
Developments in the New Zealand corporate sector

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This article examines recent trends in the New Zealand corporate sector by analysing data from various sources. The corporate sector has enjoyed increased profitability over the past few years on the back of strong economic growth. While the absolute level of debt has also been rising in the past few years, the overall balance sheet position has improved. The recent strong investment growth appears to have been funded out of retained earnings or equity raisings rather than via debt. This has allowed businesses to strengthen their balance sheets while investing for future growth at the same time. Margins started to come under pressure towards the end of 2004. Looking forward, rising input and labour costs, and higher cost for some capital items may lower profitability over the coming year. At this stage, it appears that businesses in the non-tradables sector are more likely to pass on increased costs on to customers. Businesses in the tradables sector have more limited pricing power.

1 Introduction

The corporate sector plays an important role in the economy. The sector produces goods and services, determines the demand for labour, and undertakes investment decisions that expand the productive capacity of the economy. Understanding developments in the corporate sector is important from both a monetary policy and macro-stability perspective. The sensitivity of the corporate sector to changes in interest rates and the exchange rate is an important consideration when setting monetary policy. Like the household sector, the effect of monetary policy is partly dependent on how leveraged the corporate sector is. From a macro-stability perspective, a weak corporate sector can lead to instability if it is unable to withstand economic shocks. The International Monetary Fund cited financial and corporate sector weakness as having played a major role in the Asian crisis in 1997.²

Despite its importance, the New Zealand corporate sector is difficult to analyse in the same detailed manner as the household sector. A main reason for this is the dearth of aggregate data on the corporate sector as a whole.³ In forming a view on how the corporate sector is performing, the Reserve Bank pays close attention to various business surveys, and has regular direct contacts with individual businesses via a programme of regular business visits around the country. Useful as this information is, it provides only

limited perspective on balance sheets and other aspects of company performance, such as profitability and cost structures. This article attempts to pull together aggregate data on the corporate sector from various sources to examine recent developments in the sector.

2 The corporate sector in brief

Table 1 shows the number of corporate enterprises by industry and the number of people employed as at February 2004. Growth over the 2000 to 2004 period is also shown. In 2004, there were some 160,000 for-profit corporate enterprises operating in New Zealand, including those owned by central (state owned enterprises) and local government (local authority trading enterprises). These enterprises had over 1.1 million employees. Farmers and sole proprietors are not included in the analysis because they have different characteristics to a typical corporate. For example, farmers and sole proprietors mainly pay 'other persons' tax rather than company tax. It is also likely that small operators borrow against their mortgage as a source of business finance. In addition, three-quarters of sole proprietors do not employ anyone.

Almost a third of corporate enterprises are involved in the property and business services industry. A further 13 per cent are in the retail trade business, and some 12 per cent are in construction. There has been a 41 per cent increase in the number of corporate enterprises between 2000 and 2004, with all industries recording increases. The number of enterprises in the education, and health and community

¹ This article was written while the author was on secondment from The Treasury.

² See Lindgren et al (1999).

³ There is a lot of information on publicly listed companies, but their industry coverage is not a good representation of the New Zealand economy due to the dominance of a few companies.

Table 1
Number of enterprises and employees⁴
(as at February 2004)

Industry	Corporate enterprises			Employees		
	Number	% of total	% growth 2000-2004	Number	% of total	% growth 2000-2004
Agriculture, Forestry and Fishing	4,920	3.1	69.3	25,050	2.2	58.1
Mining	340	0.2	18.3	3,300	0.3	36.4
Manufacturing	14,960	9.4	20.2	251,060	22.1	14.7
Electricity, Gas and Water Supply	170	0.1	41.0	6,330	0.6	33.0
Construction	18,960	11.9	48.6	84,540	7.4	49.2
Wholesale Trade	13,570	8.5	17.3	100,850	8.9	18.4
Retail Trade	21,150	13.2	29.3	198,110	17.4	21.2
Accommodation, Cafes and Restaurants	6,770	4.2	59.7	81,040	7.1	26.1
Transport and Storage	6,150	3.8	32.2	68,130	6.0	10.6
Communication Services	760	0.5	52.8	12,490	1.1	-9.2
Finance and Insurance	7,010	4.4	29.4	12,730	1.1	5.1
Property and Business Services	50,800	31.8	50.2	162,570	14.3	32.8
Education	1,410	0.9	79.2	12,300	1.1	97.4
Health and Community Services	5,160	3.2	76.8	56,520	5.0	45.6
Cultural and Recreational Services	3,700	2.3	60.6	26,230	2.3	13.2
Personal and Other Services	3,960	2.5	60.5	19,220	1.7	36.7
Total	159,790	100.0	40.7	1,137,022	100.0	23.3

