Company Profitability and Finance

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Overview

In the second of an annual series of articles[1], the results of the National Statistics First Release, 'Profitability of UK Companies' are analysed. This release (July 24th) measured the profitability of corporate sector operations in the United Kingdom, using rates of return on capital employed. For the first time, a quarterly measure of profitability was calculated. This article reports these data, but also analyses the financial position of non-financial companies in 1999 and in the first quarter of 2000.

In 1999, the UK corporate sector was not able to maintain its profitability and the net rate of return on capital fell to 12.0 per cent, from 12.8 per cent in 1998. Margins for manufacturers have been cut, both in home and export markets. As a result, profitability fell sharply. Despite competitive trading conditions, rates of return for service companies declined only slightly. In the first quarter of 2000, manufacturers continued to find it difficult to pass on higher input prices and productivity in manufacturing fell back for the first time since the third quarter of 1998. Rates of return earned were below 7 per cent, around one-half the rate earned two years previously. Rates of return earned by UK Continental Shelf companies rose in the first quarter to their highest levels since 1996, reflecting rises in crude oil prices and cost savings achieved by these companies.

Other main points from this review include the record borrowing of the corporate sector in 1999 and the first quarter of 2000, what caused it and how it was financed.

The structure of the article is as follows:

- Background: the approach to calculating profitability and data sources
- Profitability of the UK corporate sector
- Manufacturing and service companies
- Manufacturing companies' profitability
- Manufacturing companies' output, productivity, costs and prices and trade
- Service companies' profitability
- Earnings and investment in manufacturing and service companies
- UK Continental Shelf companies' profitability
- Key income and capital account movements of the UK corporate sector
- Financial transactions and acquisitions and mergers in the UK corporate sector
- Company insolvencies
- Conclusions

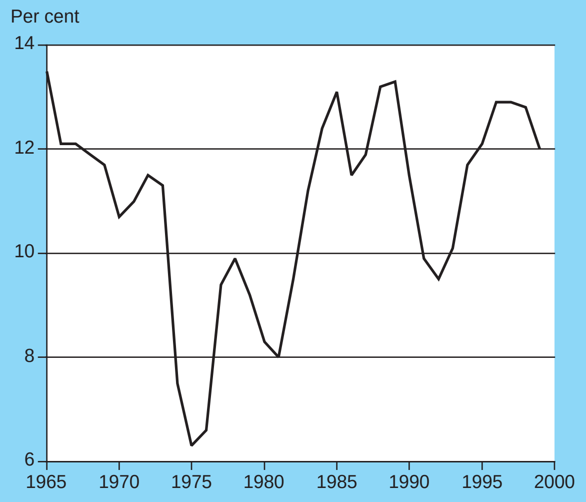
[1] 'Company profitability and finance', December 1999 Economic Trends, pages 35–46. This Review covered the period 1989 to 1999 quarter two and included background information on the manufacturing and services sectors of the economy.

Background: the approach to calculating profitability and data sources

The latest Press Release on Profitability of UK Companies was issued by National Statistics on 24 July 2000. For the first time, quarterly rates of return for UK private non-financial companies were calculated. This release included data for the first quarter of 2000. Subsequent releases will follow closely after publication of the quarterly national accounts' data. Rates of return on capital are calculated as the ratio of profits to capital employed. The annual profit data are collected from companies in their tax returns to the Inland Revenue. They have been supplemented in 1999 and 2000 Q1 by data which the ONS receive from ONS quarterly inquiries. 1,600 non-financial companies complete these quarterly inquiries.

UK private non-financial corporations include UK companies and all business partnerships. Profits earned by parterships were 20 per cent of the total. The majority of partnerships are in the services

Figure 1
Net rates of return of private non-financial corporations



sector. Approximately 30 per cent of profits generated by partnerships were in the fields of legal work, accountancy, consultancy and advertising. A further 25 per cent were earned in the wholesale and retail trade and in the repair and maintenance of motor vehicles. No work has yet been started on whether larger companies are more profitable than small.

National Statistics is considering whether it would be feasible to include UK financial corporations in its measure of profitability. This will have to take account of FISIM (Financial Intermediation Services Indirectly Measured). This arises because banks make a large part of their money by lending at higher rates of interest than they pay on deposits. The difference between the two results in banks receiving net interest receipts. Because this income (FISIM) arises from the difference between interest rates, banks do not need to charge directly for all the services they provide.

Total company profits are an important component of the income measure of Gross Domestic Product. This component is known as the gross operating surplus which is defined as trading profits earned from businesses located within the United Kingdom, plus rental income minus inventory holding gains (at current prices). Profits earned by subsidiaries and branches located outside the United Kingdom are not included. As a key component of the income and capital accounts of companies, movements in profits influence the use of funds and the extent to which companies need to borrow in the financial markets. As an economic indicator, profits provide an interesting insight into the behaviour of the corporate sector.

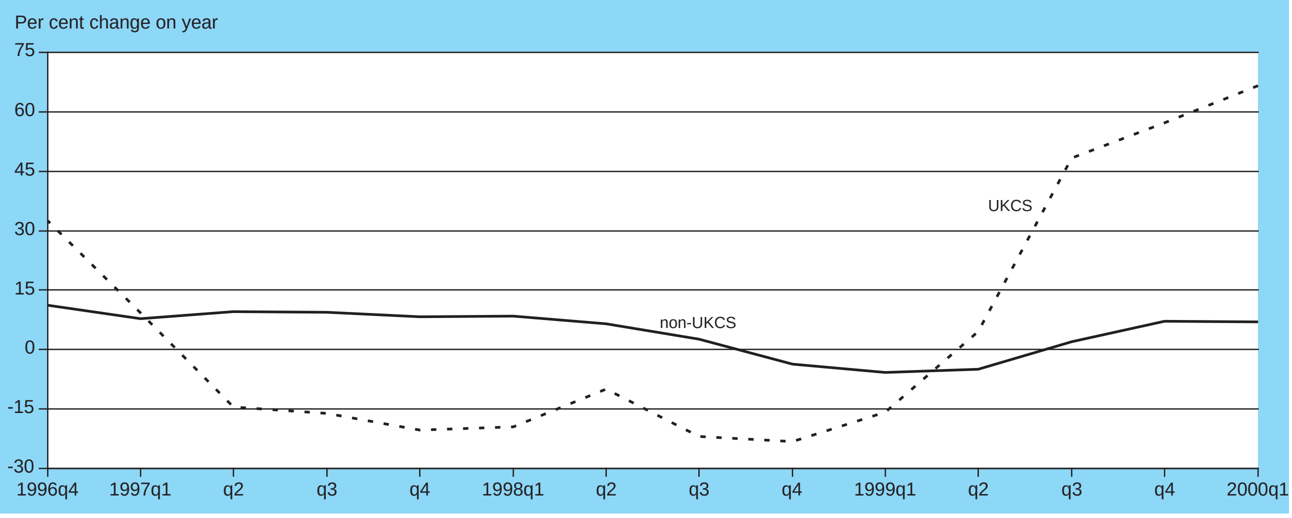
The capital account of the corporate sector includes their net lending/borrowing. This is equivalent to their financial surplus or deficit and represents the amount companies have to invest in financial assets or to borrow through financial liabilities. As such, it has been used as a measure of private non-financial corporations' financial health. Finally, the financial account of the private non-financial corporations' sector explains how the borrowing requirement is funded.

Further details of the income, capital and financial accounts and financial balance sheet of UK non-financial companies are available in the ONS quarterly publication, UK Economic Accounts. Tables A20, A21, A22, A46 and A57 provide detailed data.

Profitability of the UK corporate sector

The recovery in profitability by the corporate sector in the 1990s, began in 1993 and was maintained in each year to 1996/1998 (Chart 1). The

Figure 2
Private non-financial corporations' profits



profitability of private non-financial corporations fell back in 1999, with the net rate of return on capital employed at 12.0 per cent, compared with 12.8 to 12.9 per cent between 1996 and 1998. Underlying these data, profits grew by only 2 per cent in 1998 and by only 1 per cent in 1999, compared with growth of 7 per cent in 1997 and 9 per cent in 1996.

In 1999, profits were subdued. Profits of companies other than those involved in exploration activity on the UK Continental Shelf declined by 0.5 per cent. However, a modest recovery in profits began in the second quarter. Although not sustained at the rate of recovery reported in the third quarter, profits ended the year at 7 per cent higher than the corresponding period in 1998 (Chart 2). Profits of UK Continental Shelf (UKCS) companies producing oil and gas from the UK Continental Shelf rose, however, by 21 per cent in 1999, mainly reflecting rises in crude oil prices.

