Box 7

DEVELOPMENTS IN LISTED NON-FINANCIAL CORPORATIONS’ INTERNAL FUNDS

Developments in listed euro area firms’ earnings growth show a relatively robust picture. However, the analysis presented in previous issues of the Monthly Bulletin suggests that some moderate declines can be expected over the forthcoming quarters, as evidenced by recent negative revisions to corporate earnings expectations.¹ A generally less favourable global macroeconomic environment will probably weigh on firms’ internal funding in the second half of 2008, although the recent drop in oil prices and the depreciation of the euro exchange rate is likely to support short-term profitability. This box looks at the signals stemming from developments in the cash flow of listed companies, which appears solid enough to withstand a situation of prolonged turbulence associated with higher costs of external finance.

In an environment in which firms recorded relatively high levels of indebtedness (Chart A), a reduction in internal funds makes them more vulnerable to unexpected and adverse shocks. In

¹ See the box entitled “Recent developments in the earnings of euro area firms” in the June 2008 issue of the Monthly Bulletin.
this respect, cash flow statements included in annual reports provide useful information on the changes affecting cash accounts during an accounting period. Generally speaking, the cash flow can be regarded as an indicator of a company’s financial health: more cash available for business operations means a greater cushion against unforeseen events. Conversely, it may indeed be the case that firms with robust income growth nevertheless have little cash at their disposal to meet their current obligations. This issue is very important in the current environment, as low cash availability on the part of euro area corporations may signal that they are particularly vulnerable to further shocks.

On the basis of annual data available for a balanced sample of listed companies, Chart B plots the overall cash flows for euro area non-financial corporations and also the decomposition into the categories “investment”, “financing activities” and “operating activities”. Three notable features can be inferred from this chart. First, euro area firms’ overall cash flows remained broadly unchanged in the period from 2003 to 2007. Second, both the inflow generated from core business operations and the outflow for investments have gradually increased in recent years, most strongly in 2007. However, the former has increased less than the latter, pointing to increased recourse to external sources of funding to finance increased investment in the recent period. Taking a smaller sample of firms – for which it is possible to decompose the investment payments into net investments in fixed and financial assets – it appears that financial investments have contributed significantly to the overall increase in investments in 2006 and 2007. This largely reflects the strong M&A activity that took place over that period. However, it should be

2 The bulk of cash flow from operating activities consists of cash received from customers, cash paid to suppliers and employees, and interest and taxes paid. Changes in equipment, assets or investments relate to cash from investing. Normally cash changes from investing are a “cash out” item, since cash is used to buy new equipment, buildings or short-term assets such as marketable securities. Changes in debt, loans or dividends are accounted for in cash from financing. Changes in cash from financing are “cash in” when capital is raised, and “cash out” when dividends are paid.
noted that more recent indications point to a moderation in M&A activity, and of financial investment in general, in 2008, which is likely to influence firms’ overall outflows of cash in investments. Third, the turmoil that began in the summer months of 2007 seems to have had little impact on firms’ net cash flow in 2007.

Looking at more recent data, Charts C shows the decomposition of earnings for a balanced sample of listed companies. It reveals that aggregated net income stabilised at high levels in the first quarter of 2008. This stabilisation was mainly attributable to higher costs relative to the increase in sales. Thus, no weakening of the balance sheet position of listed firms is likely to have occurred at the beginning of 2008.

Chart C Sales, costs and net income for large listed non-financial firms in the euro area

(four-quarter moving average, EUR billions)

<table>
<thead>
<tr>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
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<tr>
<td>300</td>
<td>340</td>
<td>380</td>
<td>420</td>
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Sources: Thomson Financial Datastream and ECB calculations. Note: Data cover around 60% of the non-financial corporations included in the broad-based Dow Jones EURO STOXX index.