S&P Global
Ratings

Global Corporates

Supply Chain Strains and Rising Costs Will Pressure Profitability in 2022

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This report does not constitute a ratings action

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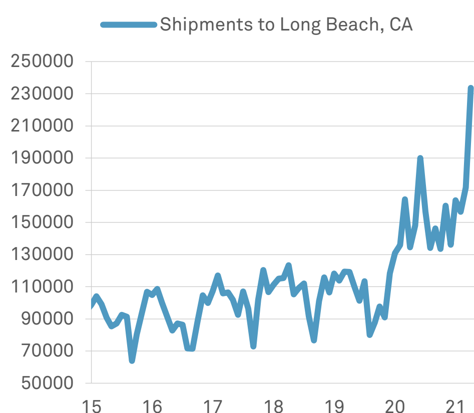
Key Takeaways

- Global nonfinancial corporates appear to be taking supply chain disruptions and soaring cost inflation in their stride. Our analysis suggests that in 54 out of 78 global sectors, most companies are finding it very easy or somewhat easy to pass on costs. Based on the last 12 months' results, EBITDA margins look set to hit a new high in 2021.
- Cost increases have been absorbed or negated in a variety of ways – demand offsets, demand shifts, product mix adjustments, hedging, indexation, positive operational gearing, cost pass-throughs, and keeping pay growth low.
- In our view, profit margin pressure will start to ratchet up in 2022. Our analysts expect supply disruption will persist until the end of 2022 for more than half of all sectors. Pay barely above 2019 levels is unlikely to be sustainable amid strong growth and rising costs, and signs of upward pay pressure are particularly apparent in North America.

While the global hard-stop triggered by COVID-19 and its associated restrictions proved a difficult operating environment for the corporate sector, the global restart has not been without its challenges. Clearly the direction of travel has been positive, with vaccines easing health risks and a barrage of fiscal and monetary policy helping companies avoid drastic labor cuts, providing supportive financing conditions and boosting revenues. Nonetheless, the sheer scale of pandemic-related disruption and altered consumption patterns, along with existing political pressures on supply chains, have created considerable difficulties. Input and freight costs have risen dramatically, shipping volumes have surged and created bottlenecks (see chart 1), and lead times for manufactured goods have worsened (see chart 2).

Chart 1

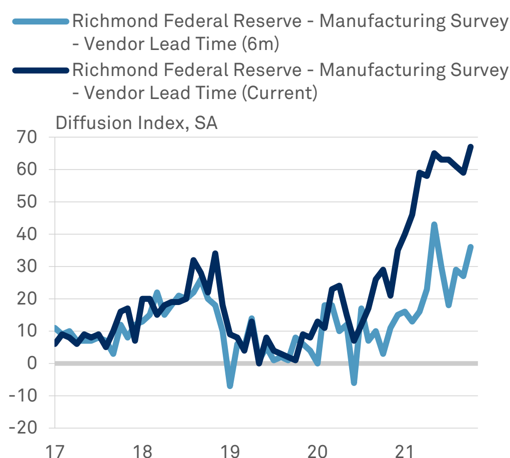
Surging Shipments...



Source: Panjiva

Chart 2

...And Growing Lead Times



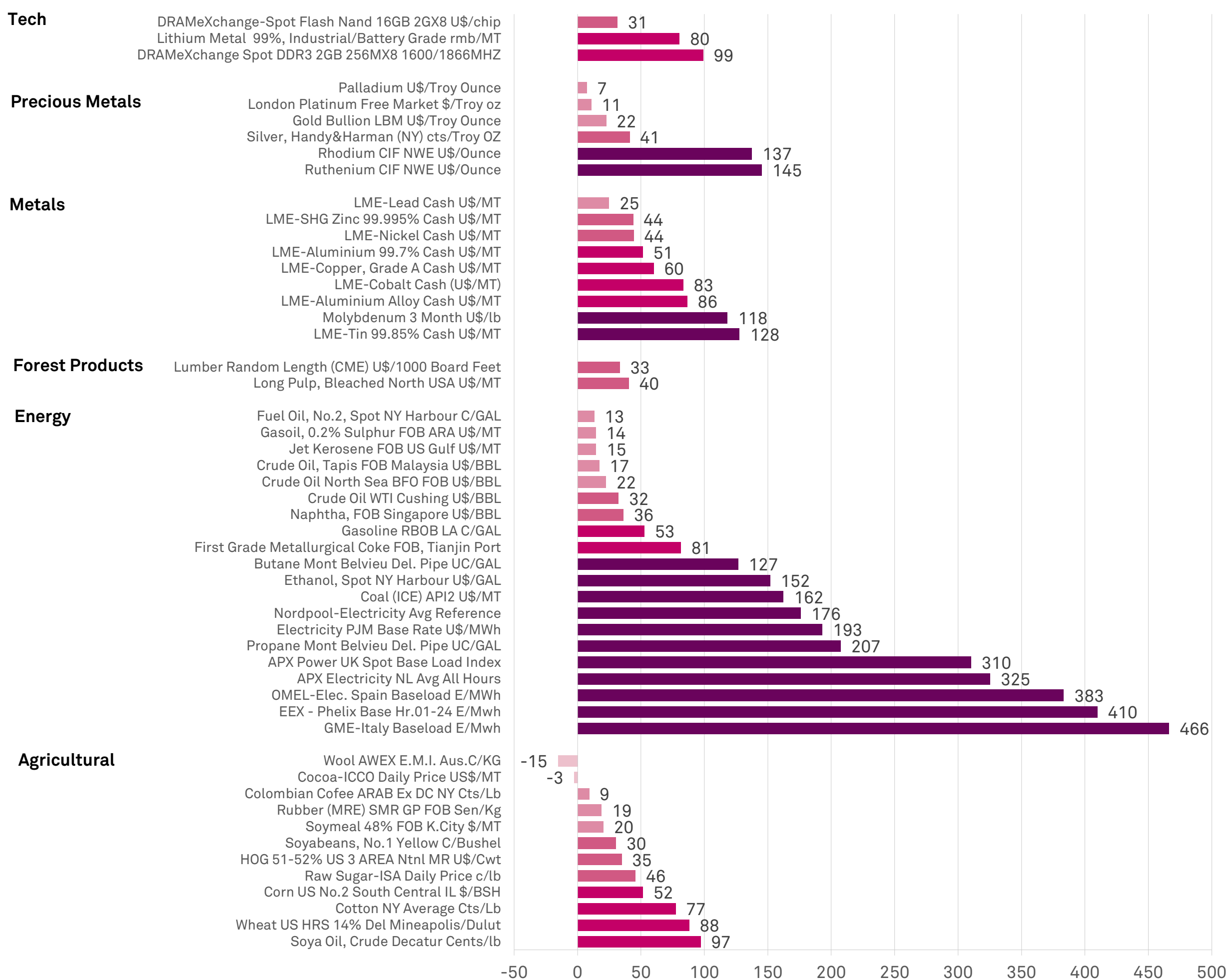
Source: Refinitiv, Richmond Federal Reserve