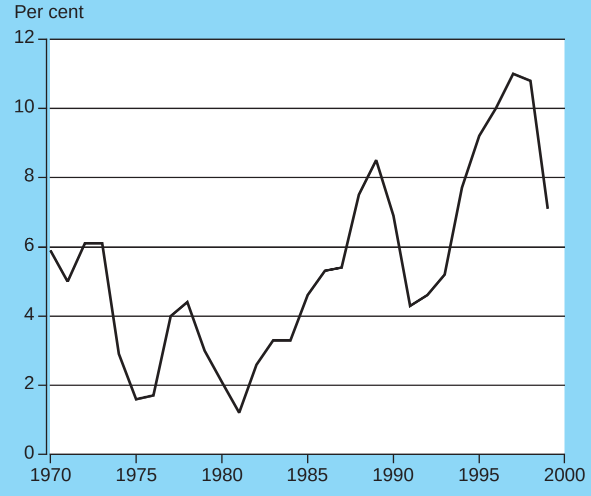
In 2000 quarter one, profit margins narrowed further for manufacturing companies and for companies in the service sector and profitability was subdued. Overall, companies reported little, if any growth in profits. This did include, however, a rise of 7 per cent in profits earned by UK Continental Shelf companies in the first quarter and a consequent rate of return of close to 25 per cent.

Manufacturing and service companies

Improved data sources have made it possible to estimate for the first time the profitability of services sector and manufacturing private non-financial companies on a quarterly basis. Survey information from National Statistics covers both sectors. Included in this survey are the FTSE 100 companies: 25 are in the manufacturing sector.

Companies are classified according to their principal activity. Ideally, this would be based on value added; in practice, a proxy, employment is frequently used. The allocation of 'new economy' companies' and 'traditional' companies to services and manufacturing, respectively, is not so simple. Companies operating in the high technology sectors are in the telecommunications and research and development sectors of services, but also in the electronics and communications equipment sectors in manufacturing. The new entrants to the FTSE 100 index in March 2000 included five companies in services, in retail, telecommunications, research and development and consultancy, but also four in manufacturing, in the manufacture of electrical equipment, paper and publishing and pharmaceuticals. The departing companies included three in manufacturing, but also four in the service sector. So, the contributions of the new computer technology and telecommunications companies affect both the manufacturing and service sector rates of return.

Figure 3
Net rates of return of manufacturing companies



Manufacturing companies' profitability

The period covered by Chart 3 above illustrates profitability during three recessions. Since the 1990/92 recession, manufacturing companies' rate of return on capital has improved in each year and in 1997/1998 reached 11.0 per cent. The figure of 11.0 per cent is higher than the two previous peaks, in 1989 (8.5 per cent) and 1972/73 (6.1 per cent) and more than double the rate of return in 1991.

1998 represented a period in which the underlying level of manufacturing profits was constrained. Manufacturing output growth dipped into negative territory at the end of 1998 and the beginning of 1999 and the growth in manufacturing exports registered declines in all quarters of 1998. One reason was the economic difficulties in South-East Asia. Another was that manufacturers reduced their export prices to remain competitive in price in overseas markets. Sterling income from exports fell for a number of companies, because they were locked into long-term contracts. In 1998, profits from domestic demand probably outweighed the effects of lower profit margins on sales overseas, but this did not happen in 1999.

In 1999, profitability declined sharply to 7.1 per cent, as export margins were lower than in 1998, domestic margins were cut and capital employed rose by 3 per cent.

Margins were under pressure throughout 1999, despite a recovery in manufacturing output in the second half of 1999 and a recovery in manufacturing exports in the second half of the year and in the first quarter of 2000 when growth was 10 per cent.

Cost cuts from manufacturing restructuring were not as great as hoped for by the large companies and companies had to absorb the costs of downsizing, mergers and of the disposals of non-core businesses. Profitability was also constrained by aggressive price-cutting.

In the face of declining profitability, manufacturing companies moved to concentrate on core high-quality growth products, dropping some high-volume, low-margin contracts. Cost cutting in 1999 and the first quarter of 2000 was helped further by lower computer hardware costs, lower levels and better monitoring of inventories and the use of business-to-business e-commerce to lower procurement and marketing costs. Profitability was sustained also by investment in computer software and hardware, improving the quality of the capital stock and through falls in computer prices improving the value of that capital stock.

To further improve profitability, companies invested in new information technology which improved the control of output, design and stocks. Companies using new IT have been able to reduce stocks and make full use of output capacity. Those companies producing the new technology have also boosted their profitability. This has enabled firms to respond more quickly to changes in customer preferences. Technology-led industries have driven down the price of information technology and created an environment in which pressures on manufacturers to be more efficient are greater than they were.

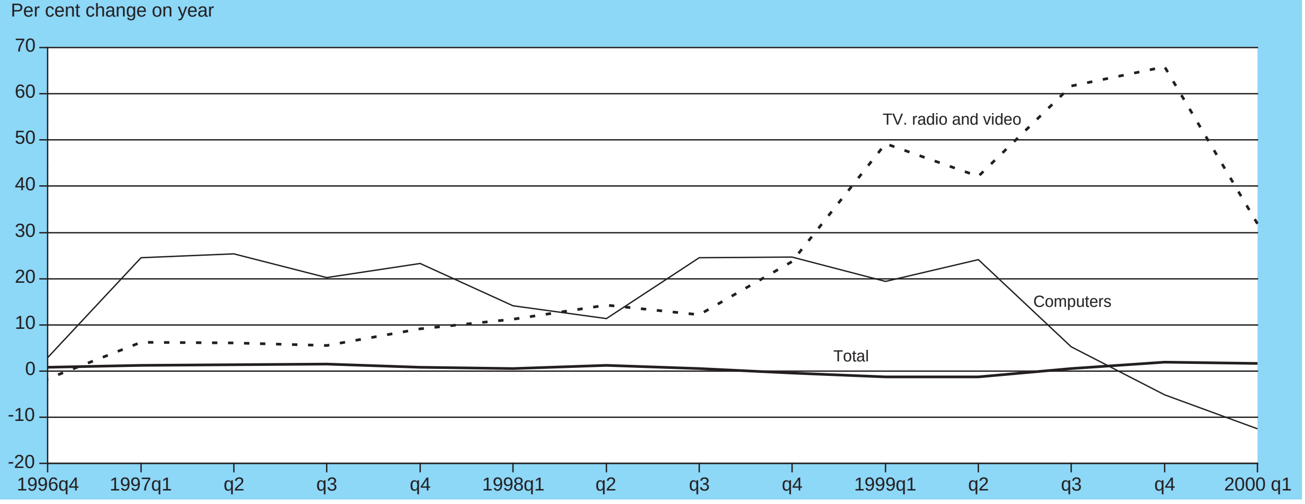
Profitability of manufacturing companies: by sector

In 1999, profitability in manufacturing was underpinned by those companies producing electrical and optical equipment and pharmaceuticals. The traditional manufacturing industries found it difficult to maintain profitability in 1999, despite operating plants at higher levels of output and achieving operational savings. These savings came through increased efficiency in procurement, distribution and marketing. Some 'old economy' companies diversified into communications and computers. But, they faced higher costs for imported commodities like plastics and metals, than manufacturers in high-technology sectors where the use of these commodities is less intensive. Costs of energy and transport were higher also. The following analysis is based on anecdotal comments made by those companies reporting profits data to the Office for National Statistics.

The electrical and optical equipment sector includes the manufacturers of office machinery, computers, telegraph and telephone equipment, electronic goods, television receivers and video recording equipment. These companies faced strong demand for optical and electrical equipment to meet product innovations and gadgets. Profits in 1999 benefited from their huge exposure to the benefits of advanced communications technology. In 1999, profits advanced, despite the higher costs incurred in producing and stocking more electrical goods, particularly digital equipment and the higher costs in attempting to merge and de-merge companies. Margins in industrial electronics and in the manufacture of mobile phones fell in late 1999 and in the first quarter of 2000.

In the chemicals sector, a decline in total profits in 1999 disguised the performance of specific manufacturers. High-tech pharmaceuticals, paints and companies producing fibre optics and semi-conductors produced a moderate profits profile. Companies were better placed to withstand competitive pressures. 1999 was a profitable year for pharmaceuticals and for biotech companies producing biotech drugs, medicines and the research and technology

Figure 4
Manufacturing output



needed by the larger pharmaceutical companies. Positive factors were the development of new products and the increased sales of anti-viral and respiratory treatments during the flu epidemic. Profits were realised from foreign trade particularly Europe and the USA, although profits growth slowed in the second half of 1999. Profitability in bulk chemicals-particularly in plastics and petrochemicals-suffered, however, from rising oil prices, increased foreign competition and rising feedstock prices. Margins on refining and marketing were cut by the rise in oil prices, reflecting the importance of oil as an input to the chemicals sector.

Engineering companies realised benefits in profit margins in 1999, from their move from conglomerates to market leaders in quality products. But, they reported lower export margins. Profits of companies in the transport equipment sector were helped by technological developments in the UK which maintained the quality of products and margins in export orders. Aerospace manufacturers benefited also from exports priced in dollars. Shipbuilders' profits were built on successful diversification, away from large warship contracts. Motor manufacturers' profits were constrained by the competitive environment relating to car pricing and by the cost of extra advertising and incentives. Margins were hit in both automotive components and in tractor manufacturing.

