The percentage of respondents replying 'no' to the question in the CBI Industrial Trends Survey: 'Is your present level of output below capacity (ie are you working below a satisfactory full rate of operation)?'
(3) See 'Investment appraisal and low inflation', *Quarterly Bulletin*, August 1994.
(4) This point is made in Driver, C, 'Tightening the reins: the capacity stance of UK firms 1976–1995', forthcoming in *Rebuilding industrial capacity*, Grieve-Smith, J and Michie, J (eds), Oxford University Press.

Company insolvencies and inflation

This box investigates some of the determinants of insolvencies, and in particular the potential impact of inflation. Previous work has suggested a link between inflation and insolvencies; this box re-examines that proposition, given the experience of the recent cycle. It first outlines the different types of insolvency, and then examines recent trends. Finally, it examines whether inflation leads to a higher rate of company failures and discusses the implications of this. Econometric work in this area is not robust, but is suggestive of some of the determinants of insolvencies.

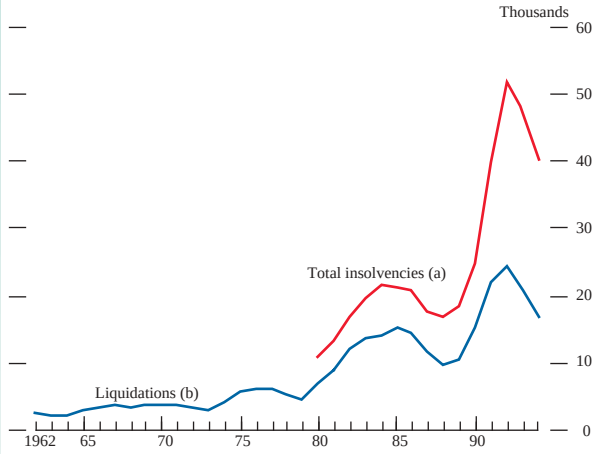
A company with obligations (eg guarantees) that it expects not to be able to meet is said to be *insolvent*.(1) Such a firm can either be liquidated, or placed into administration or receivership. A *compulsory liquidation* occurs when a company is made insolvent after a successful petition to the Courts by creditors; *creditors' voluntary liquidations* occur when an insolvent firm voluntarily goes into liquidation. The 1986 Insolvency Act instituted procedures to enable firms to continue trading under an *administrator* appointed by the Court. The administrator may reorganise the company or, if it is clearly insolvent, may petition the Court to wind up the company. Lastly, a *receivership* occurs when a creditor with debentures appoints accountants either to rescue the company or to sell off its assets.

Chart A shows two different measures of insolvencies: the Department of Trade and Industry's (DTI's) record of insolvencies and the Dun and Bradstreet measure of total insolvencies (available only since 1980). The latter measure includes receiverships, which have risen much more sharply than liquidations in the 1990s.

Experience of insolvency need not imply that a company will 'die'—part or all of it may be purchased or reorganised and return to trading. A recent survey by the Society of Practitioners of Insolvency suggested that roughly 18% of firms are preserved (in whole or in part) through the insolvency process.(2) It also suggested that it is larger firms that are more likely to be preserved; 28% of companies with a turnover greater than £1 million were saved by insolvency practitioners. In addition, insolvency figures do not include those companies that suffer financial distress but are rescued in a financial work-out, avoiding formal insolvency procedures.

Chart A suggests that insolvencies have been falling since 1992, although Dun and Bradstreet suggest that numbers rose in the second quarter of this year (by 10% compared with the previous quarter). According to the DTI estimates, there were around 16,730 liquidations in England and Wales in 1994, compared with around 14,900 in 1985. There were 160 administrations in 1994 (see Table 1 below); these remain a small proportion of total insolvencies. Dun and Bradstreet estimate that total insolvencies amounted to 40,160 in 1994, almost double their level in 1985. As Table 2 shows, in the recent recession insolvencies in services and the construction and transport sectors increased at a higher rate than elsewhere, but they have also fallen fairly significantly in these sectors in the recovery.

Chart A
Company insolvencies



(a) Source: Dun and Bradstreet. (Series began in 1980.)
(b) Source: DTI.