Source: Statistics New Zealand.

services industry recorded the largest percentage increase from 2000, albeit from a small base. In absolute terms, half of the increase in corporate enterprises over the 2000 to 2004 period came from two industries – property and business services, and construction.

In terms of employment, over 22 per cent of people employed by corporate enterprises are in the manufacturing industry. Retail trade is the second largest employer at 17.4 per cent. The number of people employed by corporate enterprises rose 23.3 per cent over the 2000 to 2004 period. All industries except communication services increased their workforce. Employees in the education industry almost doubled over this period, possibly due to the rapid expansion of language schools and private training establishments. In absolute terms, half of the increase in employees over the 2000 to 2004 period came from three industries – property and business services, retail trade, and manufacturing.

3 Profits and costs

Profit measures for the corporate sector are not readily available. A broad aggregate measure of corporate profits can be obtained from Statistics New Zealand's estimate of net operating surplus, published as part of the annual *National Accounts*. Net operating surplus is equivalent to accounting profit before the deduction of direct taxes, dividends, interest paid and bad debts, and before the additions of interest and dividends received. It is roughly equivalent to an EBITDA⁵ measure, as it also deducts the consumption of fixed capital (or depreciation). The net operating surplus figure has been adjusted to exclude farmers, sole proprietors and owner-occupied dwellings, to correspond as closely as possible to profits generated by the corporate sector. Another source of information on overall corporate profits is the amount of company tax collected by the government. The company tax data is a useful verification of the corporate profit measure estimated from the *National Accounts* data.

Figure 1 shows the growth in corporate profits and company tax since 1994. Corporate profits correlate reasonably

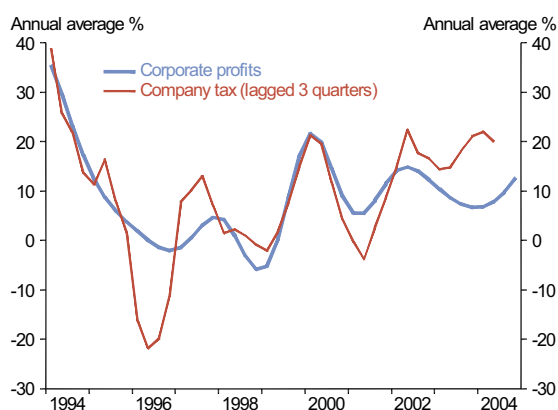
⁴ The figures have been rounded to the nearest 10. The figures may not add up due to rounding.

⁵ Earnings before interest, tax, depreciation and amortisation.

well with the business cycle. Corporate profits recovered strongly following the recession of 1997/98, and since 2000 have grown by an average of around 11 per cent per annum. Profit growth rose over 2004, in line with the pick-up in GDP growth for that year. Not surprisingly, there is a strong correlation between the growth in corporate profits and company tax, but with the former leading by about three quarters. This can be explained by timing differences between when corporate profits are accounted for and when taxes are paid. Over the past few years, company tax has been growing at a faster pace than corporate profits, even after adjusting for the timing differences. A run-down in the stock of past accumulated tax losses when corporate profits recovered strongly in the late 1990s could explain the faster growth in company tax.⁶ Another possible explanation may be that the estimate of corporate profit growth over the past year or so has been underestimated, and actual profit growth could in fact be much higher.