Input Costs Have Soared Above Pre-Pandemic Levels

The magnitude of input cost inflation in the past couple of years is extraordinary and has taken the prices of a swathe of key production inputs far beyond their pre-pandemic levels. Chart 3 shows the percentage changes in prices for a global basket of input costs, encompassing agricultural goods, energy, forest products, metals and precious metals, and key technology items. Of the 52 items shown, prices for only two fell (wool and cocoa), and for another two (palladium – used in catalytic converters – and coffee) rose less than 10%. The average increase versus pre-pandemic levels has been 95% and the median 52%. Even if rates of increase slow, these are substantial level changes in input costs. Equally large rises in the freight costs of moving these items also add to the greater input-cost burden.

Chart 3

A Tidal Wave Of Cost Inflation – Percentage Changes In Key Input Costs From End-December 2019 To Now



Source: Refinitiv, S&P Global Ratings.
Chart shows the percentage change in prices for each factor shown between Dec. 31, 2019 (pre-pandemic) and Nov. 14, 2021.

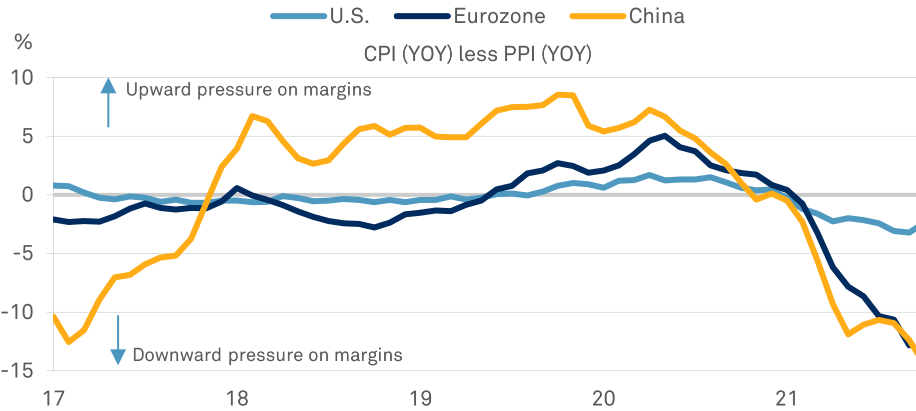
Implicit Pressure On Profit Margins Has Not Materialized

Implicitly, surging input costs that are not matched in selling costs ought to be bringing substantial margin pressure. Chart 4 shows annual consumer price inflation rates less producer price inflation

rates for the U.S., eurozone, and China, a proxy measure for profit margin trends. It suggests strong downward margin pressure across all three countries and regions.

Chart 4

CPI Inflation Rates Less PPI Inflation Rates Imply Significant Pressure On Profit Margins

