

UK corporate sector report

Executive summary

Both corporate profitability and corporate borrowing picked up strongly during 2006 and growth in business investment continued to recover. But higher interest rates and rising corporate debt are pushing up corporate debt servicing. While corporate insolvencies remain very low, the rapid increase in administration orders in late 2006 suggests that financial pressure on corporate balance sheets is rising.

Key trends

- **Corporate profitability reaches new high.** The net rate of return on private non-financial corporations rose to a record 15.2% in September 2006, underpinned by strong returns for services companies.

- **Rapid growth in business borrowing.** Strong growth in corporate profitability supported rapid growth in borrowing by the corporate sector during 2006.

- **Recovery in business investment continues.** Business investment continued to gather pace during the second half of 2006, with very strong growth in investment in the oil and gas sector in the first nine months of 2006. Business surveys indicate that investment intentions for early 2007 are strong.

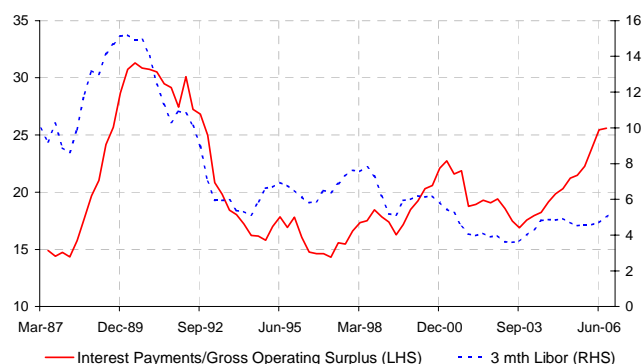
- **Corporate debt-to-asset ratio continued downward trend.** Underpinned by higher equity prices, corporate capital gearing continued to trend down during 2006.

- **Higher interest rates and rising corporate debt lead to increased debt servicing.** Debt servicing rose to its highest level in three years in September 2006, reflecting higher interest rates and a net increase in company debt.

- **Corporate liquidations remain low but administration orders accelerate.**

Company insolvencies, as a percentage of total active companies, remained at record lows in 2006. Administrative orders, on the other hand, accelerated rapidly in late 2006, suggesting that company insolvencies may rise in 2007.

Corporate debt servicing and short term interest rates (percent)



Corporate profitability hits new high

UK company finances strengthened in the nine months to September 2006. The net rate of return of private non-financial corporations increased to 15.2% in the third quarter last year, exceeding the peak in both the late 1980s and late 1990s. The net rate of return for services companies remained strong at 19.3%, only marginally below its peak of 19.7% in the previous quarter. The net rate of return for manufacturing edged up to 7.2% in the September 2006 quarter but remained well below the rates of return recorded during the 1990s and early 2000s.

Growth in M4 lending to business sector, defined as the sum of both lending to private non-financial corporations and the unincorporated sector, rose rapidly during 2006. By December 2006, annual growth in M4 lending was up by 18.1% on year earlier levels, compared with annual growth of 15.6% in December 2005. While real estate companies continue to account for a significant portion of the

borrowings, other areas of services and manufacturing have also made a large contribution to the rate of growth in lending over the past 1-2 years.

A strong financial position and robust demand underpinned a strong recovery in business investment during 2006. Business investment rose by 3.1% in the September quarter last year to be 8.2% higher than a year earlier. A strengthening in oil prices was accompanied by very strong growth investment in the oil and gas sector in the first nine months of 2006. Growth in investment in other areas of manufacturing, on the other hand, has been relatively subdued. While investment by distribution companies was relatively flat during 2006, other private sector services companies recorded solid growth in investment.

The results of recent business surveys point to buoyant prospects for investment in 2007. The BCC Quarterly Economic Survey for the December 2006

**M4 lending to the business sector
(percentage change, year on year)**



quarter indicated that investment intentions amongst manufacturers had risen to its highest level since the beginning of 1997, supported by stronger confidence in profitability. Investment intentions in services remained strong. That said, in light of the recent increases in interest rates and the likelihood of a further rate rise by mid-2007, some of these investment intentions might not be realised.