Profitability in textiles was affected adversely in 1998 by the strength of sterling which contributed to a fall in clothing exports and to cheaper imports. This continued in 1999 when UK textile firms faced competition not only from South East Asia, but also from countries such as Morocco, Turkey and Romania to supply UK high street retailers. In addition, more British producers moved production abroad to Eastern Europe and Asia where labour was relatively cheap. Companies in these sectors were not able to maintain profitability in 1999, despite competing on quality, shifting into growing sectors and retaining a brand name. Companies have also invested in product innovation and in technology, to allow flexibility and swifter response times. Similarly, manufacturers of metal products reported that profits had been subdued by the strength of sterling against the Euro and by the impact of cheaper metals, particularly steel.

Cement producers' profits suffered in 1999 as a result of weak cement prices, prompting a price war which, to a degree, offset cost reduction consolidation programmes. Glass manufacturers' profits improved due to the cost savings achieved through restructuring and through selling glass over the Internet. Paper and printing companies' profit growth did not match rises in 1997 and 1998, although revenues from web design and from the transfer of printed material to electronic formats did expand.

Companies in food, drink and tobacco production reported a slight decline in profits, after a 5 per cent fall in 1998. This was, in part, due to costs of new product development in core convenience foods and of the focus on a narrower range of 'value-added' consumer brands, divesting brands which were not 'strategic'. In part, profits in food production were affected by higher raw material prices and by over capacity and tobacco profits were hit by the decline in the duty-paid market. Cost savings in the competitive food market began to be achieved from mergers and from concentrating on core products with higher profit margins. Companies had a very strong fourth quarter in 1999, in large part due to the strength of sales over the Christmas and Millennium periods.

During the 1990s, manufacturing companies' profitability showed a more rapid improvement than in service companies and by 1997 the differential in rates of return had narrowed to within four percentage points, compared with 10 percentage points in 1991. But , in 1999 the differential widened to 8 percentage points.

Manufacturing companies' output, productivity, costs and prices and trade

Output

According to data published by National Statistics, output in manufacturing was flat in 1999, compared with rises of 0.5 per cent in 1998 and 1.3 per cent in 1997. The weakness in manufacturing output in the first quarter of 2000 was across a number of sectors, including those 'new economy' companies in the manufacture of computers, electronic components and office equipment.

Different industries have grown faster than others. Computers and other information processing equipment was strong between 1997 and the first half of 1999. The growth rates in output of television and video recording equipment reached 65 per cent year on year in the final quarter of 1999 (Chart 4).

Productivity

The background to robust manufacturing productivity growth in 1999 (Chart 5) was the flat profile of output and the fall in employment of 140,000. As a consequence, unit wage costs fell.

In the first quarter of 2000, manufacturers' unit labour costs were no longer falling. Employment in manufacturing was cut by 14,000, but output fell and unit labour costs started to rise again. Productivity in manufacturing slowed, rising at the annual rate of 4.7 per cent, year-on-year. There was also pressure on earnings growth in services around the end of 1999 and the first quarter of 2000.