Table 1
Company insolvencies in England and Wales(a)

	1992	1993	1994	1995 Q1
Compulsory liquidations	9,734	8,244	6,597	1,380
Creditors' voluntary liquidations	14,691	12,464	10,131	2,154
Total liquidations	24,425	20,708	16,728	3,534
Administrator appointments	179	112	159	59
Company voluntary agreements	76	134	264	95
'Other' insolvencies	27,277	27,112	23,004	5,314
Total insolvencies	**51,957**	**48,066**	**40,155**	**9,002**

(a) Figure on liquidations, administrations and company voluntary agreements are from DTI. Total insolvency figures are from Dun and Bradstreet.

The Wadhwani model

In a study of the determinants of insolvencies, Wadhwani highlighted the role of inflation and its link to firms' cash-flow difficulties.(3) He argued that interest rates are a key determinant of insolvencies when debt is nominal and not indexed, giving rise to the problem of *front-end loading*. For example, if the real interest rate were a constant 1%, with zero inflation the nominal interest payment on a debt of £1,000 would be £10. If inflation were to rise to 10% while the real interest rate remained unchanged, however, nominal interest rates would rise to 11.1% and the interest payment to £111. In this case, revenue would rise tenfold, but interest payments would rise elevenfold.

(1) Insolvent individuals and small firms who are unincorporated are closed via the bankruptcy laws. They are not examined further.
(2) See 'Company insolvency in the UK, the third SPI survey', Society of Practioners of Insolvencies, 1994.
(3) See, for example, Wadhwani, S (1986), 'Inflation, bankruptcy, default premia and the stock market', *Economic Journal*, pages 102–38.

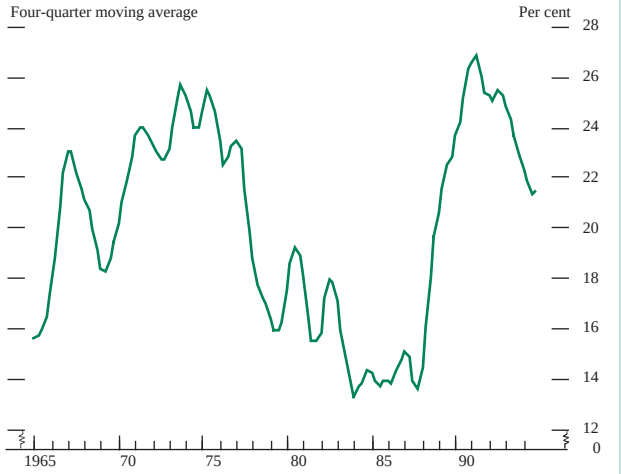
Table 2
Company insolvencies by sector

Percentage changes in italics

	1991	1992	1993	1994
Manufacturing	5,023	5,449	4,590	3,608
	31.0	*8.5*	*-15.8*	*-21.4*
Construction and transport	4,619	5,091	4,271	3,175
	36.8	*10.2*	*-16.1*	*-25.7*
Wholesaling	1,280	1,246	1,012	994
	20.1	*-2.7*	*-18.8*	*-1.8*
Retailing	2,114	2,477	2,005	1,711
	32.2	*17.2*	*-19.1*	*-14.7*
Services	3,538	4,361	3,748	2,843
	50.6	*23.3*	*-14.1*	*-24.1*
Others	5,254	5,801	5,082	4,397
	86.0	*10.4*	*-12.4*	*-13.5*
Total	**21,827**	**24,425**	**20,708**	**16,728**
	45.0	*11.9*	*-15.2*	*-19.2*

Source: DTI.

Chart B
ICCs' net debt to market valuation(a)



(a) ICCs' debt at market value as a proportion of their market value.

The effects of firms' institutional borrowing arrangements are also emphasised in Wadhwani's model. Agreements often specify a maximum debt to equity ratio or a ratio of profits to nominal interest payments. Such nominal rules will mean that if the firm's market valuation fails to keep pace with inflation, the probability of bankruptcy will rise.

