

# Business profitability and investment – latest figures

March 2012

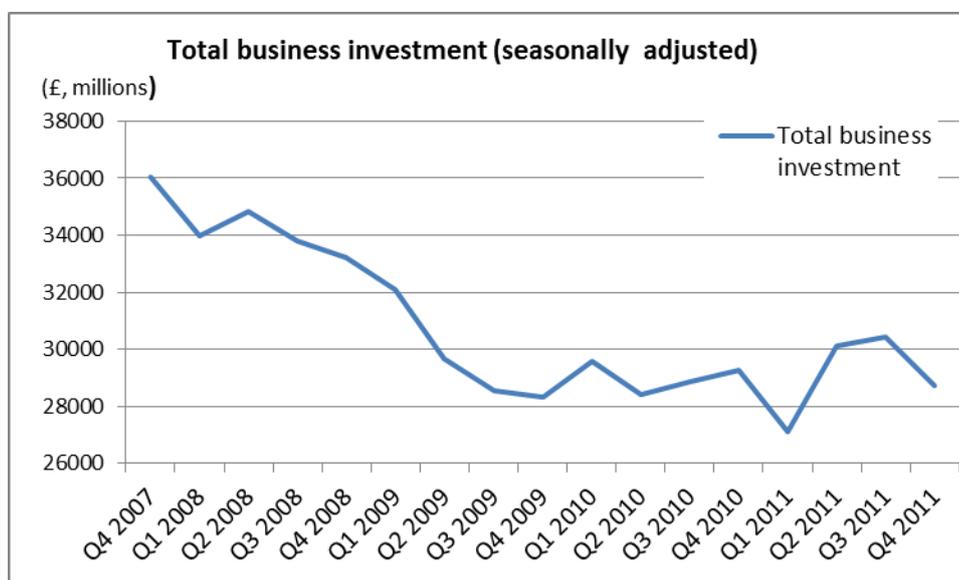
## Background

The release of business profitability and investment data provides interesting insight into their historical performance and future intentions. The data is released quarterly. By using both datasets we can also begin to understand what businesses' margins are, what they are doing with these earnings – whether they are retaining surpluses to improve their balance sheet or investing to expand or improve market share.