Another measure of profitability is the profit margins that companies earn from their sales. Information on this can be obtained from the Regional Economic Indicator (REI) and Quarterly Employment Survey (QES) data compiled by Statistics New Zealand. The REI uses Goods and Services Tax (GST) data to produce estimates of total sales and purchases by selected industry types. The QES provides total labour cost estimates by industry. By subtracting purchases and

Figure 1
Growth in corporate profits and company tax



Source: Statistics New Zealand, The Treasury.

labour cost from sales, a profit measure akin to an EBITDA measure can be obtained. An estimate of profit margins can then be calculated by dividing the EBITDA measure by sales. The REI and QES data relate to the total economy, and not just corporate enterprises. Therefore, the profit margins estimated and shown in table 2 should be regarded as indicative estimates only of the margins experienced by the corporate sector. Education, and health and community services have been excluded due to the dominance of the government sector, and the agriculture, forestry and mining sector is excluded due to difficulties in reconciling the different data sources.

Table 2
Profit margins
(EBITDA as a per cent of sales)

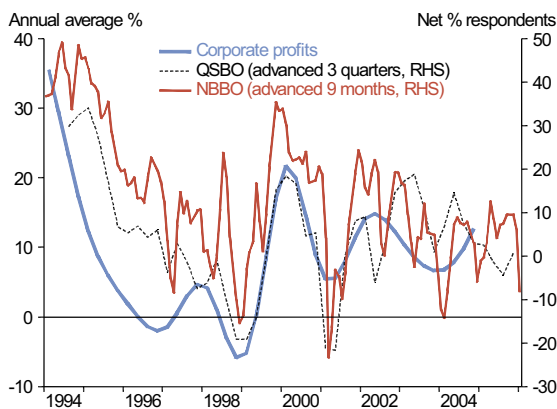
Industry	1998	1999	2000	2001	2002	2003	2004
Manufacturing	9.5	10.0	8.5	7.5	9.7	10.4	9.5
Construction	13.4	12.5	12.7	15.1	14.7	14.9	15.1
Retail Trade	7.2	6.5	6.5	6.6	6.9	7.6	7.4
Accommodation, Cafes and Restaurants	9.7	11.1	10.4	9.9	11.6	12.8	15.5
Transport and Storage	40.9	38.4	36.1	36.8	38.5	36.5	39.1
Property and Business Services	22.6	24.6	24.0	25.8	26.9	26.9	26.2
Cultural and Recreational Services	20.2	18.2	18.3	18.9	21.8	24.5	25.4
Personal and Other Services	15.5	12.2	18.4	19.1	18.4	19.4	16.9
Other	17.2	15.6	14.9	14.6	14.2	15.5	15.4
Total	16.3	15.6	15.1	15.1	15.7	16.5	16.6

⁶ This was an explanation put forward by The Treasury in the 2003 December Economic and Fiscal Update to explain the rapid growth in company tax.

Table 2 suggests that overall profit margins have risen since 2001, with most industries experiencing increased margins. The retail trade industry has the lowest margin, largely reflecting the 'high volume, low margin' nature of the business. The services industries on average enjoy higher margins, with transport and storage estimated to have the highest margin. Higher margins in these areas may reflect the large fixed-cost nature of many parts of the service sector.

Despite strong profit growth and increased margins over the past few years, the backward nature of the data does not tell us how the corporate sector will perform over the current year. Business surveys of firms' future profit expectations can give us some insight into how corporate profits will evolve. Figure 2 shows the relationship between growth in corporate profits and profit expectations from the Quarterly Survey of Business Opinion (QSBO) and the monthly National Bank Business Outlook (NBBO) survey. The surveys warn of a slowdown in corporate profits for this year, although profit expectations tend to be volatile and past historical relationships suggest caution in reading too much into the data.

Figure 2
Corporate profits and expectations



Source: Statistics New Zealand, NZIER, National Bank.