Figure 5
Productivity in manufacturing

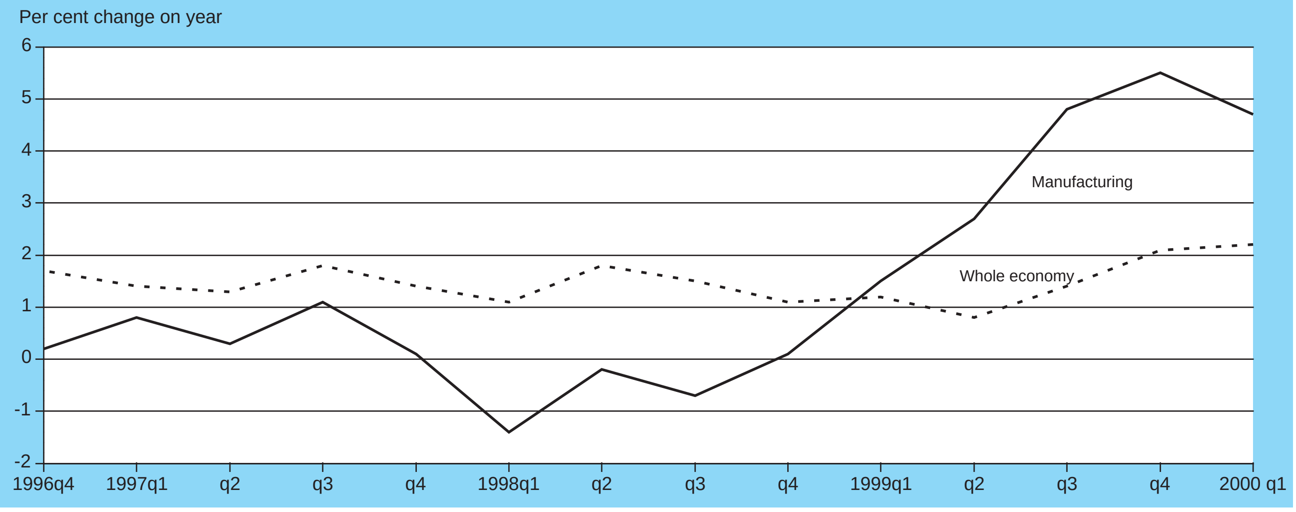


Figure 6
Costs and prices in manufacturing

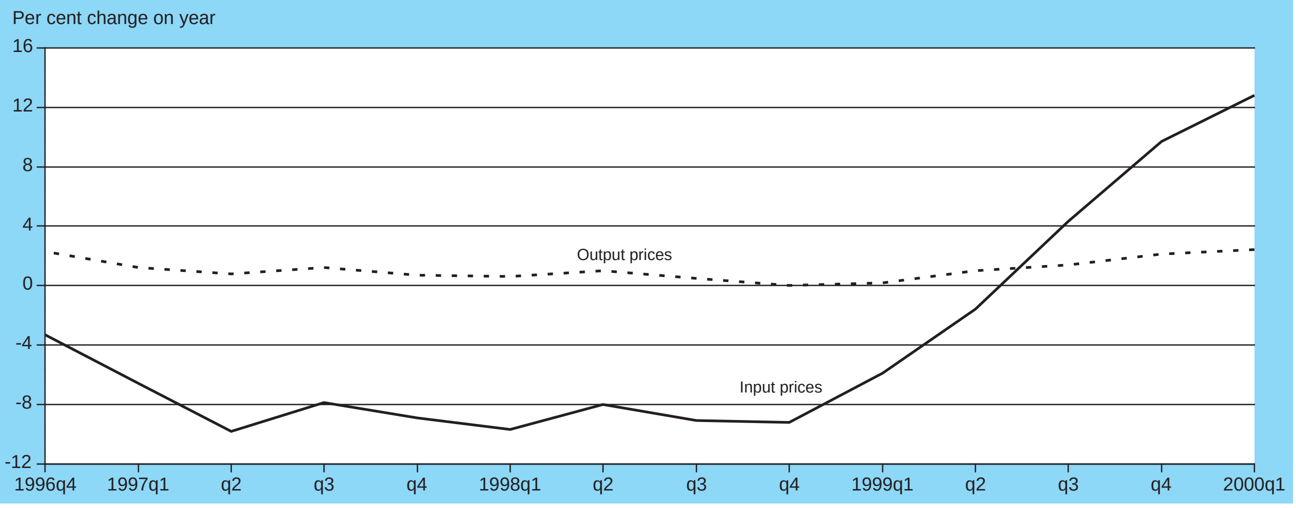


Figure 7
Exports of manufactures

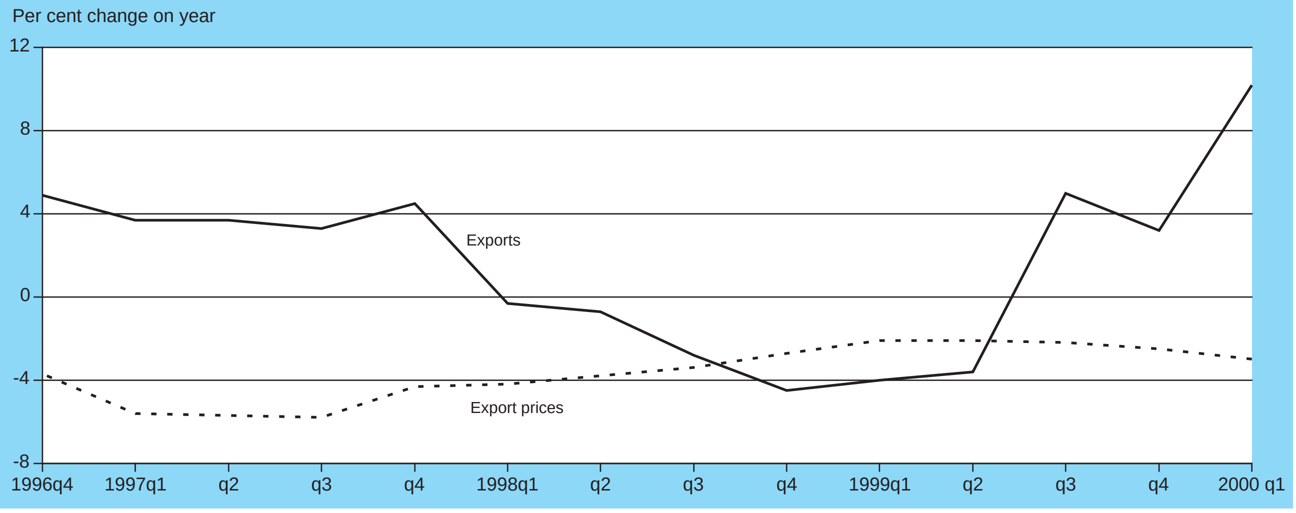
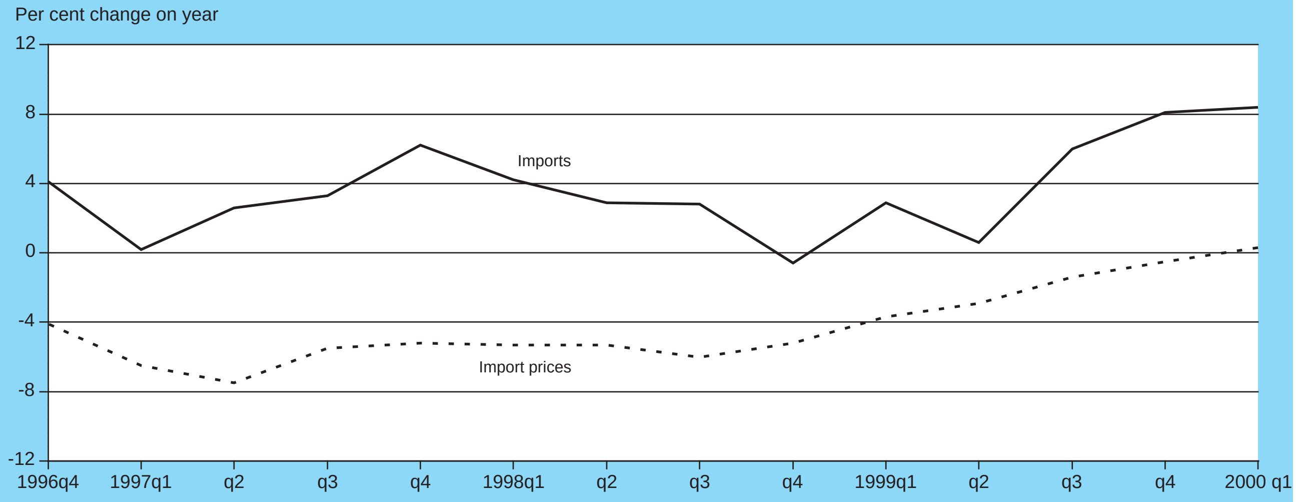


Figure **8**

Imports of manufactures



Costs and prices

1998 was a year of subdued prices. This was driven by responses to the financial crisis in South East Asia, as producers cut prices to keep shares in overseas markets. In 1998, input prices for materials and fuel purchased by manufacturing industry fell, on average, by 9 per cent, due to the fall in oil prices (Chart 6).

The second half of 1999 and the first half of 2000 were periods when input price growth was stronger than output price growth. Cost increases were absorbed by margins, as manufacturers were unable to pass on the increase in costs to prices.

Trade

Manufacturing companies export a larger proportion of their output than service companies and are more exposed to international competition and exchange rate movements.

Sterling weakened against the US dollar and the Yen in 1999, after appreciations in 1998, and strengthened against the Euro in the second half of 1999 and in the first quarter of 2000

The majority of UK trade in manufactures is with countries in the Euro area: in 1999, 59 per cent of the value of exports and 54 per cent of the value of imports. The export of manufactures began to fall in 1998 and this continued into the first half of 1999 (Chart 7). By the first quarter of 2000 with demand strong in Europe, levels of manufacturing exports had recovered to 10 per cent, compared with the same quarter in 1999. Export prices of manufacturing goods have fallen consistently over the last two and a half years, as manufacturers sought to remain competitive in price in overseas markets.

Equally important for manufacturers was the impact of import competition during the second half of 1999 and the first quarter of 2000 and, in particular, competition from the emerging market economies in East Asia. These countries began to cut their prices of microchips, electrical consumer goods, clothing and footwear and thus compete with UK companies' exports to other countries. Some companies have also faced low-price competition from companies in the Euro-zone. Import prices fell on average by 5 per cent during 1998 and by nearer 2 per cent in 1999 (Chart 8). The slight rise in import prices in the first quarter of 2000 could have reflected rises in imported raw materials denominated in dollars.

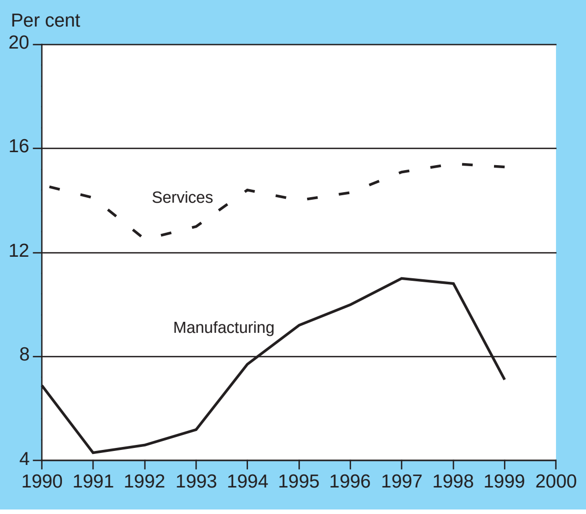
Service companies' profitability

Chart 9 indicates that service companies' profitability has remained in the narrow range of rates of return of between 12.5 per cent in 1992 to 15.4 per cent in 1998. This reflected stable profitability gains. In 1998, the UK had one of the most profitable service sectors in the world[2]. In 1999, profitability fell back slightly and the rate of return fell to 15.3 per cent. The net operating surplus rose by 10 per cent, but capital rose by over 10 per cent.

The factors influencing the level of profits in 1999 were weighted less towards the exchange rate and more towards new competition brought about by lower barriers to entry and pricing strategies in which discounting is becoming an integral part. Competition and cost control, particularly in holdings of stocks and purchases from suppliers, has been intensified by the use of information technology

[2] 'International comparisons of profitability', January 2000 edition of Economic Trends, pages, 33–46.

Figure 9
Net rates of return of manufacturing and service companies



including the Internet, and by a greater price transparency. The growth in business-to-business online commerce has provided cost savings to the services sector.

The economic background reported by National Statistics included a slower rate of growth in service sector output in 1999 (3.0 per cent) than in 1998 (4.1 per cent) and in 1997 (4.4 per cent). This slowdown was seen across all industries, except post and telecommunications. The fall in computer services output, for example, in the fourth quarter was the first since the first quarter of 1997. In the first quarter of 2000, growth slowed in post and telecommunications and other business services. The areas principally affected by this slowdown were telecommunications, courier services, management consultants and architects.

Profitability of service companies in 1999 was constrained by increasingly competitive pricing conditions. Companies held down prices in the face of demands for higher levels of service. This was reported by companies in areas like food and clothing retailing and in telecommunications and transport, including road haulage. IT hardware and accountancy services and business consultancy services were other industries in which there were new low-cost, discount competitors and deep price discounting in an ‘everyday low pricing’ environment.

Margins were maintained through cost savings as a result of restructuring. The Internet also began to contribute to profit margins, by reducing costs. This was through business-to-business purchases and sales linking retailers and wholesalers and as a marketing aide. Costs were cut further in the sourcing of products and in improving forward ordering and stock control to reduce inventory to sales ratios. Wholesalers were able to handle E-commerce purchases alongside trade for goods from traditional retail outlets. The Internet also brought a more competitive environment, in which price competition increased in areas like travel and house purchase.

Profitability of service companies: by sector

The analysis which follows is based on the anecdotal comments made by those companies surveyed by National Statistics.