Empirical results

Wadhwani's research covered the period up to 1981; he found that there were significant positive effects running from inflation, interest rates and the level of debt to rates of insolvency. Re-estimation of the Wadhwani model has shown a similar pattern of results for the period up to 1994. The *liquidation ratio*—the ratio of liquidations to the stock of 'active' companies—was strongly influenced by financial variables (debt, real interest rates and the inflation rate) over the sample period 1965 Q1–1994 Q2. In the re-estimation, a dummy variable was also introduced to allow for the introduction of the Insolvency Act of 1986. Debt was measured by the net debt of firms relative to their market valuation, as shown in Chart B. In the late 1980s, there was a sharp rise in this ratio (though only to levels similar to those in the early 1970s, when liquidations were lower). The net debt measure provides an alternative to looking at debt as a proportion of the capital stock; a rise in the ratio means that net debt is rising at a faster rate than the market value of those firms and—in the model—is assumed to increase the probability of bankruptcy.

The estimated long-run relationships are given by equation **(1)**:(4)

$$LR = 0.8\ D/MV + 0.72\ \Delta P + 1.3\ RR; \qquad \textbf{(1)}$$

where *LR* is the log of the liquidation ratio, *D/MV* is the ratio of net debt to market valuation, ΔP is annual producer price inflation and *RR* is the real interest rate (measured by the yield on short-term treasury bonds less the rate of producer price inflation). The estimated elasticities of the liquidation ratio (rather than the *log* of the ratio) with respect to each variable are:

for *D/MV*	0.2;
for ΔP	2.4; and
for *RR*	4.3.

Debt has a significant impact—a 1% increase in the ratio of net debt to market valuation may increase the liquidation ratio by 0.2%.(5) There are long-run effects on insolvencies from producer price inflation and real interest rates.(6)

These results are broadly comparable with Wadhwani's, although the other variables which were significant in his estimated long-run relationship—real wages and a time trend—were not significant in the re-estimations. Cyclical variables were not statistically significant, though there may be correlations within the data between cyclical activity and inflation. The 1986 Insolvency Act was found to have reduced business failures slightly, (although there is, technically, no long-run effect).(7)

This simple econometric model of insolvency is suggestive of the factors which may have contributed to the sharp rise in insolvencies in the recent recession: higher debt levels, real interest rates and higher inflation all seem to have increased insolvencies. And compared with 1985, debt in particular has been higher in this recovery. The reduction in corporate gearing, lower real interest rates and lower inflation may all have contributed to the sharp falls in business failures recently. And permanently low inflation may lead to a lower level of insolvencies in the long run.

(4) The single, four-variable cointegrating vector was identified using the Johansen method.
(5) Liquidation data are from the DTI.
(6) The specification is of the form, $\alpha 1\ (NR–\Delta P) + \alpha 2\ \Delta P$, which is equivalent to $\alpha 2\ NR + (\alpha 1 – \alpha 2)\ RR$, where *NR* is the nominal interest rate, *RR* is the real interest rate and ΔP is the inflation rate.
(7) There was also a sharp rise in the liquidation ratio in 1981 Q1: a dummy was included in the estimation to allow for this. It was found to be significant in the short run, but not in the long run.

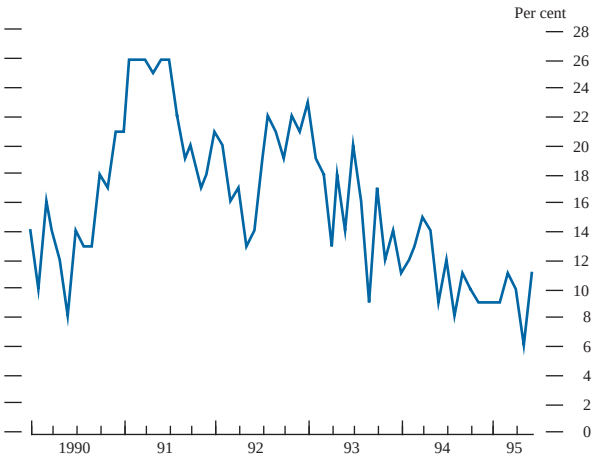
their rising incomes to reduce their liabilities to the banking sector. However, companies' net repayment of bank debt came to an end last year, suggesting that balance sheets have been repaired (see below).

Most commentators forecast that company investment will strengthen this year. With some of the factors that had constrained investment diminishing in importance and with profitability still high, the conditions are favourable for an increase in investment growth. Survey evidence also suggests a further pick-up. Recent CBI Industrial Trends Surveys, which include questions about investment intentions in manufacturing, have pointed in this direction. And British Chambers of Commerce Surveys have continued to show a positive balance of firms revising their investment plans upwards.