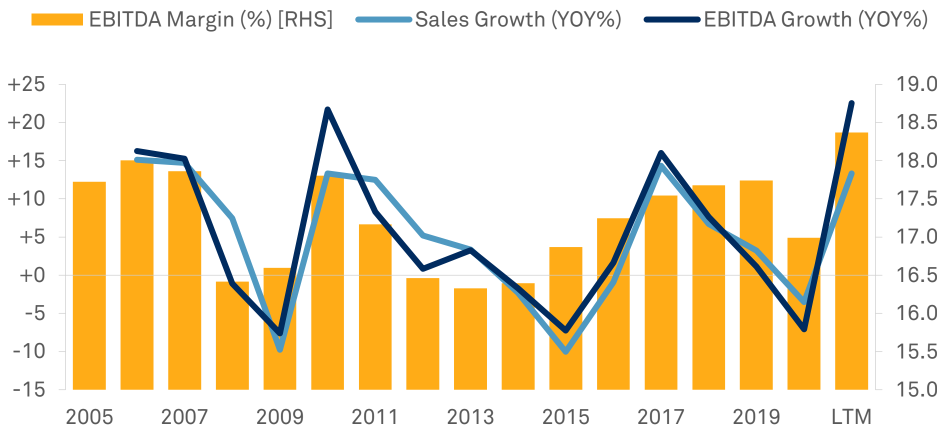


Source: Refinitiv, S&P Global Ratings

For now, that pressure has not materialized. Chart 5 shows aggregate sales growth, EBITDA growth and EBITDA margins for the 4,900 nonfinancial corporates rated by S&P Global Ratings. The most recent datapoint is calculated from last 12 months (LTM) data, which incorporates half-year and third-quarter data where available to give an effective run rate of growth and profit trends. It shows global sales surging 13% versus 2020, and EBITDA growth outpacing this with a 23% increase. This has brought current LTM profit margins to a record high of 18.4% for the 2005-present period.

Chart 5

S&P Global Ratings-Rated Nonfinancial Corporates
EBITDA growth has outpaced rapid sales growth, pushing LTM margins to a post-2005 high



Source: S&P Capital IQ, S&P Global Ratings. All data expressed in USD converted at historical rates.
LTM--Last 12 months, incorporating midyear and third-quarter results where available.

Strong demand growth is not surprising in the context of a rapid global economic recovery from the low point of the pandemic, but strong profitability is more so given surging cost inflation. To understand these trends, S&P Global Ratings sector analysts provided detailed assessments on

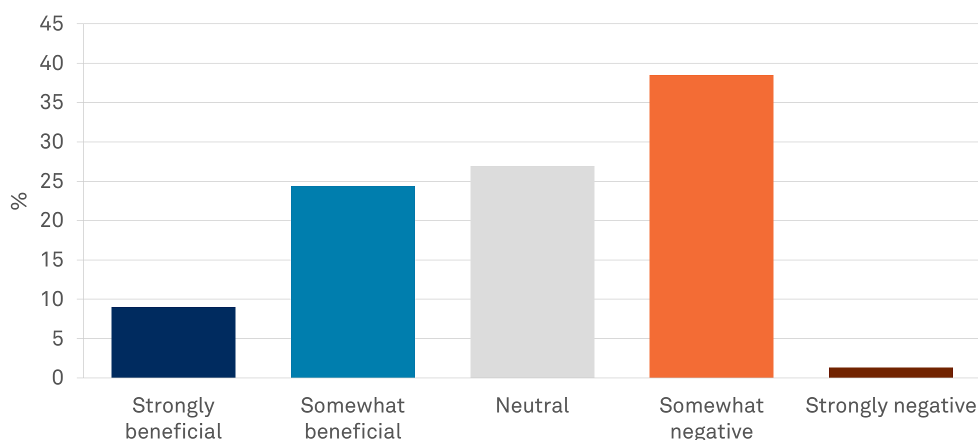
current trends and expectations for their industries, the results of which are aggregated in charts that follow. These provide valuable insights into the profitability paradox:

Global supply-chain disruption and higher prices have created winners as well as losers. Based on an assessment of 78 global sectors (29 in North America, 28 in EMEA, 13 in Asia-Pacific, and eight in Latin America), our analysts assess that current operating conditions are proving difficult for 40% of sectors, and positive for 33%. Those benefitting strongly (9%) considerably outweigh those finding conditions strongly negative (1%). Just over a quarter of sectors have not been particularly affected one way or another.

Chart 6

Supply Chain Disruption And Higher Prices Have Created Winners As Well As Losers

Question: Considering current global operating conditions (surging global demand, supply and labor shortages, higher input costs), what is the average impact on your sector?



Source: S&P Global Ratings' corporate ratings sector analysts were surveyed with between Nov. 1 and Nov. 14, 2021.

Several themes emerged explaining the resilience of margins:

Demand offsets. For some sectors, while costs have surged this has been more than offset by the rapid rise in demand. For *North American homebuilders*, record-low mortgage rates and a pandemic-induced surge in demand have pushed home prices up about 20% since early 2020, which has more than offset higher input costs, particularly for lumber.

Operational gearing. Significant operational gearing has boosted profits for some sectors, particularly those upstream in terms of the broader pass-the-parcel of cost increases. For *metals and mining companies*, record prices and profits for metals producers are adding to several years of financial discipline and yielding windfall profits and cash flows and credit improvement. This is also sparking large shareholder returns, capital spending, and acquisitions, which may pose credit risks down the line, particularly if supply-chain disruptions start to negate the ability to meet demand. *Semiconductors* are another example of very high demand offset by relatively fixed capacity.

Demand shifts. The pandemic has brought about shifts in consumption patterns and behavior, some temporary, others likely to endure. *Technology* companies have benefitted from strong demand reflecting both macroeconomic tailwinds and accelerating digital transformation by enterprises and consumers—with strength in most subsectors, including hardware, enterprise software, and IT services.

Improved product mix. *Auto manufacturers* have coped with shortages of semiconductor chips and batteries partly by using existing capacity to serve the most expensive vehicle segments, which has consequently benefitted revenues and margins. Of course, there are limits to this approach. In the medium term this could translate to the loss of customers that cannot afford more expensive

models. Also, maintaining current production capacity without furlough schemes will be expensive if supply constraints persist.