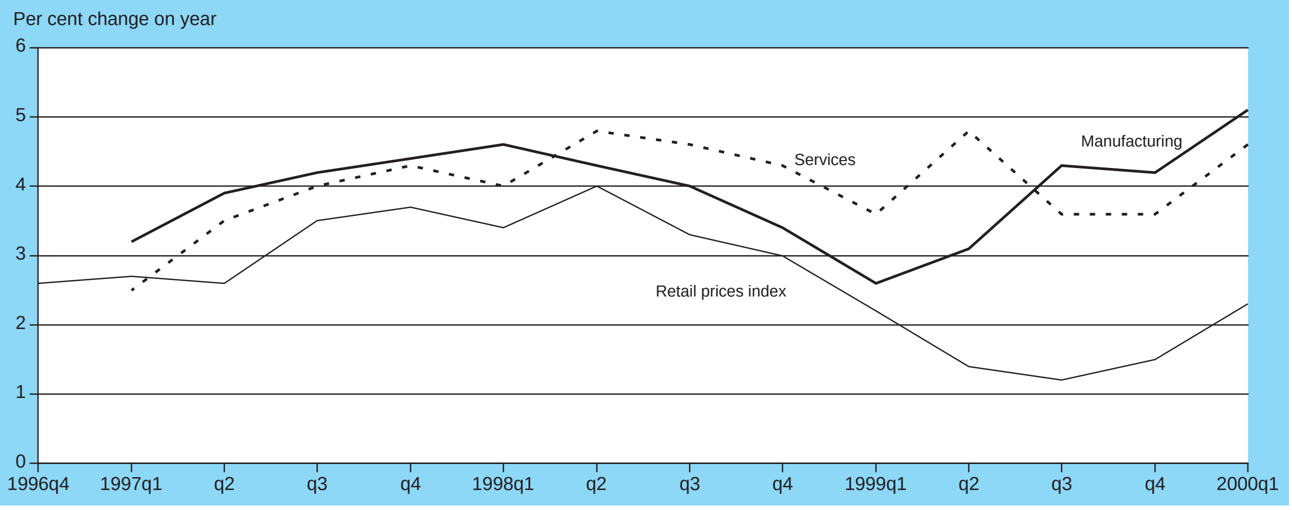
Profitability of major retailers and wholesalers increased in 1999, despite lower output growth. This sector is an important component of service sector profits: the sector contributes 25 per cent of service companies‘ profits and 27 of the ‘top 100’ companies in the survey. Profitability was led by a rise in operating profits of discount store chains selling ‘own-label’ goods, specialist and ‘designer’ retailers and by strong Christmas and Millennium trading for the major high street retailers. Companies met an expansion of their cost base and low prices by investing in technology and by increasing productivity. Increases in costs occurred though increased rents in floor space, sometimes expanding out-of-town stores, including warehouses for home shopping services and sometimes extending existing retail outlets. There was an extension in opening hours and the move into new markets such as direct home shopping by catalogue and by the Internet. Major supermarkets also incurred a steep rise in staff costs over the Millennium which cut profits in the first quarter of 2000.

The greater costs, in time, packaging and distribution, marketing and space by companies in the food and clothing retail sector have not been recovered in higher prices charged. There has emerged a growing consumer resistance to price rises. On-line suppliers have exploited the cost savings of E-commerce which High Street retailers are now driving forward. Prices for goods sold in major department stores fell in 1999, with the effect particularly noticeable in clothing, footwear, electrical and audio-TV. Also, there were falls in fruit and vegetable prices. Although the fourth quarter of 1999 was very strong in Christmas and Millennium trading, the first quarter of 2000 brought renewed pressure on margins which were squeezed by competitive trading, low prices and higher wage costs.

Companies in the leisure industry including recreational activities had a less successful year than in 1999. Profits were constrained by rising competition from more contemporary brands in the supply of health and fitness facilities, wine bars, restaurants, pubs, beauty salons, acupuncture and aromatherapy centres. Hotels and restaurants reported lower profits due, in part, to weaker demand and ‘at-home’ Millennium celebrations.

Profitability in the services sector in 1997 though 1998 was driven by the telecommunications sector. In 1999, profitability was

Figure **10**
Earnings in manufacturing and services



maintained, in particular by turnover in Internet and in mobile and fixed-line phone usage. Profits were helped by companies restructuring and merging to focus on high growth sectors. In the UK, 250 people per 1000 are reported to have a mobile phone and 25 per cent of all households have access to the Internet from a home computer. Europe leads the way in ownership of mobile phones and Vodafone became the world's largest mobile phone operator, after it acquired Airtouch in January 1999 and successfully acquired Mannesmann in February this year. Profits growth in 1999 did not, however, match 1998 and 1997, as costs rose to complete and extend telecommunications networks. Competition increased, as cable television operators and other carriers offered lower prices for long-distance and international calls. In addition, increasing competition amongst Internet Service Providers led to cheaper services, for example on unmetered broadband Internet access.

In the transport and transport support (including travel agencies), there was little, if any, rise in profits in 1999, due mainly to stronger competition, rising fuel costs and the scrapping of duty-free sales. Prices in the fourth quarter of 1999 and first quarter of 2000 were too high for the Millennium demand. Post-Millennium tourism demand was weak also. Higher levels of capacity led to discounting across the travel industry and low-cost airlines offering competitive fares in Europe also cut into margins of the larger operators. The rise in oil prices and the strength of the US dollar was another factor, because airline fuel is priced in US dollars. In rail transport, higher operating costs had a similar impact on margins. In freight transport, competition constrained profits.

Companies involved in real estate, renting and business activities reported profits in 1999 at levels lower than in 1997 and 1998. Property-related services, including estate agents had a profitable year. Competition increased, but profits of estate agents in London and the South-East were sustained by buoyant house prices and by a surge in prices for luxury property and the traditional estate agents began to display properties on web-sites, responding to competition from Internet estate agents. Legal and accountancy services maintained profit margins, by the ability to increase service fees. Competitive rental markets caused sluggish profits; growth in profits occurred when longer-term contracts were put in place. Computer consultancy services found profits constrained as major projects - for EMU entry at the end of 1998 and Y2K preparations - ended. New IT projects were put on hold and IT budgets curtailed until after January 2000. A pick-up in profitability from the development of e-business infrastructure may, however, be delayed beyond the first quarter of 2000. Business and management consultants, including recruiting, advertising and facilities management companies included in 'Other Business Activities' also found margins difficult to maintain in 1999. In part, this was due to the increased costs of launching on-line services. These costs began to be offset in the first quarter of 2000, by an expansion in advice to new e-companies on marketing and business strategies and to traditional companies who were expanding business online.

Earnings and investment in manufacturing and service companies

Earnings

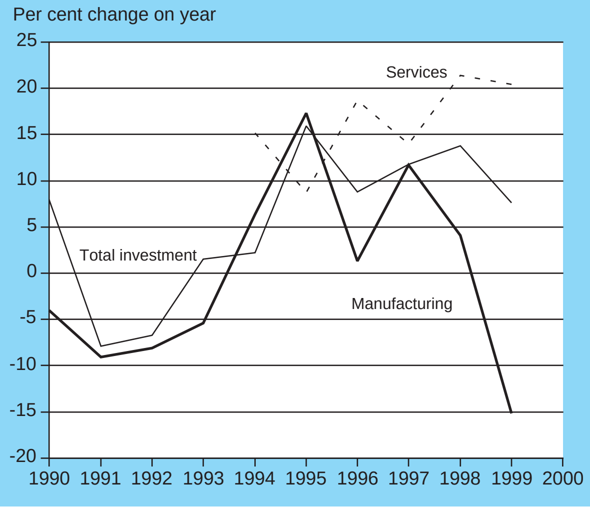
Profitability in manufacturing and services sectors has been affected adversely by stronger pay pressures.

Unit labour costs and non-wage costs including legal, insurance and accountancy fees are the dominant element of both manufacturing and service companies' costs. Raw material costs typically account for around one-third of manufacturers' total costs. Earnings published by National Statistics shown in Chart 10 exclude bonuses, to reflect companies' treatment of bonuses to be paid out of profits already earned, rather than as a production cost.

For manufacturers, earnings increased in the second half of 1999 and at March 2000, the growth in average earnings was 5.1 per cent, compared with 2.6 per cent one year earlier.

Service companies' earnings had grown more strongly than manufacturing earnings, since the second quarter of 1998 and by the second quarter of 1999 the differential was 1.7 percentage points. The strength in manufacturing earnings in the most recent period contrasted, however, with a weaker profile in service earnings. Between September 1999 and March 2000, the differential reversed and at the latter date, manufacturing earnings exceeded service companies' earnings by 0.5 percentage points.

Figure **12**
Business investment



Investment

Profits are closely linked to investment (gross fixed capital formation) through retained earnings, the main funding source for companies.

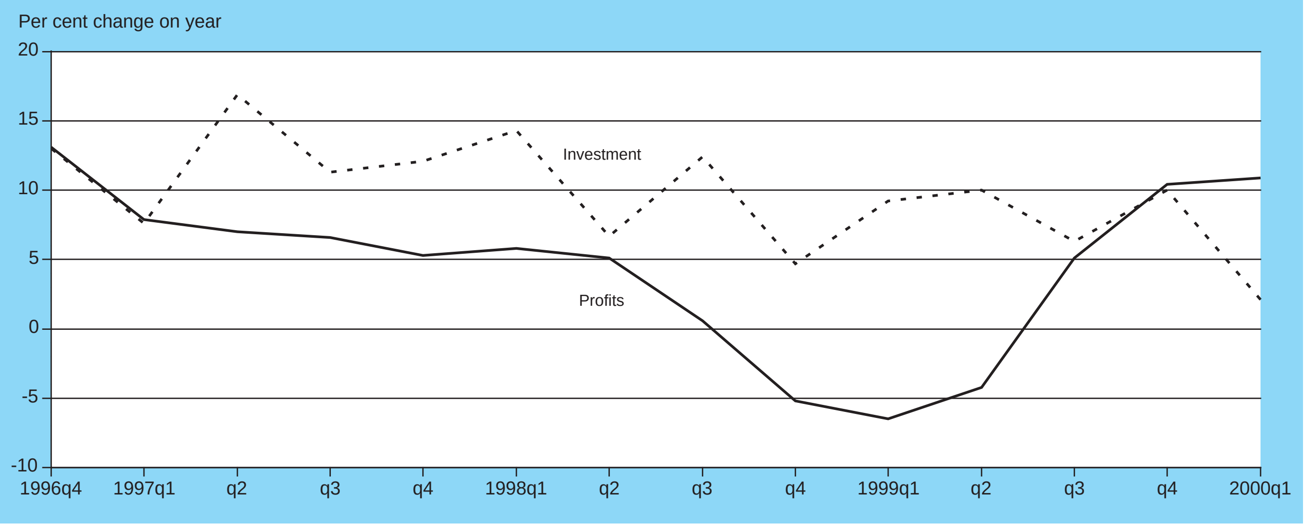
Investment rose strongly between 1995 and 1998, encouraged by the rise in share prices and by profit expectations. The pace of investment was strong in this period.

