

---

# ‘Oscillate Wildly’: asymmetries and persistence in company-level profitability

*Working Paper No. 128*

Andrew Benito

Competition is central to an understanding of the corporate sector. Such competitive forces are best viewed in the dynamic sense of how quickly high rates of profit are competed away by entry and the threat of entry, and how quickly less profitable companies that survive improve their financial health. If profits persist from one year to the next this indicates that competitive forces do not act especially swiftly in removing such abnormal returns.

In this context, most of the existing literature has focused on those companies with high returns, motivated by concerns about market power. For financial stability it is the low-performing companies that are of special interest. A low rate of profitability is one indicator of financial distress. But the extent to which it is an indication of the company's profitability the following year and its ability to withstand any adverse shock depends on the degree of persistence in profits. Moreover, the emphasis in such financial stability surveillance work concerns the most vulnerable companies in any year. For this reason, the degree of persistence of profitability amongst the weakest companies is especially important. But previous studies of profit persistence have not attempted to distinguish between the experiences of this set of companies from others.

More generally, the motivation for a study of the persistence in profits is based on the notion that examining rates of return of companies, even with disaggregated data, provides only a snapshot of the financial position of a company. Mobility between points in the distribution of returns over time is also of interest. To this end, the paper employs panel data methods using data constructed from the company accounts of 2,129 quoted UK companies over the period 1974 to 1998, making it the most comprehensive study of its kind for the United Kingdom.

A useful precursor to the main empirical analysis is to study the relative position of companies' profit rates and how this varies from one year to the next. This reveals a number of stylised facts. The level of persistence in companies' positions in the distribution is quite high. Moreover, this persistence differs across different parts

of the distribution of profitability. Almost three quarters of companies in the top quintile of companies in one year remain there in the following year, on average. This compares with two thirds of companies in the lowest quintile remaining in that part of the distribution the following year.

The more detailed analysis focuses on the extent to which the profit rate of a company deviates from its rate the previous year. The paper finds that persistence in profits is less strong for companies with low rates of profitability in a particular year. The results indicate that surviving companies are able to recover from periods of relatively poor performance more rapidly than previous linear models of profit persistence would suggest. One other possible explanation for this finding is that companies favour a conservative approach to accounting, preferring to report good performance over more years than they would allocate any poor performance. At the same time, the results indicate that previous studies of the persistence of profits are likely to have understated the degree of persistence of high returns.

Only a modest degree of variation among industries has been found on the basis of the standard linear models for persistence, with an increase in the extent of this variation between industries being found on the basis of the non-linear models. The asymmetries in the persistence of profits are estimated to be stronger in 'energy and water supply', a heavily regulated sector in which regulators have had a responsibility for ensuring that companies can finance their functions. The result that high profitability persists more than low profitability is estimated to be present in each industry.

Companies are far from passive to the shocks that they experience. They respond by adopting strategies that involve financial and/or real implications for outcomes such as employment, dividends, wages, productivity and investment. This suggests that future work could explore the strategies available to companies in times of financial distress, the factors that will lead a company to favour one option over another and the implications of each for the wider economy.