Demand being brought forward. In *capital goods* segments most severely affected by supply chain shortages, some customers are increasing orders or bringing them forward to ensure they can meet demand. This might mean that orderbooks are overstated and could, in the worst case, result in excess inventory and overcommitment of working capital.

Hedging. Many companies hedge critical costs to limit cost volatility. These are complex and difficult to aggregate, but the protections may begin to wear off into 2022 should existing price increases prove sticky or increase further. This can cut both ways. European power prices have risen substantially, and *power generators* are benefitting but less by than expected because a large proportion of existing contracts are hedged. Hedges usually cover two years, meaning that 2022 is almost entirely covered.

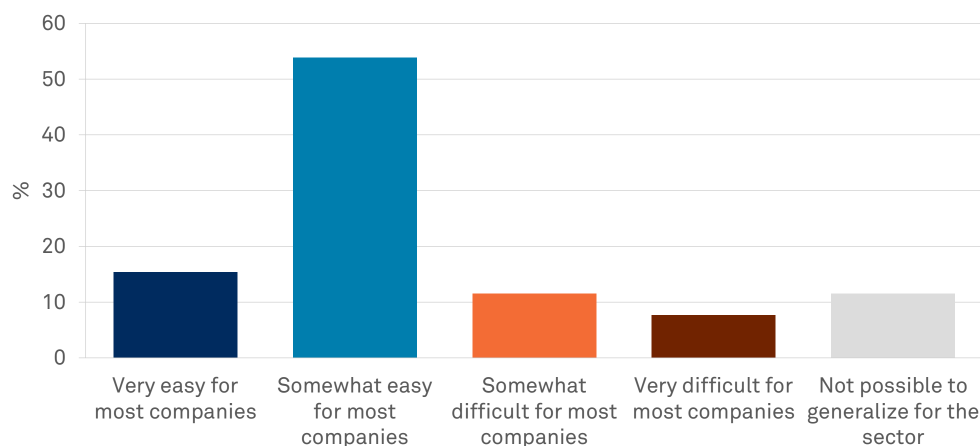
Indexation. Many regulated sectors and assets have prices and returns linked to inflation, mitigating its impact, *utilities and transport infrastructure* being two examples. Similarly, sectors reliant on asset values such as *REITS* have a natural hedge against inflation.

Passing through costs. For now, companies are finding it relatively easy to pass on cost increases to customers. Of the global sectors surveyed, 69% reported that it was easy or somewhat easy for most of the companies to pass cost increases on (see chart 7). Only 8% said it was very difficult. It is doubtful that this benign situation can persist indefinitely, particularly given the magnitude and breadth of cost inflation. At some point end consumers will object, particularly if wages are failing to keep up with costs. For now, a powerful and rapid recovery is oiling the wheels, and shortages are creating scarcity that is supporting demand. This pricing power is reflected in the resilience of gross margins, which have also risen slightly on an LTM basis (see chart 8).

Chart 7

Cost Pressures Are Being Readily Passed On, With Four Out Of Five Sectors Reporting Pass-Through As Being Very Easy Or Somewhat Easy For Most Companies

Question: How easy is it to pass on cost increases?



Source: S&P Global Ratings' corporate ratings sector analysts were surveyed with between Nov. 1 and Nov. 14, 2021.

Some of these pass-throughs reflect variable pricing power usually deployed at the producer's discretion – some *consumer, retail, and household products*, for example. Here the choice is about market position and demand elasticity.

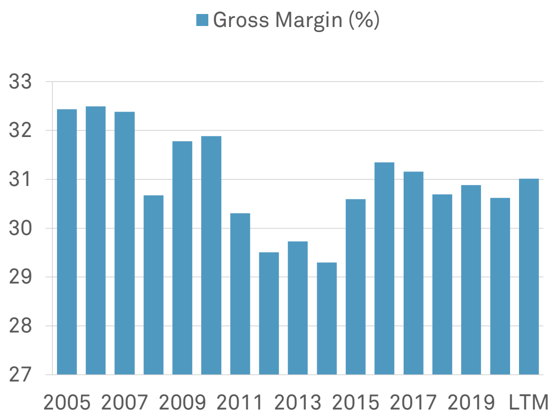
Others are more specifically fixed. The *engineering and construction* sectors often use “cost-plus” agreements, and time and materials contracts have pass-through mechanisms. Even in fixed-price work that doesn’t have these mechanisms, companies can often go back to clients and recoup

additional costs. Similarly, for *freight transportation* most business is under contracts that allow them to pass through (to some extent) higher fuel costs.

Keeping labor cost increases low. Although cost of inflation means that the cost of goods sold has risen sharply—by 13% on an LTM basis for rated nonfinancial corporates—wage growth has lagged far behind, being essentially flat on a comparable basis. Not all companies break out salary and benefit costs in reported accounts, so the data are indicative rather than definitive, but they point to another critical factor that has protected profit margins for now. There are also sharp regional differences. In North America, LTM salaries and benefits are up 6% versus 2020. In Europe, the same figure is minus 3%, partly reflecting the impact of government-supported furloughs and short-working schemes that have helped limit unemployment by partially subsidizing wages.