The slowdown in investment growth in 1999 and the first quarter of 2000 could be related to the impact on the main funding source-retained earnings-caused by lower levels of profits earned by companies from the second quarter of 1998 (Chart 11). Some investment programmes were halted, in expectation that profits and oil prices would fall. Some companies completed one-off investment projects designed for Millennium solutions. Some constraints on investment programmes may have been to improve financial deficits, where higher corporate expenditure exceeded internal funds and consequently where funds were needed to meet the extra costs of borrowing. Firms may also have been postponing their investment in research and development in the United Kingdom or planning to locate projects abroad.

In terms of sectors of industry, 1999 saw a rise in business investment by private service companies of 20 per cent, compared with 21 per cent in 1998 (Chart 12).

In 1999, the expansion in business investment in services was led by the telecommunications industry where developments have included cable and satellite television, mobile phone communications networks, Internet services and digital technology. Investment by computer hardware and software consultants and suppliers was,

Figure **11**
Investment and profits



however, subdued in the second half of the year, as the projects for Euro solutions and Y2K completed. In the first quarter of 2000, investment by service companies fell. Although funds were available for E-commerce and Internet sites and for new retail outlets and home delivery warehouses, some of these projects were delayed. Net average capital employed increased by over 75 per cent (£225 billion, at current prices) between 1990 and 1999.

Manufacturing companies' business investment declined sharply in 1999 by 15 per cent, reflecting earlier changes in business confidence and output. This was the largest decline since 1981 and was across all sectors. Investment could have been constrained by the costs of finance and by the modest growth in profits both earned and expected. Traditional manufacturers were also using IT more intensively.

Investment by companies in the chemicals and food, drink and tobacco sectors fell, after having risen in 1998 and investment by engineering companies fell for the second year running. A modest recovery in manufacturing investment did, however, begin in the fourth quarter of 1999 which continued in the first quarter of 2000 (5 per cent growth in each quarter) which was led by engineering companies.

The net average capital employed has increased by only 12 per cent (£28 billion, at current prices) since 1990. Consequently, modest growth in profits earned was sufficient to boost net returns on capital.

Inventories held by companies fell by £1.6 billion in 1999, compared with stock building in the previous six years. Inventories last fell in 1992. This could point to manufacturing industries managing their inventories more efficiently. In the first quarter of 2000, inventories of wholesalers and retailers rose, in part related to buying before tax increases and, in part, in expectation of price rises.

UK Continental Shelf companies' profitability

In 1999 and the first quarter of 2000, profitability of UK Continental Shelf companies rose to 25 per cent, the highest levels since 1996. A doubling in rates of return over the past year mainly resulted from rising crude oil prices. Companies have also made profits from lower production costs, as a consequence of companies realising costs savings from a reduced workforce and from the focus on new low-cost fields. In addition, rates of return on capital have been boosted by tighter capital expenditure. Capital was unchanged in 1998 and rose by only 4 per cent in 1999.

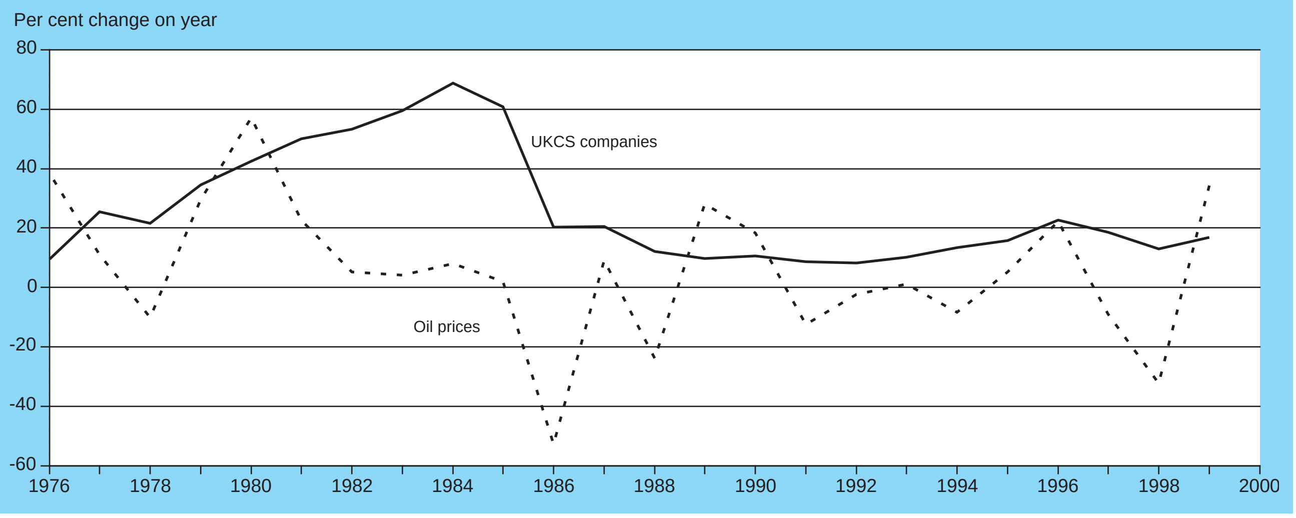
Chart 13 shows that the peak in profitability for UK Continental Shelf companies was reached in 1984/85 when the rates of return were in excess of 60 per cent. The volatility in the oil price dominates recent trends, particularly the major collapses in oil prices in 1986, 1988, 1991/92 and more recently in 1997/98.

Gross trading profits of United Kingdom Continental Shelf companies fell by 11 per cent in 1997 and by 19 per cent in 1998. As a result, the net rate of return fell to 18.5 per cent in 1997 and to 12.9 per cent in 1998. The main reasons were the fall in crude oil prices of 10 per cent and 30 per cent, respectively, in those years, due in part to the contraction of world demand and high world oil stocks. Adding to these factors was a rise in the cost base of activity on the UK Continental Shelf and consequent rise in operating costs.

The fall in the net rate of return in 1997 and 1998 also reflected the rise in net average capital employed. In the four years, 1990 to 1994, net capital employed rose by £3.1 billion. In the four years 1994 to 1998, net capital employed rose by £5.6 billion.

Figure **13**

Net rates of return of UK Continental Shelf companies



The level of profits in 1999 was 21 per cent higher than in 1998 and the net rate of return rose to 16.9 per cent. Profitability was driven by the rises in oil prices. World crude oil prices rose in 1999 from $9 per barrel - the lowest in real terms since 1972 - to above $30 in the first quarter of 2000, their highest level since the Gulf crisis in 1991. The rises were underpinned by restrictions on production by the Organisation of Petroleum Exporting Countries (OPEC) in March 1999 which were renewed in September. Although OPEC supplies less than 40 per cent of the world's oil demand, its share of marginal oil production is much higher. OPEC were able to cut back production by 3.2 million barrels a day, equivalent to 13 per cent of OPEC output, at a time of growing world demand, particularly given the recovery in Asia, and a build up in supplies held by industrialised countries, ahead of Y2K. In 1999, UK Continental Shelf companies reduced jobs and overheads, reducing costs per barrel of oil. Profits were boosted also by cost reduction programmes put in place by the oil companies.

In 1999, the UK's net exports of oil rose to £4.2 billion, a rise of £1.2 billion from 1998. In the first quarter of 2000, net exports were £1.3 billion, the third consecutive quarter when net exports exceeded £1 billion.

Towards the end of the first quarter of 2000, oil prices peaked, as OPEC eased production restraints and agreed to raise production by 1.45 million barrels per day. Measures also included an automatic production increase to deal with average prices outside a target range of $22 – $28 a barrel. Profitability was, however, maintained. The net rate of return was 25 per cent, three percentage points higher than in the fourth quarter of 1999. During June, OPEC announced an output increase of 708,000 barrels per day, but the oil price continued to rise, moving back above $30 per barrel.

BP Amoco and Royal Dutch/Shell and Totalfina Elf launched, in the first quarter of 2000, the Intercontinental Exchange, an online commodities market for over-the-counter oil and metals transactions. This provided the companies with greater liquidity and price transparency. Electronic procurement and Internet trading was also providing cost savings.

Key income and capital account movements of the UK corporate sector

Gross trading profits are the largest component of private non-financial companies' resources, accounting for around 75 per cent in 1999 (see Table 1). A fall of 1 per cent in companies' resources in 1999 and an increase in dividends, meant that income available for investment fell by £9 billion. With growth in investment, companies needed to increase their borrowing. For the following components of the income and capital account, of dividends, tax and interest, a manufacturing and services sector split is not possible.