Stockbuilding

There was a strong upturn in stocks last year and stockbuilding was also high in the first quarter of this year. Stockbuilding can represent a voluntary decision by firms, in anticipation of future demand for their own product or of a shortage of their suppliers' products. Alternatively, it can be involuntary, if demand is less than anticipated. There are a number of possible interpretations of the recent past. The rise in manufacturers' stocks of materials and fuel in 1994 and 1995 Q1 may have reflected firms' willingness to build up stocks in anticipation of future supply problems, in the form of higher prices or shortages. Since 1993, there has been a downward trend in the balance of firms reporting in the CBI Industrial Trends Survey that their stocks of finished goods are more than adequate (see Chart 9). This might suggest that some manufacturing firms reached the stage where their stocks of finished goods needed replenishing. However, it is also possible that the slowdown in retail sales growth in 1994 and 1995 Q1 took retailers and manufacturers by surprise, leaving them with unwanted stocks of finished goods.

Chart 9
Adequacy of stocks(a)



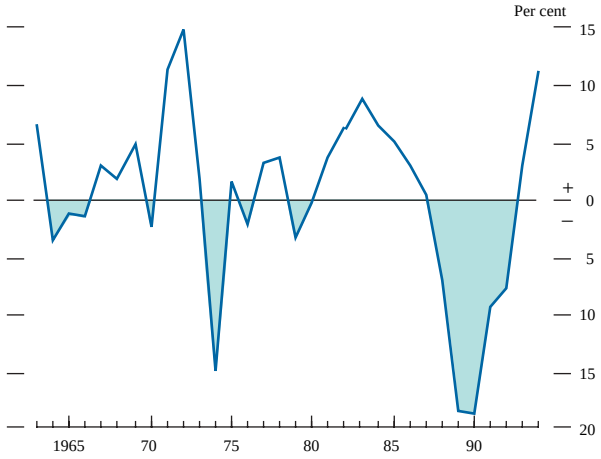
Source: CBI.

(a) Balance of firms reporting that current stocks of finished goods are more than adequate.

Financial transactions

One measure of ICCs' financial health that receives much attention is the financial surplus/deficit. Chart 10 shows that, on this measure, ICCs are in a fairly strong financial position, having been in financial surplus since 1993. The Central Statistical Office's preferred measure of the financial surplus/deficit is taken from the income and expenditure side of the accounts. But this clearly has counterparts in terms of financial transactions: changes in the level of companies' financial assets or liabilities should match the surplus (or deficit) of income over expenditure. However, the surplus measured from the income and expenditure side of the accounts does not match its counterpart measured from the financial transactions side. A balancing item is therefore included in the accounts to reflect this measurement error. Because this balancing item has been large in the past two years, there has been a financial surplus, measured from the financing side of the accounts, only since 1994—when it was substantially lower than the surplus on the income/expenditure measure.

Chart 10
ICCs' financial surplus/deficit as a proportion of income



Source: CSO.

One of the largest elements in ICCs' financial transactions over the past two years has been the issue of new equity (part of 'other borrowing' in Table B). Equity issues increased substantially in 1993, following the strong recovery in share prices at the end of 1992, but then fell back somewhat in 1994. The relative weakness of equity prices last year reduced the attractiveness of new issues. But in addition, some firms with cash surpluses engaged in share 'buy-backs'.

ICCs have made net repayments of bank borrowing in each year since 1991. In 1993 and 1994, they also increased their bank deposits. The combination of the two has substantially reduced the cost to ICCs of increases in short-term interest rates.

But 1994 Q4 and 1995 Q1 were the first consecutive quarters in which ICCs had borrowed from the UK banking sector since 1991. The figures for the first quarter of this year were heavily influenced by Glaxo's bank borrowing to fund its

Table B
Financial transactions of industrial and commercial companies

£ billions; current prices (a)