Chart 8

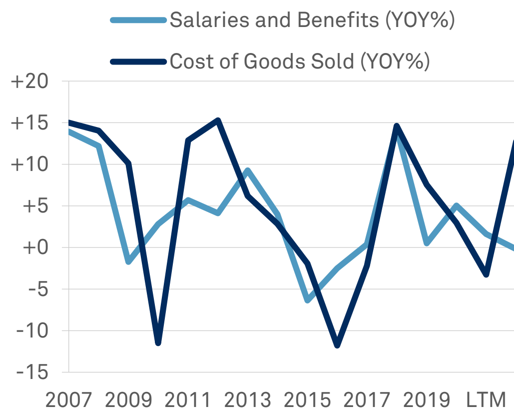
S&P Global Ratings-Rated Nonfinancial Corporates Gross Profit Margins Have Held Up



Source: S&P Capital IQ, S&P Global Ratings. LTM--Last 12 months, incorporating midyear and third-quarter results where available.

Chart 9

S&P Global Ratings-Rated Nonfinancial Corporates Wage Growth Has Not (Yet) Followed Other Costs Higher



Source: S&P Capital IQ, S&P Global Ratings. LTM--Last 12 months, incorporating midyear and third-quarter results where available.

There are regional differences. North American sectors are largely able to pass on cost increases, with 83% of sectors finding it somewhat or very easy. The same isn't true in Asia-Pacific, where 46% are finding it somewhat or very difficult to pass on costs. This reflects a less broad-based recovery than in the U.S. and Europe, subdued consumer sentiment, and overcapacity in some sectors (building materials, construction), which, taken together, constrain the ability to pass through cost increases.

Chart 10

North America

Question: How easy is it to pass on cost increases?

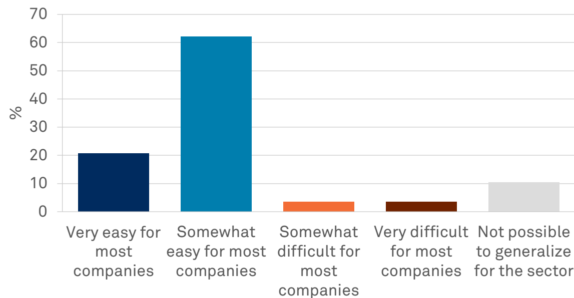
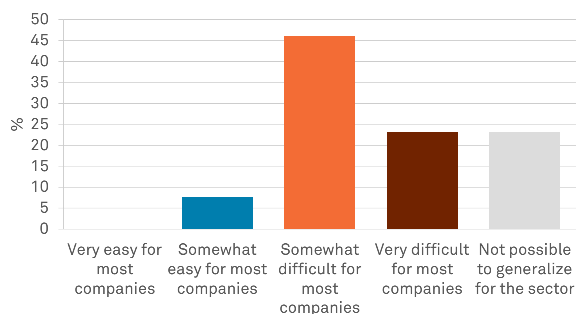


Chart 11

Asia-Pacific

Question: How easy is it to pass on cost increases?



Source: S&P Global Ratings' corporate ratings sector analysts were surveyed with between Nov. 1 and Nov. 14, 2021.

Supply Chain Disruption To Persist Through 2022

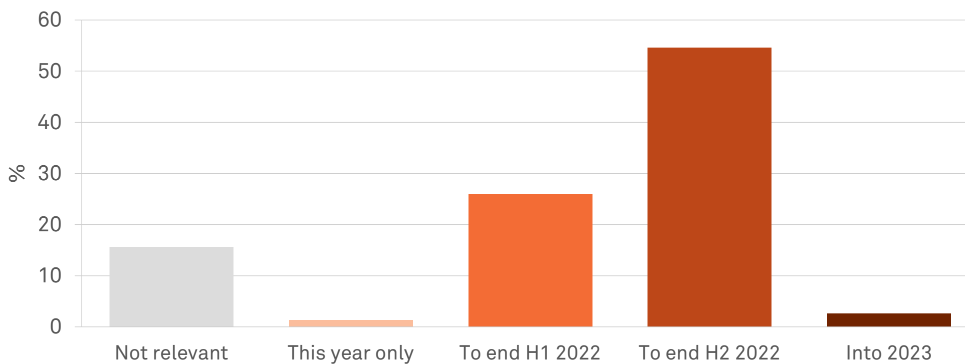
Can this benign scenario last? The pace of sales and EBITDA growth will inevitably slow as the recovery matures and growth momentum ebbs. Significant regional, industry and even intra-industry outlook differences remain given that pandemic conditions still vary widely. There is also the question of stimulus withdrawal and what that may mean for financing conditions. Focusing purely on supply chain and cost issues, **there are two main sources of concern that suggest benign profit margin conditions in most regions won't persist in 2022.**

First, it seems likely that supply chain issues will persist well into 2022. Our analysts suggest that 55% of global sectors will see disruption persist through next year, and a quarter still expect problems in the first half. There are considerable uncertainties around this that could alter the timing, but there seems little prospect of supply problems being confined to this year alone. Given this, some of the ameliorating factors that allowed companies to pass on costs might start to fade.

Chart 12

Nearly Half Of All Sectors Anticipate Supply Chain Disruption Persisting Through To The End Of 2022

Question: If your sector is being affected by or benefitting from supply chain and cost issues, how long do you expect the most important effect to persist?