One possible reason for the subdued profit expectations is the rising cost of inputs into production, as measured by the producer price index.⁷ Figure 3 shows the changes in output prices charged by producers, and prices incurred by producers

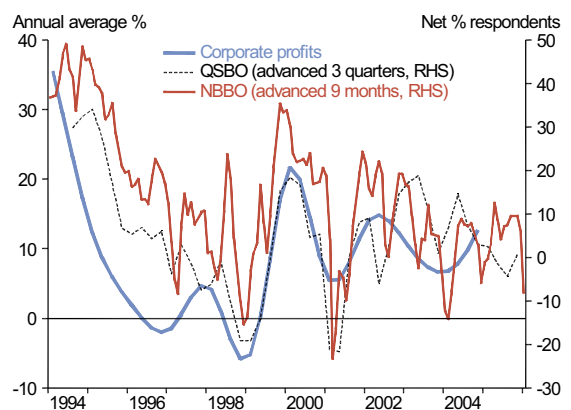
⁷ The producer price index measure price changes in costs of production, excluding labour and depreciation costs. Agriculture, government sector and owner-occupied dwellings have been excluded from the index.

for their non-labour inputs. Again, the data relates to the total economy and not just corporate enterprises, and should be seen as indicative of changes in prices experienced by the corporate sector. The large increase in input costs over 2000 was due to a depreciating exchange rate, which increased the cost of imported materials. Producers were unable to increase their prices by more over this period, and this saw margins contract. Since mid-2002, producers appear to have lifted output prices more quickly than input prices, perhaps due to relatively buoyant demand conditions in the economy. This is consistent with the rise in profit margins shown in table 2. Over the latter part of last year and early this year, however, input costs have risen faster than output costs, possibly signifying an end to margin expansion.

A further dis-aggregation into tradable and non-tradable sectors shows a divergence in price patterns (see figures 4 and 5). Producers involved in the tradables sector have seen a more rapid increase in their input costs over the past year than those involved in the non-tradables sector, although this followed a period of declining input costs. Despite producers in the tradables sector increasing their output prices, it was not sufficient to cover the increase in their input costs since the second half of 2004. In contrast, producers in the non-tradables sector have consistently been able to increase their output prices by more than the growth in their input costs since the end of 2001.

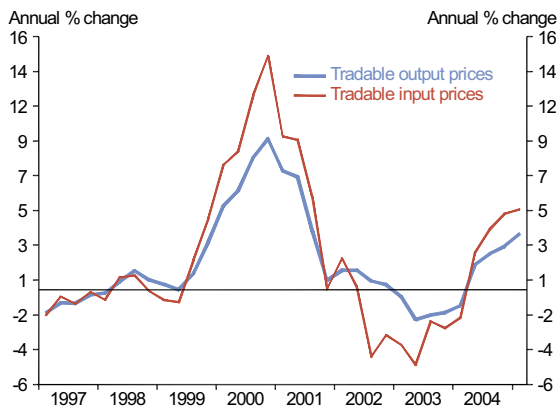
On top of rising input costs, the corporate sector is also facing rising labour costs (figure 6). In addition, the cost of

Figure 3
Producer price index



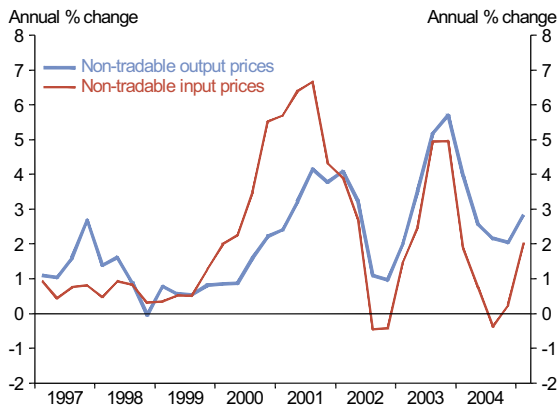
Source: Statistics New Zealand, RBNZ calculation.