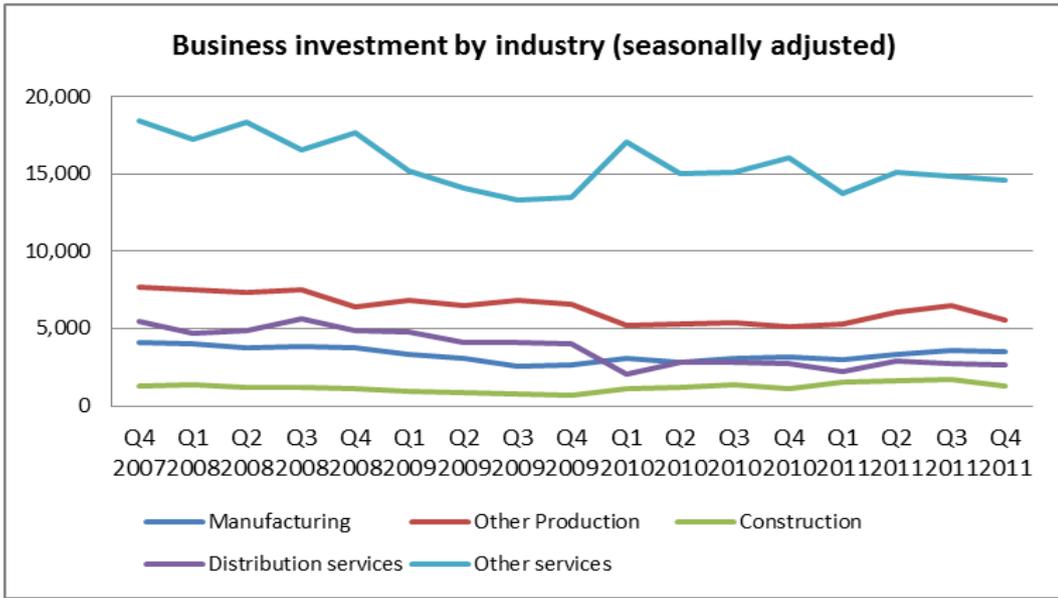
## Business investment

Business investment estimates are a short term indicator of capital expenditure by manufacturing and non-manufacturing businesses within the UK. Capital expenditure is defined as the spending on physical assets such as buildings and machinery.

Total business investment in the fourth quarter of 2011 was 2% lower than the same quarter the previous year, and 5.6% lower than Q3 2011. It appears this has been led lower by a significant fall in investment by non-manufacturing companies – experiencing a quarterly fall of 6%. This was equally due to a fall in investment by other production businesses (primarily electricity, gas and water) and construction. In comparison, manufacturing investment only fell by 2.4%. On a yearly basis, investment by manufacturing companies actually increased by 11.3%.

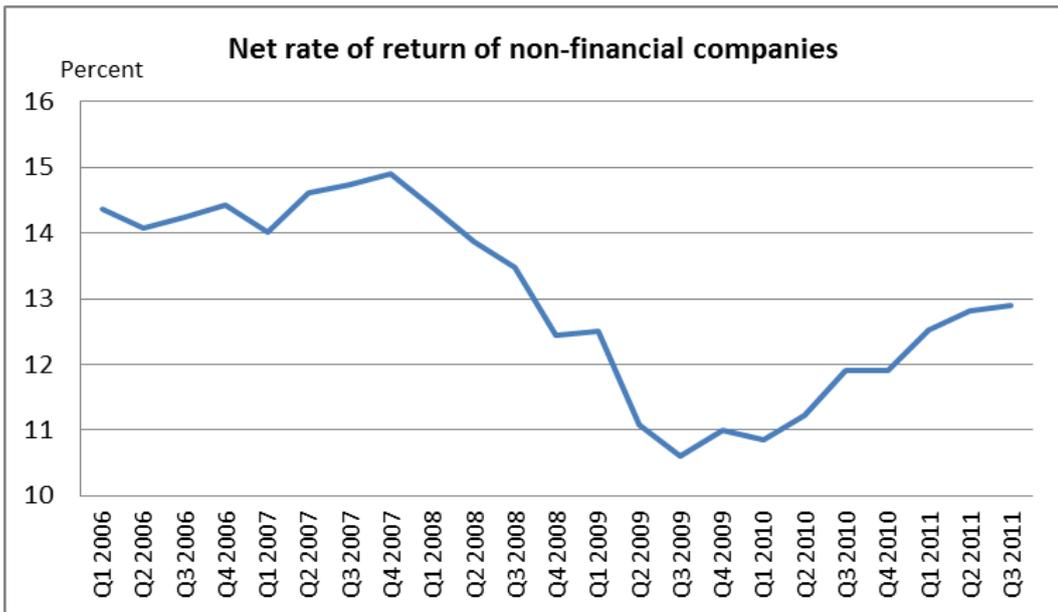


The below chart shows that all parts of the economy suffered declining investment throughout the recession and that fragile confidence has hindered a return to pre-recession levels.