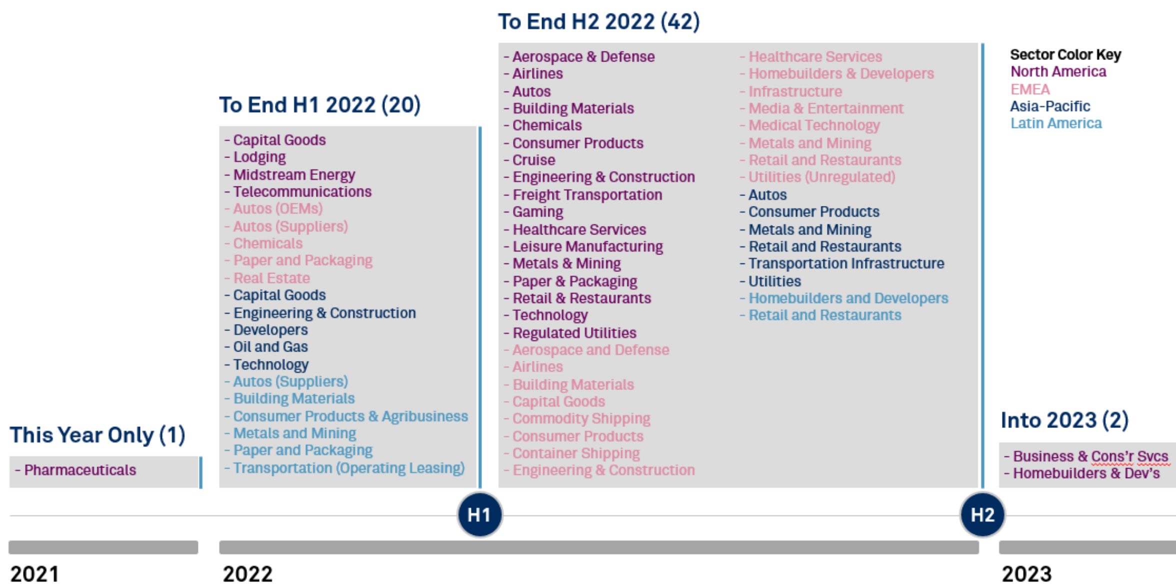


Source: S&P Global Ratings' corporate ratings sector analysts were surveyed with between Nov. 1 and Nov. 14, 2021.

Chart 13

Sector Timeline For Global Supply Chain And Cost Disruption

Question: If your sector is being affected by or benefitting from supply chain and cost issues, how long do you expect the most important effect to persist?



Source: S&P Global Ratings' corporate ratings sector analysts were surveyed and interviewed between Nov. 1 and Nov. 14, 2021. Possible answers to this question were "This year only", "To end H1 2022', "To end H2 2022", "Into 2023", or "Not relevant". "Not relevant" answers are not shown above.

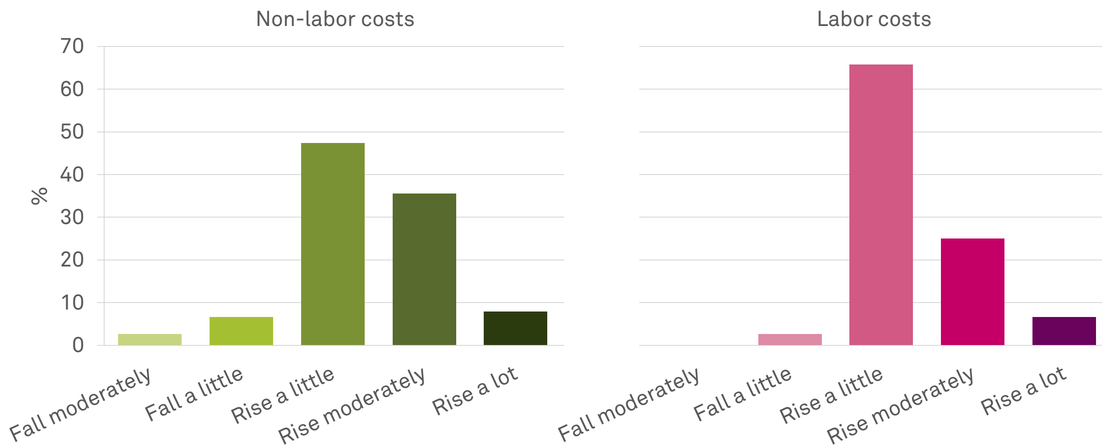
Labor Cost Pressures May Start To Build

Second, we may see wage cost pressures start to build, particularly in North America. For the moment there is greater concern around non-labor costs, for which 36% of sectors anticipate further moderate rises and 8% expect them to rise a lot (see chart 14). This suggests that costs that are now substantially higher than they were pre-pandemic will become locked in, keeping up the pressure on margins. For labor costs, two-thirds of sectors expect them to "rise a little," which—at face value—suggests concerns around wage-inflation spirals is misplaced.

Chart 14

Further Non-Labor Costs Increases Anticipated

Question: What is the likely direction for average sector labor and non-labor costs for 2022 versus 2021?