Figure 4
Tradable producer price index



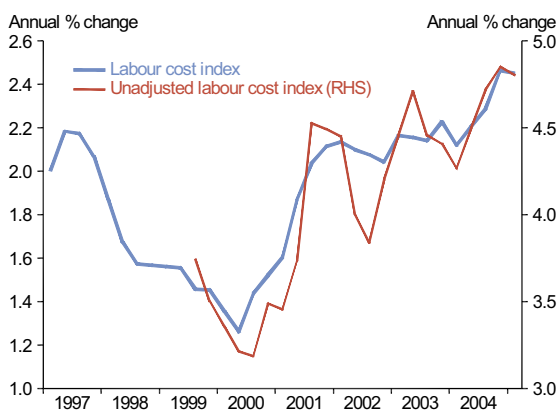
Source: Statistics New Zealand, RBNZ calculation.

Figure 5
Non-tradable producer price index



Source: Statistics New Zealand, RBNZ calculation.

Figure 6
Private sector labour cost index



Source: Statistics New Zealand

some capital goods associated with construction has been rising rapidly. Offsetting this somewhat is the declining cost of capital equipment due to the rising New Zealand dollar. For example, the cost of plant, machinery and equipment has fallen for the previous 13 consecutive quarters, and the price level is 7.7 per cent lower than in the December 2001 quarter.

The corporate sector has enjoyed strong profit growth and margin expansion over the past few years. But the rising costs of production, labour and some capital items, in conjunction with limited pricing power especially for businesses in the tradables sector, should see lower profit growth and margin contraction over the course of 2005. This is consistent with current surveys of profit expectations. The degree of the slowdown in profit growth will depend on the ability of firms to take costs out of their business, and how much they can contain their wage bill.

4 Leverage and balance sheets

Comprehensive data on corporate debt are difficult to obtain. The Reserve Bank collects data on lending to businesses by banks and non-bank financial institutions. This domestically sourced debt funding includes a small amount of debt issued by non-financial corporates on New Zealand financial markets. Data on other sources of funding by businesses, such as corporate bonds and direct offshore loans, are more difficult to obtain. A very rough estimate of corporate lending sourced directly from overseas can be obtained from the International Investment Position (IIP) statistics. The IIP disaggregates overseas borrowing into banks, public sector and other sectors (table 3). As banks borrow from overseas to on-lend to households and businesses (which are already captured by the Reserve Bank data), the 'other sector' borrowings are assumed to be by the corporate sector. Data on other domestic sources of funding, such as those via managed funds and corporate bond issuance to non-financial institutions, are scarce and have been left out of the analysis.⁸

⁸ Thorp (2002) estimated that some \$8.6 billion of business debt was sourced from managed funds and non-institutions in 2000, which was around 10 per cent of total borrowings from financial institutions and overseas.

Table 3
Foreign borrowing by New Zealand
(NZD millions)

	Jun-03	Sep-03	Dec-03	Mar-04	Jun-04	Sep-04	Dec-04
Banks	70,627	72,004	76,150	80,990	76,957	86,734	85,528
General government	19,002	17,578	18,682	18,240	16,007	18,503	19,685
Monetary authorities	4	10	2	6	1	2	3
Other sectors	47,117	44,707	42,347	43,669	46,440	46,626	47,088
Total	136,751	134,300	137,181	142,903	139,406	151,867	152,305
Other sectors adjusted for direct investment relationship	17,061	15,359	14,562	15,388	16,594	16,836	16,297

Source: Statistics New Zealand.

There are two complications in using the overseas debt data from the IIP, which should be borne in mind when analysing the corporate debt position. The first is that the figure is influenced by the exchange rate. Around half of the value of overseas debt is denominated in New Zealand dollars, with a further one-third in United States dollars and the remainder mainly in currencies included in the Trade Weighted Index (TWI). Hence, changes in the value of overseas debt due to exchange rate fluctuations could misrepresent the true level of borrowing. This is especially the case for companies that hedge their foreign currency borrowing. In 2004, some 88 per cent of total foreign currency denominated overseas debt is hedged.