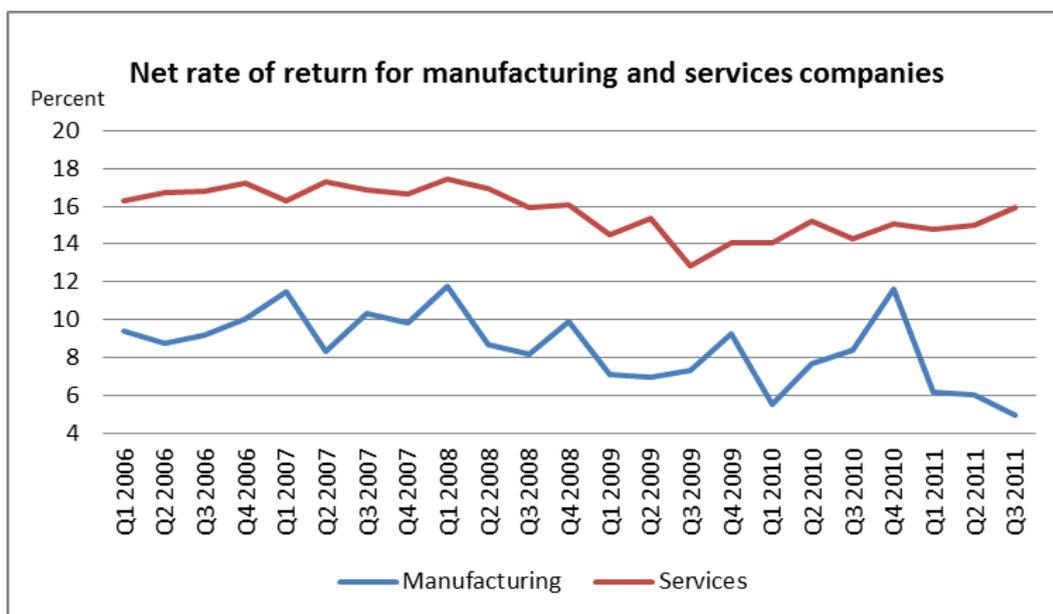
### Business Profitability

Figures relating to Q3 2011 highlight that, rather contrary to the trend seen above in business investment, profit levels for businesses are holding up relatively well and recovering some of the ground lost during the recession. Again, however, levels have not yet fully returned to pre-recession levels. Overall, the net rate of return by private non-financial corporations in the third quarter of 2011 was 12.9%. This compares with the revised estimate of 12.8% in the previous quarter. The annual net rate of return in 2010 was 11.5%.



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The overall figures do contain some contrasting sectoral differences. The better performance mainly relates to the service sector rather than manufacturing, whose net rate of return (the ratio of operating surplus compared to capital employed – net of depreciation - and expressed as percentages) has fallen to the lowest level since Q1 1997. Service companies' net rate of return was 15.9%, the highest value since Q4 2008.



This latest data shows that competitive conditions for manufacturing companies remain high, the consequence being that rates of return are low<sup>1</sup>. To put this starkly, the rates of return for manufacturing companies do not greatly exceed the rate of return that would be expected if that finance was simply invested into an interest-bearing bank account (although the fact that interest rates are at historically low levels may act as a saving grace in this rather simple comparison).

Clearly, the profitability of manufacturing companies is at such a low ebb that any further shock to demand conditions in the UK could lead to more companies going out of business. In contrast, it appears that service companies may have more of a buffer.

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<sup>1</sup> Generally, net rates of returns for manufacturing companies will tend to be lower than services because of the higher rates of depreciation that are incurred on capital items. The gross rates of return tend to be less divergent.

## **Conclusion**

At first glance, it appears that profitability levels are returning well to pre-recession levels. However, this hides major differences between the manufacturing and services sector. One of the impacts of the declining profitability in manufacturing seems to run through to business investment levels remaining subdued.

What we also know from analysing the financial results of companies is that they are taking the opportunity to also rebuild their balance sheets and reducing debt levels – mirroring individuals' activity in reducing their outstanding mortgage. It appears as though this may certainly be the case in the services sector where profit margins have been improving but yet investment levels remain below the historical trend.

It is probable that a combination of profit margins remaining under pressure – particularly in manufacturing – and the reduction in debt is having an impact on investment levels going forward. We will need investment levels to recover in order to sustain growth in the longer-term. Any successful economy has a healthy level of business investment underpinning the strength of its growth.

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## **Contacts**

Please contact the SW Observatory Core Unit for any queries relating to this data alert.