Following the slump in aggregate euro area corporate sector profitability in 2001 and 2002, there was a significant turnaround (see also Chart 2.2). At the same time, the accumulation of debt slowed down as companies sought to restructure their balance sheets. Since aggregate figures may hide differences at the sectoral level, and because banks may have different exposures to different corporate sectors, it is of interest to analyse measures of corporate
financial performance at a sectoral level. This Box examines recent developments in profit and leverage indicators for the non-financial corporate sectors in the euro area based on firm-level data.1

Beginning in 2003 and continuing into 2004, there was a substantial recovery of net income-to-sales ratios across almost all corporate sectors (see Chart B5.1).2 Profitability based on this measure performed strongest in more export-oriented sectors, especially the manufacturing sector, in an environment of strong global demand. In addition, the profitability of the transportation and communications sectors also picked up significantly, the latter possibly reflecting the efforts made in the telecommunications industry to cut back on operating costs. By contrast, the improvement in profitability of more domestically oriented sectors, such as retail trade (and in part wholesale trade), was more muted. Although this probably reflected to some extent the sluggishness of domestic demand during this period, profitability in these sectors has also tended to be less cyclical.

Turning to financial leverage, a pattern common to all sectors was a significant build-up of debt in the late 1990s and 2000, indicated by rising debt-to-total assets ratios (see Chart B5.2). The accumulation of debt was particularly strong in the transportation and communications sectors, and above average in the retail and wholesale trade sectors.3 Debt ratios for the manufacturing and construction sectors, on the other hand, stood at more moderate levels. Later on, there was an overall stabilisation of debt-to-total assets ratios, as firms started restructuring and

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2 Net income is a narrow corporate profit indicator and is defined as the operating and financial profit after interest expenses, taxation and extraordinary items.
3 The transportation, communications, electric, gas and sanitary services sector includes air transport; railroads; transportation services; water transportation; motor freight services; and electric, gas and sanitary services.
deleveraging their balance sheets, and in 2004 there was even a broad-based reduction. The deleveraging efforts were particularly notable in the communications sector. In addition, manufacturing firms, supported by the strength of cash flows, also appeared to take the opportunity to reduce their debts. In the retail sector, the debt-to-asset ratio stabilised at a high level in 2004, probably reflecting the relatively weak earnings performance of this sector. Likewise, the debt ratio of the wholesale sector (both with respect to the durable and non-durable goods sub-sectors) remained at a relatively high level at the end of 2004.

All in all, patterns in sectoral profit and leverage indicators show that the profitability and indebtedness of export-oriented manufacturing companies has improved substantially in recent years. In addition, the balance sheet conditions of the communications sector also improved strongly in 2003 and 2004, owing to rising profits and significant debt-reducing efforts. By contrast, profit developments in the retail trade sector, and to some extent also in the wholesale trade sector, were more muted, partly reflecting weak private consumption growth in the euro area. As a result, the debt ratios of these sectors remained high. This means that the balance sheet conditions of some companies, particularly in the retail sector, could prove to be vulnerable to continued weakness in domestic demand, and any unexpected deterioration could impair the ability of these companies to honour their debt obligations. To the extent that euro area banks tend to have large exposures to the retail sector, including to many SMEs and to other consumer-oriented companies, such a scenario might pose risks for the soundness of the banking sector.4

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4 For a further analysis of the sectoral credit risk exposures of euro area banks, see Box 7.