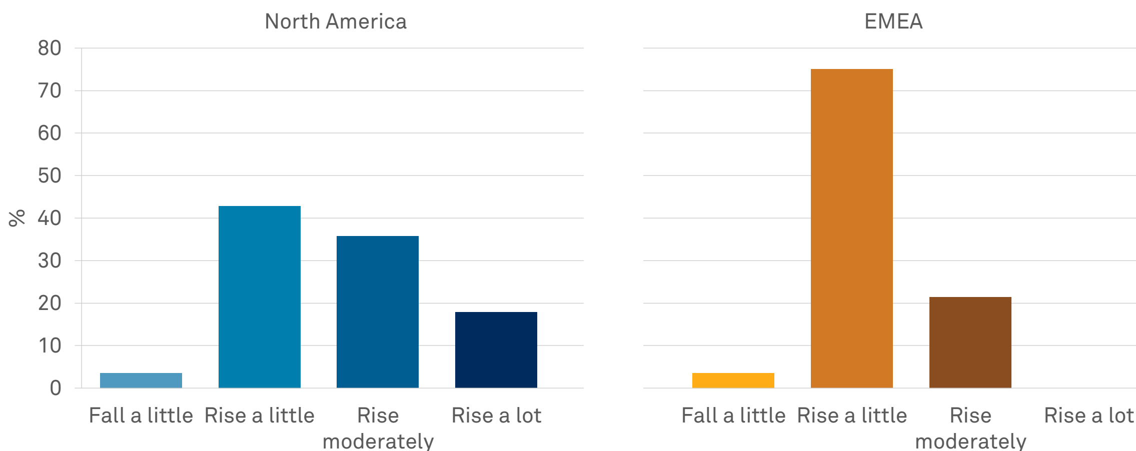
Source: S&P Global Ratings' corporate ratings sector analysts were surveyed with between Nov. 1 and Nov. 14, 2021.

The labor cost outlook is notably different in North America (see chart 15). A third of sectors expect to see them rise moderately and just under a fifth expect them to rise a lot. In contrast, no sectors anticipate labor costs rising a lot in EMEA.

Chart 15

Labor Cost Pressures Appear Significantly Greater In North America Than EMEA

Question: What is the likely direction for average sector labor costs for 2022 versus 2021?

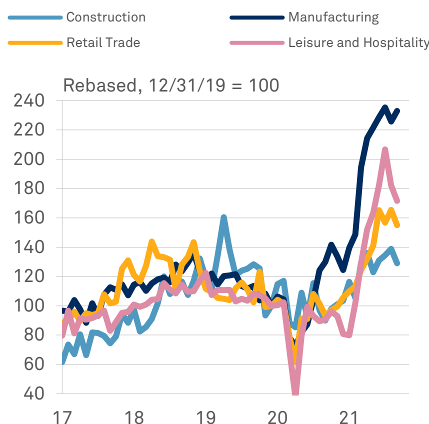


Source: S&P Global Ratings' corporate ratings sector analysts were surveyed with between Nov. 1 and Nov. 14, 2021.

In the U.S., labor shortages have become a significant issue across many sectors of the economy (see chart 16), a problem amplified by the unusual volume of people quitting work (see chart 17), which our analysis suggests is a structural problem rather than a short-term consequence of extended federal unemployment benefits (see "Economic Research: Where Are The Workers? Three Explanations Point To An Answer", Nov. 4, 2021). Pay growth has lagged too. Sales for rated nonfinancial North American corporates are now 11% above calendar year 2019, and EBITDA is 17% above (see chart 18). The cost of goods sold has risen 10% over the same period, but salaries and benefits are up just 1%. Given a strong recovery, labor shortages and withdrawals, it seems difficult to see how corporate salary costs can remain this subdued next year.

Chart 16

U.S. Job Openings Have Surged



Source: Refinitiv, Bureau of Labor Statistics, U.S. Department of Labor, S&P Global Ratings

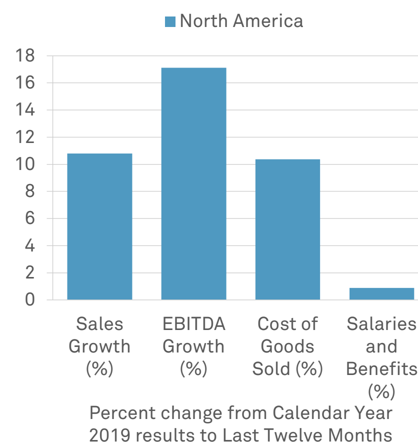
Chart 17

U.S. Workers Quitting At Record Rates

Source: Refinitiv, Bureau of Labor Statistics, U.S. Department of Labor, S&P Global Ratings

Chart 18

Sales And EBITDA Are Well Above Pre-Pandemic Levels, But Salaries Are Not



Source: S&P Capital IQ, S&P Global Ratings. Refers to North American nonfinancial corporates rated by S&P Global Ratings. Figures show percentage difference between last 12 months and calendar year 2019.

For some sectors, delays in delivering products or services because of labor shortages are more worrisome than the rising cost of labor. And while some shortages of workers are directly attributable to the pandemic (and in specific occupations), others were undergoing secular shifts pre-COVID:

- **Aerospace and defense.** The problem isn't costs, which can be passed on, but rather attracting workers—with even skilled, relatively well-paid jobs (e.g., mechanics) suffering shortages.
- **Engineering and construction.** Labor shortages could affect margins if companies can't staff jobs, resulting in delayed completion.
- **Health care services.** The effects are being felt mostly in lower-skill positions such as home health care, couriers, etc. However, there's a shortage of nurses, which could lead to inefficiencies in scheduling /performing procedures, adding costs to the system. Total U.S. health care employment is still down by roughly 500,000 versus pre-pandemic.
- **Truck drivers.** The well-documented dearth of truck drivers has been exacerbated (rather than caused) by the pandemic. Trucking companies have been raising pay but also increasing the rates they charge customers.
- **Engineering and construction workers, homebuilders.** Similarly, these industries were suffering labor shortages before COVID.