Table 1 Private non-financial companies' income and capital accounts

£ billions, seasonally adjusted

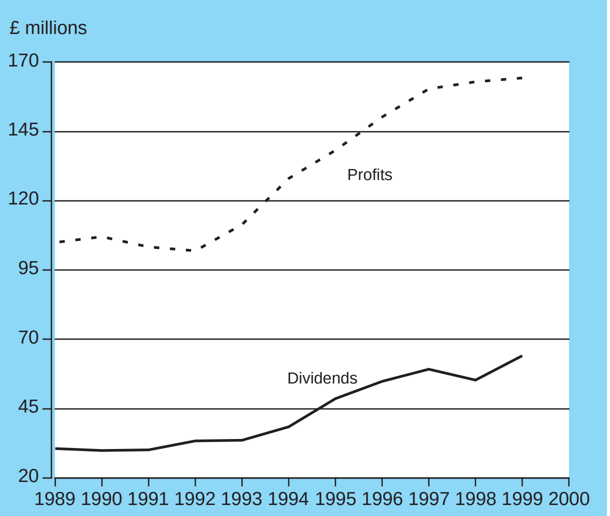
	1997	1998	1999	1999Q1	1999Q2	1999Q3	1999Q4	2000Q1
Income account								
Resources	221.1	226.9	224.8	51.2	58.4	56.8	58.3	59.4
Of which:								
Profits								
Oil companies	13.8	11.2	13.6	2.5	3.1	4.0	4.0	4.2
Non-oil companies	146.6	151.6	150.8	36.3	36.8	38.7	39.1	38.8
Uses								
Of which:								
Dividends	59.3	55.2	64.1	8.8	25.8	15.0	14.4	14.5
Interest	26.0	31.2	30.3	7.5	7.2	7.6	8.1	8.9
Taxes	27.7	25.0	21.2	3.4	7.3	6.2	4.3	5.3
Gross saving	79.8	87.9	78.7	25.7	10.8	19.9	22.2	23.1
Capital account								
Gross fixed capital formation	81.6	89.3	97.2	24.0	24.3	24.4	24.5	24.5
Inventories	3.7	4.0	-1.6	0.1	-1.6	-0.5	0.4	1.0
Net lending/borrowing(-)	-5.5	-5.6	-17.1	1.8	-12.0	-4.1	-2.8	-2.4

Dividends

With corporate profitability coming under pressure from the third quarter of 1998 and the pre-announced future changes in income and corporation tax taking effect from 6 April 1999, dividends fell by 6.9 per cent in 1998, reversing the growth in 1997 and providing the first fall since 1990 (Chart 14).

Private non-financial corporations' dividend payments subsequently rebounded to £26 billion in the second quarter of 1999. In the second half of 1999 and in the first quarter of 2000, dividend payments were £14–15 billion per quarter. Over the longer term, company dividends were on an upward trend until 1997, since when they have been falling. One factor could be that UK companies are now investing more of their earnings back into the business. There is an increasing proportion of earnings being used to finance the costs of higher borrowing and the increase in mergers and acquisitions. In addition, more companies are reported to be investing retained earnings back into business, for example, in research and development, rather than returning cash to investors.

Figure 14
Dividends and profits of non-financial companies



Dividend payments account for one-third of the remaining income (i.e., total income less interest payments and tax) of private non-financial corporations (Chart 15). This weight is comparable with the average for 1998. The dividend payout ratio for the first and second quarters of 1999 were, however, distorted by the abolition of advance corporation tax (ACT) on dividends. For some companies, the abolition meant that there was a financial benefit in their deferring their dividends until after 5 April 1999.

Interest payments

Interest payments by private non-financial corporations fell by £0.9 billion in 1999. This occurred against a background of a fall in UK banks' base rates from 6.0 per cent at the beginning of the year to 5.0 per cent in early June, to finish the year at 5.5 per cent. Interest payments rose sharply by 10 per cent in the first quarter of 2000, as companies used their resources to finance their debt.

Tax payments

Private non-financial corporations' tax payments fell by 15 per cent in 1999. This was due to three factors. The first was the fall of £4.4 billion in payments of ACT, as discussed above. The second was that tax payments in 1998 (and 1997) included the instalments of the windfall tax on utilities (£2.6 billion in each year). The third was changes in income levels, reliefs and allowances.

Figure 15
Private non-financial corporations' dividend payout

(a) Dividends as a percentage of post-tax income, less interest paid

Mainstream corporation tax payments increased by 32 per cent in 1999. Following the abolition of ACT, larger companies with accounting periods ending in December 1999 or March 2000 were making quarterly instalment payments (April, July, October 1999 and January 2000) in respect of their estimated profits on their 1999 accounts. This was in addition to the annual payments of mainstream corporation tax in respect of 1998–1999 accounting periods. Gross trading profits in 1999 for all companies showed very little growth. But an important factor was the balance between profit makers and loss makers. The former can produce an increase in the tax yield even if net profits are falling.

Net borrowing of the private non-financial corporations

In the UK national accounts, the overall financial position of companies is measured according to net lending/borrowing of the corporate sector. The primary determinants are profits and investment.

The company sector has been running a financial deficit for the past three years. This could suggest higher levels of capital gearing. The last comparable period of sustained deficits was between 1988–1992 when, in aggregate, the company sector borrowed £67 billion.

During 1999, the corporate sector's financial health showed deterioration and the financial deficit was at its highest percentage of GDP (6 per cent) since 1990 (chart 16). With a weak profits' profile, unusually strong dividend payments and current investment still held at a high level, companies' net borrowing (i.e., financial deficit) was particularly strong, at £17 billion. Unlike the early 1990s, a relatively small proportion of this debt was raised through the banking system. Companies were able to finance this huge borrowing mainly through capital market issues. Insurance companies and pension funds were heavy investors in these securities (see below).

Company financial transactions and acquisitions and mergers in the UK corporate sector

Financial account

Over the past decade, companies have reduced the proportion of their financial liabilities provided by monetary financial institutions in the UK from 19 per cent to 8 per cent. In this period, equity finance raised rose from 53 per cent of financial liabilities to 70 per cent. To finance the borrowing requirement in 1999 (and in the two previous years), companies developed their borrowing in the capital markets.

In 1999, the very large net borrowing requirement and the high level of mergers and acquisitions activity put pressure on corporate liquidity. Companies met these demands by borrowing in the capital markets and, in the second quarter by borrowing from banks in the UK. The shortage of long-dated gilt-edged securities and the minimum funding requirements for Pension Funds and Life Insurance companies encouraged private non-financial companies to issue longer-dated securities. Pension funds also had a tax incentive to invest in bonds rather than in shares, as a result of the change in tax arrangements for profits distributed as dividends. The attraction of bond finance included lower long-term rates of interest and the avoidance of margins paid to banks. Net investment in UK company securities by insurance companies, pension funds and trusts was £29 billion in 1999 and £10 billion in the first quarter of 2000.

Private non-financial corporations' capital market issuance was a record £39 billion in 1999, as companies took advantage of market interest rates to finance business investment and to pay for mergers and acquisition activity.

Figure **16**
Private non-financial corporations' financial balance

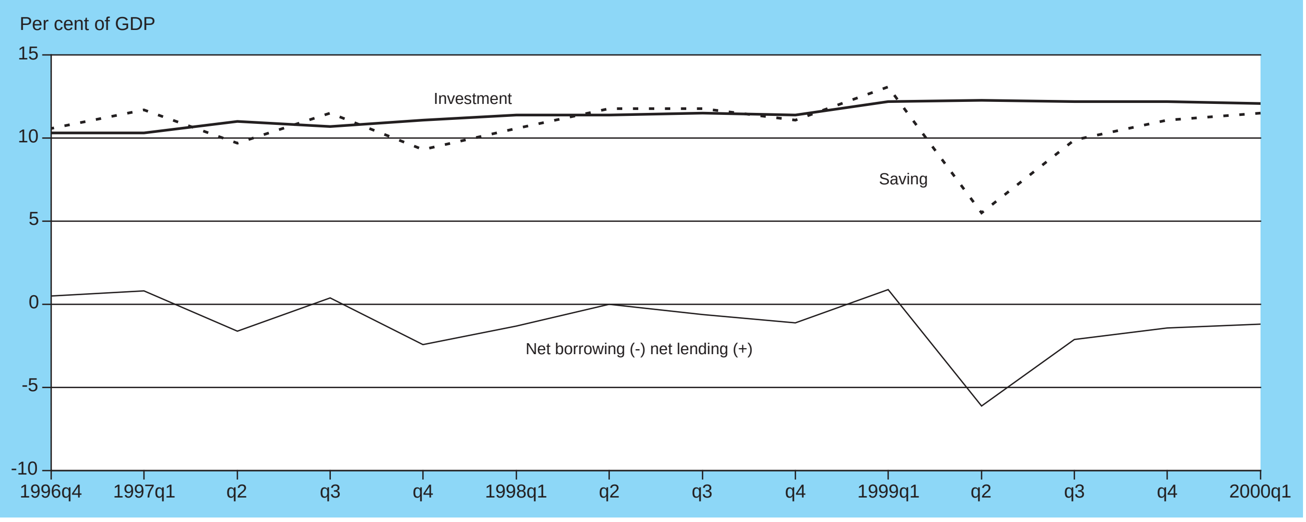
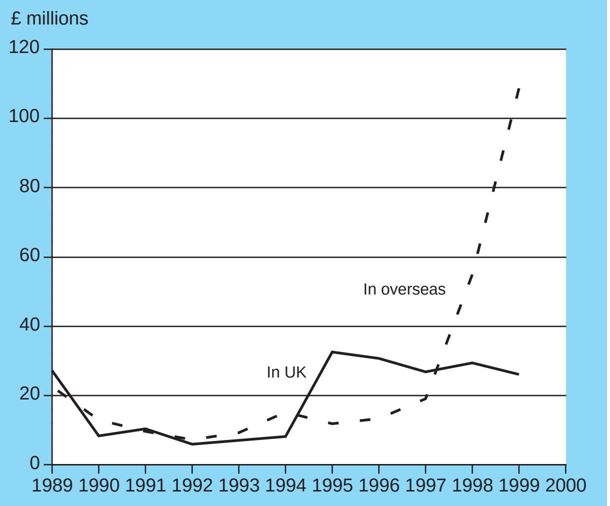