The other complication relates to borrowings, either directly or indirectly, from a non-resident related entity. Borrowing by a firm from their overseas parent company is an example of a direct borrowing; while indirect borrowing can involve the issue of debt to a holding company in New Zealand, which then takes an equity position in a firm. In the latter case, debt issued to a holding company is recorded as overseas debt, when in fact the economic substance of the flow to the actual investment is equity. In some instances, debt due to direct borrowing from related entities may really function as equity, much like debt issued to holding companies.⁹ When adjustments for direct investment relationships are made, the overseas sourced debt levels are around 35 per cent of what was originally reported (table 3).¹⁰

Figure 7 shows the growth in corporate debt sourced domestically, and the estimate of debt sourced directly from overseas. Growth in corporate domestically sourced debt was stable at around 7½ per cent per annum over the 1998 to 2001 period, and started to slow over 2002 and 2003 before accelerating sharply over 2004. In contrast, growth in overseas sourced debt has been quite volatile, peaking in 1998 and trending downwards since then with a sharp decline over 2002 and 2003. Exchange rate fluctuations are likely to have contributed to this volatility.

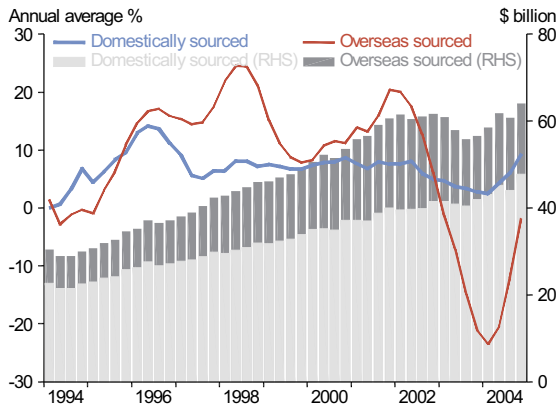
Figure 8 shows two common debt ratios – debt to profit and debt to net capital stock,¹¹ which can be viewed as a rough proxy for the debt to asset ratio. The debt to profit ratio rose from 1994 and peaked in 1998, due to slowing corporate profit growth and rapid growth in overseas sourced borrowing. Since then, the debt to profit ratio has trended downwards as profit growth recovered from the 1997/98 recession and overseas sourced borrowing slowed rapidly. The debt to net capital stock ratio rose from 1994 to peak in 2001, and has trended downwards since then. The decline in the two debt ratios suggests that the corporate sector has improved its aggregate balance sheet position over the past few years, although there are likely to have been significant sectoral variations around this general trend.

⁹ See Hull (2002) for more information on debt to related entities.

¹⁰ The adjustments were only available from the June 2000 quarter. Data prior to that was estimated assuming a constant ratio of direct investment relationship.

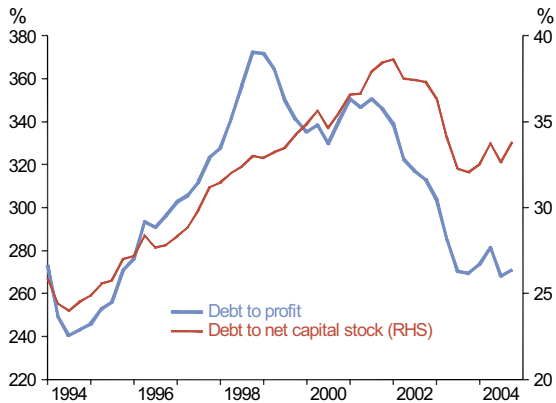
¹¹ The net capital stock data is Statistics New Zealand's measure of fixed assets (excluding land) at replacement cost. Agriculture, owner-occupied dwellings and the government sector are excluded.

Figure 7
Growth in corporate debt



Source: Statistics New Zealand, RBNZ.