Note that these observations aren't unique to North America. In Europe, for example, *utilities* and *engineering and construction* are particularly exposed to the risk of labor shortages. This is because of the large demand for construction related to government schemes to refurbish buildings in many

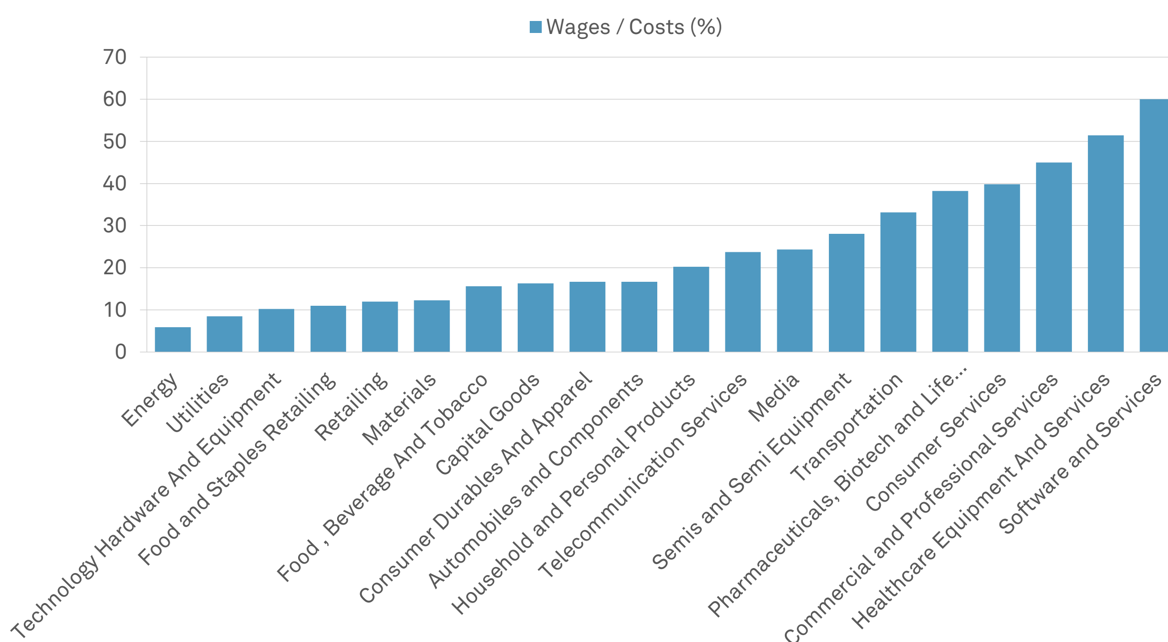
European countries and the need to build new renewable energy capacity to meet energy transition targets.

If labor cost inflation takes hold, sector margin pressures will shift

If labor shortages, labor reluctance, and the impact of rising costs do start to engender a more pronounced upturn in wages, this will start to tilt the balance of margin pressure unfavorably for sectors where pay accounts for a relatively high share of cost structures. Chart 19 shows wages (salaries and benefits) as a percentage of all costs for rated global nonfinancial sectors. Software, health care equipment and services, busines services, consumer services (largely leisure, hotels, and gaming), and pharmaceuticals and biotech are the most exposed.

Chart 19

S&P Global Ratings-Rated Nonfinancial Corporates – Wages As Percentage Of Total Costs By Sector



Source: S&P Capital IQ, S&P Global Ratings. Data show aggregate salaries and other benefits as a percentage of total costs. Not all companies disclose this information, so percentages reflect available values only. Based on full-year 2020 results.

Conclusion

Nonfinancial corporate sectors have weathered supply-chain disruptions and surging non-labor costs relatively well so far. Aggregate financial trends suggest EBITDA growth is outpacing sales growth – while both being rapid – taking EBITDA profit margins to new highs. Cost increases have been absorbed or negated in a variety of ways – demand offsets, demand shifts, product mix adjustments, hedging, indexation, positive operational gearing, cost pass throughs, and keeping pay growth low.

The outlook is quite finely balanced, but we suspect that these buffers will start to wear thin in 2022. Supply chain disruption looks set to persist for many sectors through the year, alongside labor shortages, and most key input costs remain substantially above pre-pandemic levels. There seems little sign of wage inflation outside of the U.S., but global salary growth of zero over the past 12 months for our rated nonfinancial corporates in total doesn't feel sustainable in the context of rising living costs, labor shortages, and pay lagging recovering profitability. **In our view, profit margin pressure will start to ratchet up notably in 2022**.

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- U.S. Corporate Cost Pressures May Hit Profit Margins In The Near Term, April 27, 2021
- COVID-19 Heat Map: Some Bright Spots In Recovery Amid Signs Of Stability, Feb. 17, 2021

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We would like to thank all the analysts listed below, who contributed their insights to this survey.

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