Capital gearing stabilises

The capital gearing is an indicator of the indebtedness of the corporate sector, and is measured as the holding of debt relative to the market value of the corporate sector. From a high of 40% in early 2003, the capital gearing of the UK corporate sector has eased, stabilising at around 25% in 2006. Research undertaken by the Bank of England suggests that the long-run equilibrium level of gearing has been relatively stable over the past decade at around 20%. Thus while the level of capital gearing has eased over

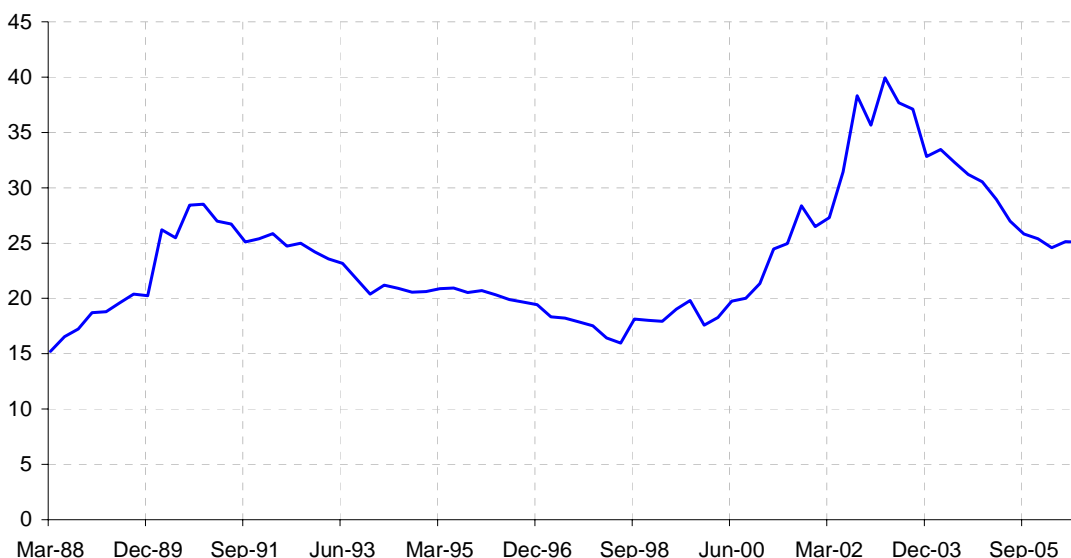
the past few years, it remains above the long-run equilibrium level.

The dominating factor behind this decline in capital gearing over the past 3-4 years has been the strengthening of the equity market. Since the beginning of 2003, the UK equity market has risen by over 60%. The level of net debt held by the corporate sector, on the other hand, has risen by around 10-12%.

The corporate sectors' net holding of debt since 2003 has fluctuated. After rising during 2003, net debt then trended down during 2004 and 2005 before rising again in 2006.

The pecking order theory states that a company has a preference for internal finance, such as retained profits, over debt capital and external equity financing. The trade-off theory looks at the balance between the benefits of obtaining debt capital, such as the tax deductibility of the interest payments, and

PNFCs capital gearing at market value (percent)



the costs of having too much debt, such as the probability of financial distress. Research undertaken by the Bank of England suggests that the growth of debt in a boom is explained by the increase in financing needs. Thus the growth in UK corporate debt during 2006, a period of robust growth in the UK economy, is consistent with these findings. The Bank of England research also found that at higher levels of debt, external finance becomes more difficult to obtain.

The Bank of England research paper also compared the determinants of corporate debt in the US, UK, France and Germany. The results showed that the movement of debt over the cycle is difference in Germany and the US than in France and the UK. In particular, the sensitivity of debt to investment and acquisitions is greatest in Germany and the US. Thus in a boom, when firms are responding to higher levels of investment and acquisitions, German and US debt tends to rise above the optimum level by more than in the UK and France. In a slowdown, when firms are

adjusting back down to their optimum level of debt, German and US debt tends to be paid down more slowly.