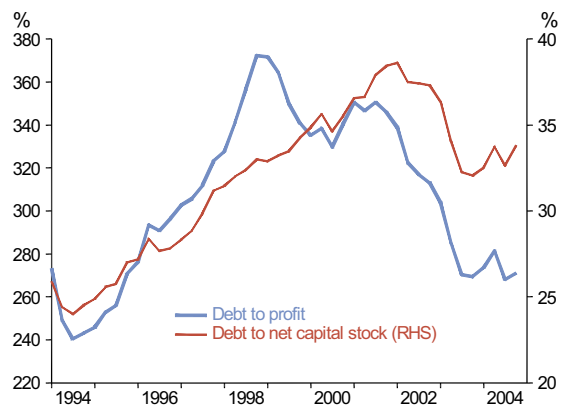
Figure 8
Corporate debt ratios



Source: Statistics New Zealand, RBNZ calculation.

Figure 9 shows the growth in total corporate debt and business investment. The sharp rise in business investment growth in 2004 was not matched by a similar rise in total corporate debt. Even the growth in corporate debt sourced domestically was at a slower rate than the growth in business investment. This could be an indication that the corporate sector is funding new investment either from retained earnings or through raising new equity. In contrast, during the mid to late 1990s, the growth in total corporate debt remained high despite investment growth being very weak. This suggests that during that period, the corporate sector was leveraging its balance sheet to either make payments to shareholders, fund working capital, or to fund shortfalls in operating revenues.

Figure 9
Growth in total corporate debt and nominal business investment

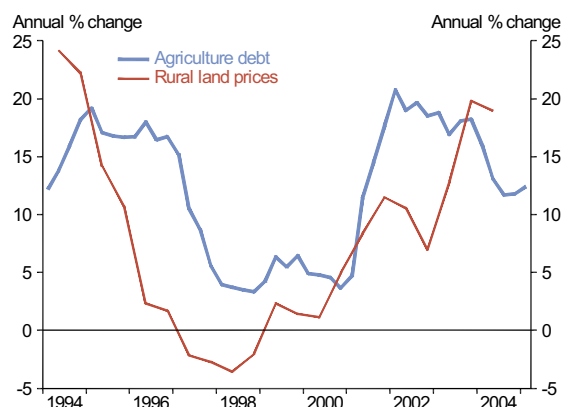


Source: Statistics New Zealand, RBNZ.

5 The agricultural sector

The agriculture sector has been benefiting from record high world commodity prices, offset to some extent by a high New Zealand dollar. Lending to the agriculture sector has been much stronger over the past few years compared to the corporate sector, although growth has slowed over the past year. Credit growth to the agriculture sector is likely to have been driven by high rural land prices, which have risen strongly since bottoming out in 1998 (figure 10). As a consequence, the debt to farm income ratio in the agriculture sector has been rising sharply over recent years. This is in contrast to the corporate sector which has been reducing its debt ratio since 1998 (figure 11). The agriculture sector's

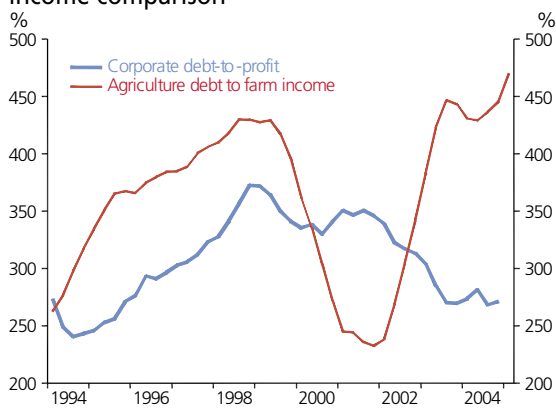
Figure 10
Agriculture debt and rural land price growth



Source: Quotable Value Limited, RBNZ.