	1993 Year	1994 Year	1994 Q1	1994 Q2	1994 Q3	1994 Q4	1995 Q1
1. Financial surplus/deficit	3.5	14.8	3.9	4.1	4.0	2.8	2.6
2. Net unremitted profits	-5.7	-10.1	-2.2	-2.4	-2.9	-2.6	-2.7
3. Net trade credit	1.2	2.7	2.6	0.5	0.2	-0.6	2.4
4. Investment in UK company securities	-2.4	-3.9	-0.9	-0.4	-1.0	-1.6	-8.0
5. Investment abroad	-5.2	0.1	0.5	0.4	-0.2	-0.6	-1.1
6. Balancing item	-5.4	-6.2	-4.2	-3.1	-1.1	2.3	-3.2
7. Bank borrowing	-11.3	-4.8	-3.2	-2.7	-0.7	1.8	6.8
8. Other borrowing	37.5	17.7	6.3	6.5	2.3	2.6	4.6
9. Liquid assets	-6.6	-6.2	-3.4	-1.9	0.2	-1.2	0.5
10. Other assets	-5.5	-4.1	0.7	-1.1	-0.8	-2.9	-2.0
11. Net borrowing requirement	14.1	2.6	0.4	0.8	1.1	0.3	10.0

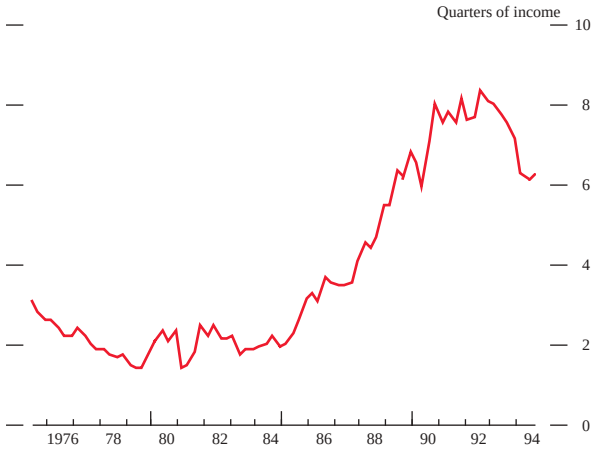
Source: CSO.

(a) Positive numbers represent inflows to, and negative numbers outflows from, the ICC sector.
(b) Lines 1–10 sum to zero; line 11 = 7 + 8 + 9 + 10.

take-over of Wellcome, but even after adjusting for this company borrowing was positive. Although ICCs as a group have not increased their investment, it is possible that some firms have begun to borrow to finance capital expenditure. But equally, with profits falling in the first quarter, it also possible that some companies needed finance for working capital.

While repaying bank borrowing, ICCs have continued to borrow from other sources largely at fixed rates. Indeed, ICCs' debt relative to their income has remained high compared with the levels seen in the late 1970s and early 1980s (see Chart 11). But companies may be content with this level of debt, particularly in light of their reduced exposure to short-term interest rate changes and relatively low income gearing.

Chart 11
ICCs' debt to income ratio(a)



Sources: CSO and Bank of England.

(a) Market value of ICCs' net debt as a proportion of their post-tax income. Data are available only to 1994 Q4.

As Table B shows, ICCs' purchases of UK company securities have been growing since 1992; they were boosted significantly in 1995 Q1 as a result of the Wellcome take-over. These data cover purchases of other companies' shares, rather than share buy-backs. They do not, however, capture all merger and acquisition activity (see the box on page 278); for instance, they exclude purchases of subsidiaries from other ICCs.

Another category of financial transaction which has recently been important for ICCs is investment abroad. This is measured in net terms: sales of UK ICCs' foreign assets are deducted from their investment. ICCs' net investment abroad rose by 20% in 1993, but fell sharply in 1994 when net investment was negative. The fall largely reflected an increase in repayments of loans by overseas subsidiaries to their UK parents. Investment abroad also includes cross-border acquisition activity. Net unremitted profits from abroad rose sharply last year: this represents the difference between the unremitted profits of foreign-owned firms in the United Kingdom and UK-owned firms overseas.

Mergers and acquisitions

According to official statistics, acquisition and merger activity within the United Kingdom—measured both by value and by numbers of acquisitions—has begun to recover from its trough in 1992. The value of these deals increased by 19% in 1993 and 17% last year, but this did not constitute a boom. (The box on page 278 looks at mergers and acquisition activity.) In the first quarter of 1995, the number of deals fell compared with the previous quarter, but the value of mergers was given a significant boost by Glaxo's purchase of Wellcome for a reported £9.1 billion.