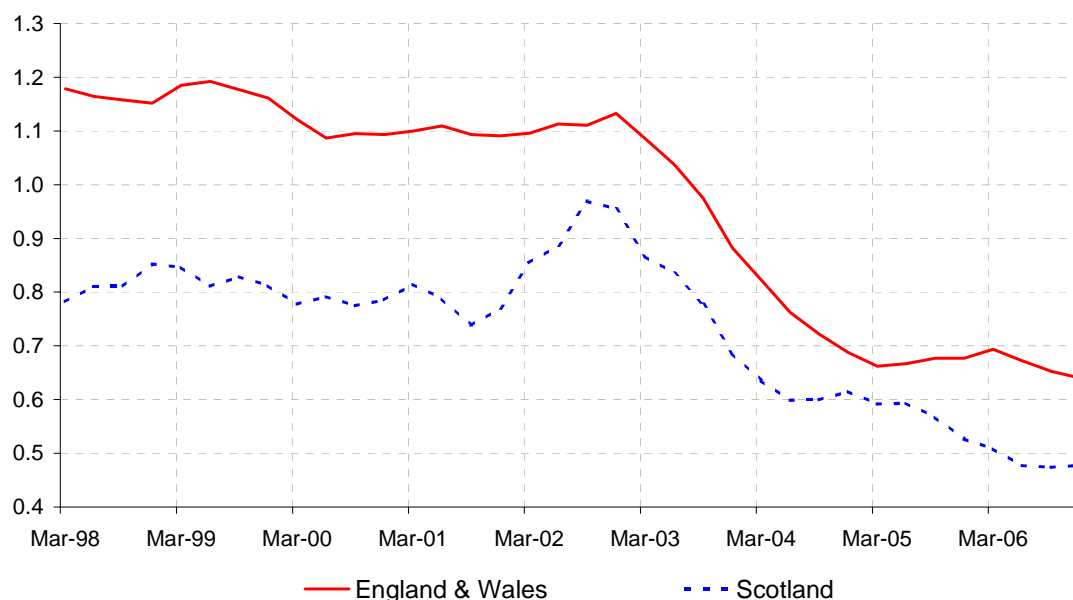
Debt servicing rises further

Corporate debt servicing, or income gearing, is defined as the ratio of interest payments to gross operating income. The upward trend in corporate debt, combined with a cumulative 175bps increase in official interest rates by the Bank of England since late 2003, has underpinned a steady rise in corporate debt servicing. By September 2006, the ratio had risen to 25½%, up from a recent low of 16¾% in September 2003.

Corporate liquidations remain low

Despite the increase in debt holdings by the corporate sector and the accompanying increase in the debt servicing ratio, data compiled by The Insolvency Service indicates that the corporate insolvency rate remained low in 2006. In the December 2006 quarter,

Company liquidations (as a % of total active companies)



the total number of company liquidations in England and Wales was steady on the same period a year earlier, with a rise in compulsory liquidations offset by a decline in creditors' voluntary liquidations. In Scotland, the total number of liquidations in the December 2006 quarter rose by 10% on year earlier levels, with increases in both compulsory and creditors' voluntary liquidations.

As a percentage of the total number of active companies, total liquidations in both England and Wales, and Scotland remain very low. In December 2006, total liquidations as a percentage of the total number of active companies was 0.6% in England and Wales and 0.5% in Scotland.

Administration orders rise sharply

The latest figures released by Experian, on the other hand, tell a very different story. Experian reported that the total number of corporate failures rose to their highest level for more than a decade in 2006. The breakdown of business failures by type during 2006 showed that the largest increase was in administration orders, up by 137.8% in 2006. The areas hit hardest by administration orders were London (up by 243%), Scotland (up by 88%) and Wales (up by 83%). Thus there is clearly a risk that this could flow through to an increase in company insolvencies in 2007.

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