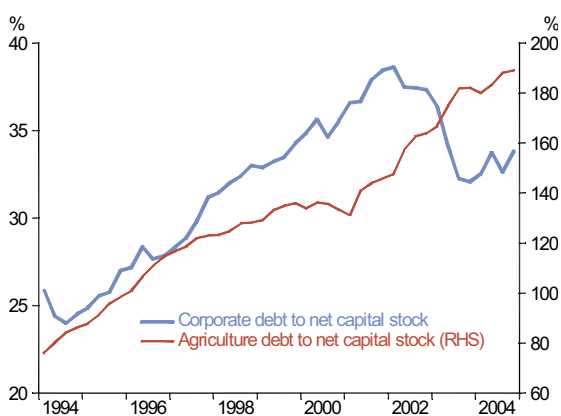
debt to net capital stock ratio has also risen to record high levels, but the majority of the agriculture sector's assets are in land, which is not included in the measure of net capital stock (figure 12). With rural land prices rising strongly, the true debt-to-asset ratio for the agriculture sector is likely to be much lower.

Figure 11
Corporate and agriculture sector debt to income comparison



Source: Statistics New Zealand, RBNZ.

Figure 12
Corporate and agriculture sector debt to net capital stock comparison



Source: Statistics New Zealand, RBNZ.

6 Conclusion

The corporate sector has enjoyed strong profit growth and increased margins over the past few years on the back of strong economic growth. While the absolute level of debt has also been rising in the past few years, the debt to profit and debt to asset ratios have improved. The corporate sector seems to be funding the recent strong investment growth

of the past year out of retained earnings or equity raisings, rather than via debt. This has allowed the corporate sector to strengthen its balance sheet while investing for future growth at the same time. Overall, the corporate sector appears sound and there are no immediate signs of stress across most sectors.

There are signs that profit margins started to come under some pressure towards the end of last year. Surveys of profit expectations of firms point to a slowdown in profit growth for this year. Rising input and labour costs, and higher cost for some capital items will likely be key drivers of the lower profitability ahead. At this stage, it appears that firms in the non-tradables sector are better able to pass on increased costs onto customers. Firms in the tradable sector have more limited pricing power. The degree of the slowdown in profit growth will depend on the ability of firms to take costs out of their business, and how much they can contain their wage bill. However, most parts of the corporate sector are in a good position to weather any profit slowdown, and its strong balance sheet position should allow the sector as a whole to absorb any temporary shocks.

Credit growth in the agriculture sector has been stronger compared to the corporate sector, and the debt to farm income ratio has risen strongly since 2002. Although strong growth in rural land prices would have improved the sector's debt-to-asset ratio, the agriculture sector appears to be more vulnerable to shocks compared to the corporate sector.

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Box 1

Data on the New Zealand corporate sector

The majority of the data used for this article comes from Statistics New Zealand. Data on the number of corporate enterprises comes from the Business Demography Statistics collected by Statistics New Zealand. The business demography statistics provide an annual snapshot, as at February, of the structure and characteristics of New Zealand businesses. Statistics are available on a range of variables, including industry, region, institutional sector, business type, degree of overseas ownership, and employment levels. This data is available from the Statistics New Zealand website (www.stats.govt.nz). The net capital stock series by industry is also available from the website. The annual capital stock series was interpolated into a quarterly series.

The corporate profit data was estimated using customised data from Statistics New Zealand. A net operating surplus figure excluding agriculture and owner-occupied dwellings was provided by Statistics New Zealand based on the

Annual National Accounts. Income from sole proprietor was deducted by using the non-farm entrepreneurial income series from the Household Income and Outlay Account, to arrive at a corporate profit estimate. The annual data was then interpolated into a quarterly series.

The Regional Economic Indicator (REI) and Quarterly Employment Survey (QES) data used to calculate profit margins can be obtained from Statistics New Zealand. The REI is an experimental series derived by integrating Goods and Services Tax data from the Inland Revenue Department with the Statistics New Zealand Business Frame.

Historical company tax data (defined as gross company tax less refunds) is available from the Treasury website (www.treasury.govt.nz). Domestically sourced corporate debt data is available from the Reserve Bank of New Zealand's website (www.rbnz.govt.nz). Overseas sourced corporate debt data was provided by Statistics New Zealand based on their Quarterly International Investment Survey (QIIS) questionnaire.