Overseas acquisitions rose by over 60% in value terms last year; overseas disposals also rose significantly. However, the number of overseas acquisitions fell from 679 in 1992 to 422 last year. Reports from the Bank's agents suggest that, with output growth having come largely from the traded sector, companies have increasingly begun to see advantages in siting production closer to their foreign markets. This suggests that cross-border acquisitions may increase.

Table C shows the number of cross-border deals expressed as a share of the total in the European Union; it shows that, as in previous years, UK companies were the most active cross-border purchasers of other companies in 1994, with a share well in excess of the United Kingdom's share in general economic activity.

Table C
Breakdown by Member State of cross-border mergers and acquisitions and GDP

	1994 Target	1994 Purchaser	1994 GDP
Belgium	4.0	2.9	3.4
Denmark	5.3	4.7	2.2
Germany	29.5	18.4	27.7
Greece	0.3	0.1	1.4
Spain	9.0	0.9	7.3
France	15.2	18.3	20.0
Ireland	0.9	4.7	0.8
Italy	7.6	2.7	15.5
Luxembourg	1.0	1.6	0.2
Netherlands	7.2	11.5	5.0
Portugal	0.5	0.3	1.2
United Kingdom	19.4	34.0	15.4
EU 12	100.0	100.0	100.0

Source: European Commission.

Mergers and acquisitions

Microeconomic theory tries to explain mergers and acquisitions in a number of ways. Firms take over or merge with others for a variety of reasons, including: to increase their market power; to improve the use of resources via economies of scale or by reducing general managerial inefficiency; to satisfy managers' desires for larger 'empires'; to protect themselves from take-over, so making their managers' positions more secure; and to spread risk by creating conglomerates.

Empirical evidence suggests that the managerial objectives—of growth and protection of their own position—are the important reasons for merger or take-over.(1) Increased efficiency appears to have been a less significant result of acquisition or merger activity.

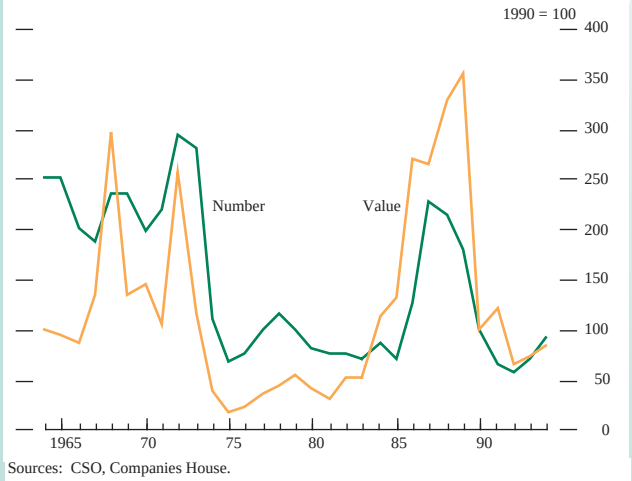
Recent work at the Bank has used company accounts to examine the financial characteristics of acquiring firms during the 1980s.(2) A range of financial characteristics were calculated—including profitability, rates of return, capital and income gearing, dividend payout ratios, interest coverage and liquidity. The work showed that acquiring firms did not have a distinct set of financial characteristics; the averages for acquiring firms were very similar to those for the whole sample. This suggests that mergers are not undertaken for immediate financial reasons. The only distinguishing feature of acquiring firms to emerge was size: acquiring firms were on average much larger than the sample average.

Merger activity within the United Kingdom

Mergers tend to occur in waves (see Chart A). In value terms, the recent peak years for merger activity were 1968, 1972, and 1985–89.(3) Take-over waves seem to some extent to follow the cyclical pattern of GDP growth and trends in profitability. But, as Chart B shows, there is also a relationship with equity prices.(4)