Figure **17**
Acquisitions and mergers by UK companies, by value



The total of £39 billion for 1999 compared with £17 billion in 1998. A new record issuance of £12.7 billion was set in the first quarter of 2000. Issues included three US dollar issues equivalent to £3.3 billion for Vodafone, relating to Vodafone's acquisition of Mannesmann. Other issues in Euro and US dollars were by UK companies using the proceeds to build up their European and US operations.

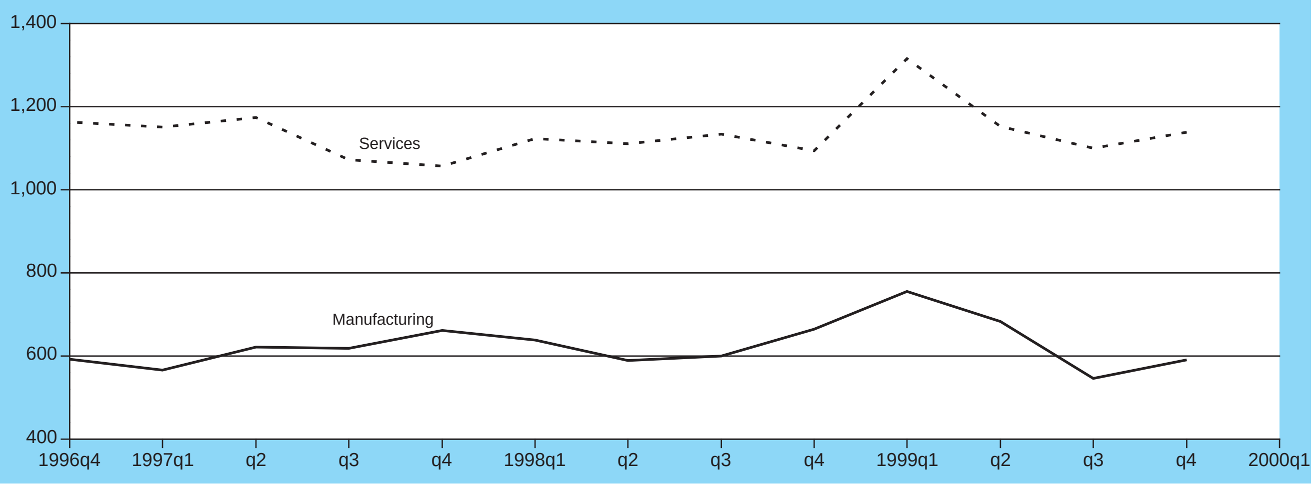
Company issues of quoted shares were £86 billion in 1999. This included (in the second quarter) the issue of shares by Vodafone (£38 billion) and Zeneca (£21 billion) in take-over deals. As most of the new issues were in exchange for overseas shares, the money raised did not go towards financing the borrowing requirement. In the first quarter of 2000, issues were a record £116 billion, dominated by Vodafone's acquisition of Mannesmann for £113 billion. The counterpart to all these deals was in the acquisition of shares in rest-of-the-world companies.

Private non-financial companies' financing from UK monetary financial institutions fluctuated sharply in 1999. Over the year as a whole, companies used the banking system to place surplus funds and to repay loans. This may have reflected treasury management of funds and liquid resources held in cash. It may also have included the proceeds of bond issues, held for future uses including finance for UK companies' acquisitions and mergers of international businesses, expansion into new overseas markets, share buy-backs and re-investment in companies' global Internet operations. In addition, two other factors prompted the build-up in deposits. The first was that a number of UK Internet companies placed deposits in monetary financial institutions overseas. These funds were raised after stock market flotation's and new share issues. Companies were reported as using these bank accounts as working capital, mainly for upgrading technology, marketing, staff costs and overheads. The second was to build up funds to finance next generation mobile phone licences, including the UK, Netherlands and German auction licences, payments for which were due in the second and third quarters of 2000.

Acquisitions and mergers

The recent peaks for merger activity involving UK companies were 1989 and 1999 (Chart 17). The peak in mergers in 1989 was caused by UK companies achieving economies of scale. Acquisitions in the US by UK firms accounted for 80 per cent of the value of mergers in that year. Between 1995 and 1997, the focus of merger activity was in the United Kingdom.

Figure **18**
Company insolvencies



In the fourth quarter of 1998 and in 1999, the focus of merger activity was overseas. In 1998, the value of acquisitions overseas by UK companies was £23 billion higher than acquisitions by overseas companies in the United Kingdom, largely as a result of the purchase of Amoco by British Petroleum. In 1999, this differential widened to £49 billion.

In 1999, UK acquisitions by overseas companies rose from £32 billion to £60 billion. Orange Plc, One-2-One, National Power Drax Ltd, Asda Group Plc, and Lucas Verity were all taken over during 1999. But, British company acquisitions abroad in 1999 jumped from £55 billion to £109 billion. This wave of acquisitions was led by the Vodafone take-over of Airtouch (US) for approximately £41 billion (£38 billion of new shares and £3 billion of cash) and by the acquisition of Astra AB by Zeneca Plc for a reported £21 billion. The Zeneca deal was an all-share deal, with Astra shareholders issued with new Zeneca shares. The third largest transaction was British American Tobacco acquiring Rothmans International BV in an all-share deal. These three deals were reflected in liabilities of private non-financial corporations (quoted shares' liabilities) and in assets (rest of the world shares). The UK even replaced the United States as the largest corporate investor, for the first time since 1988. In the first quarter of 2000, the largest-ever UK take-over took place when Vodafone's purchased Mannesmann (Germany) in an all-share deal for £113 billion.

This wave of acquisitive activity could realise UK companies economies of scale and international networks. This would maintain the corporate sector's competitiveness, by consolidating market share in product markets and by sharing high investment costs in information technology and high research and development expenditures.

Company insolvencies

The level of insolvencies in 1999 was at the highest level since 1995. In 1999, total insolvencies rose by 8 per cent, compared with 5 per cent in 1998 (Chart 18). Over the year to the fourth quarter of 1999, the proportion of insolvencies in the manufacturing sector fell by 3 percentage points to 17 per cent. The proportion of insolvencies in service sector companies increased slightly to one-third.

Conclusions

Levels of profitability were not maintained in 1999 and UK companies faced a deteriorating borrowing position. Oil companies benefited from the rise in oil prices and this continued in the first quarter of 2000.

The competitive economic environment forced companies to cut costs to preserve margins. Price rises to maintain margins were difficult to achieve. Companies may have reached a point of not being able to cut costs further and of seeking to raise prices to offset increasing input costs.

The unusual bounce-back in dividends in 1999 drained resources available for investment. Internal funds available for investment and in particular for research and development have been constrained by the lower growth and, in some periods, falls in profit earned since the second quarter of 1998. In these circumstances, internal funds were supplemented by record borrowing from the capital markets to finance major investment programmes.

UK companies were among the most profitable in the world in 1998. In 1999, companies faced a squeeze on profits and a tighter liquidity position. To maintain profitability in 1999, companies ran a massive financial deficit. This may reflect higher capital gearing and was readily funded. Record issuance of bonds and of share issues financed this borrowing. Insurance companies and pension funds were heavy investors in these securities. Borrowing is set to continue in 2000 and to be driven by the need to pay for the 'third genertion' spectrum licences in the UK, Netherlands and Germany.

Forward-looking indicators could, however, suggest that the competitive economic environment will intensify in 2000 and profitability will remain weak. Rather than cutting margins further, companies may maintain or even increase prices and risk losing orders. Companies may also be looking to moderate dividend payments and so free resources for investment. Investment intentions could have decreased due to inadequate net returns, including uncertainty over future profitability. Raw material costs continued to rise in the second quarter, as oil prices remained firm and prices of imported non-oil commodities rose. It is difficult, therefore, to see how profitability can improve further without having an impact on labour costs and hence how the borrowing position of the UK corporate sector is likely to improve in the near future.