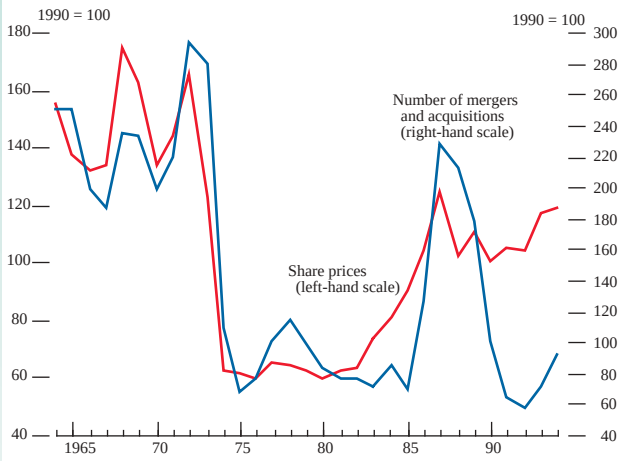
Movements in equity prices are, of course, connected to more general cyclical movements. And buoyant equity prices may themselves be a function of high levels of take-over activity. However, economic theory suggests that movements in share prices can affect take-over activity. Mispricing in the stock market will probably be greatest when share prices are changing rapidly. And predator firms are more likely to strike when equity prices are rising, as there will tend to be more favourable demand conditions in product markets for the enlarged firm to exploit. Equally when stock prices are high and rising, firms can more easily use equity to finance take-overs.

Chart A
Acquisitions and mergers by value and number



Sources: CSO, Companies House.

Chart B
Take-overs and share prices



Sources: CSO, Companies House.

The relationship with share prices was more complicated during the last merger boom. The number of mergers peaked in 1987, at the time of the stock market crash. But activity remained high and did not fall significantly until 1990. And in value terms, merger activity really took off *after* 1987 (see Chart A). One explanation is that take-over activity in the late 1980s may have been a function of special factors:(5) specifically, the Single European Act and financial deregulation. The Act introduced the prospect of a single European market and so of economies of scale, and, by enhancing future competition, reduced the need for the authorities to worry about the anti-competitive effects of merger activity. Following financial deregulation, banks and other lenders competed more aggressively for business; consequently, it became easier for firms to borrow to finance take-overs.

Cross-border activity

Like acquisitions within the United Kingdom, the value of cross-border activity peaked in 1989.(6) In that year, acquisitions in the United States by UK firms accounted for nearly 80% of their cross-border acquisitions; last year they formed only about half. It is not surprising that the United States should be so prominent, given the size of its market and the common language. But acquisitions by UK companies in other EU countries have grown in importance recently, as might be expected with increasing European integration.

(1) See Hay, D A and Morris, D J, *Industrial economics and organisation*, Oxford University Press 1991, which provides a useful summary of merger theory and evidence.
(2) The work used data supplied by Datastream International; on average, the sample consisted of 900 quoted firms a year.
(3) Activity within the United Kingdom covers industrial and commercial companies only. The value and number of mergers and acquisitions have been divided by current-price GDP and the number of registered companies respectively to allow for the effect that increasing activity and prices have on the series.
(4) Equity prices are given by the FT All-Share index divided by current-price GDP to allow for the effect of activity and general price rises on the index.
(5) See, for example, Begg, D, Fischer, S and Dornbusch, R, *Economics*, McGraw-Hill, 1994.
(6) Data are only available from 1987. Cross-border activity data cover industrial and commercial companies and financial companies.

Insolvencies

According to Department of Trade and Industry estimates, the number of company insolvencies in England and Wales continued to decline both last year and in the first quarter of this. The falls appeared to be evenly spread across sectors, although they were less pronounced in wholesaling. The box on pages 274–75 gives some more general background on insolvencies and considers some econometric models of insolvency behaviour.

Summary

Aggregate figures often hide a wide diversity of behaviour. But corporate sector data suggest that companies ended 1994 in a healthy financial state: profitability was at a relatively high level; companies ran a financial surplus; and insolvencies declined for the second successive year.

Industrial and commercial companies' investment failed to recover last year, however. This was in part the result of special sectoral factors. But cautious expenditure on fixed assets in the recovery so far may also reflect the high levels of spare capacity built up in the recession, firms' uncertainty about the sustainability of the recovery and of low inflation, and their need to restructure balance sheets. With capacity pressures growing, profitability high and signs that balance-sheet adjustment may have been completed, however, investment is likely to strengthen during this year.

Stockbuilding made a positive contribution to domestic demand last year—probably for a number of different reasons. Firms at the start of the supply chain may have been building up precautionary inventories, whereas companies closer to the consumer may have accumulated unwanted stocks because retail sales growth was lower than anticipated.