

Industry Top Trends Update

Capital Goods

As end markets recover, cost inflation risk rises

What's changed?

Faster-than expected demand recovery after COVID disruption. Industrial demand is reviving, driven by economic and end-market recovery. Manufacturing activity in the U.S. remains expansionary at 60.6 in June vs. 52.6 a year ago.

Supply chain headwinds could dampen margin recovery. Cost inflation could be meaningful (particularly for raw materials, labor, and freight), but we think rated issuers can pass on higher costs given the improving demand. Companies are also increasing their supply base and building inventory to manage these headwinds. Rising costs could drag margin recovery, but EBITDA recovery should get closer to 2019 levels in 2021.

Moderating negative rating bias. Rating actions in 2021 have swung between positive and negative. We expect the negative rating bias to ease from 23% in the second half of 2021 as credit metrics improve. We had more upgrades than downgrades in 2021, mostly at the low end of the rating spectrum.

How is recovery taking shape?

Recovery across end markets. As economic recovery accelerates, we expect inventory restocking and higher customer capex. This should lead to revenue growth in the mid- to high-single-digit range in 2021, approaching 2019 levels. The recovery in commercial aerospace and oil & gas end markets could lag, delaying improvement for some issuers.

Profitability growth. We expect overall EBITDA margin to improve after the decline in 2020, driven by higher volumes, benefit of prior cost cuts, and the ability to pass on cost increases. We think the cost increases are temporary until supply chains normalize. Higher working capital and capex could dampen free cash flow to some extent.

Credit metrics should reach 2019 levels by 2022. Credit metrics recovery should support greater rating stability in the rest of 2021 and ease negative ratings bias. Improving cash flow should also alleviate liquidity pressure for issuers in the 'CCC' and 'B' categories.

What are the key risks around the baseline?

Weak recovery in global markets. Many diversified industrials are exposed to global markets. New strains of COVID could result in regional lockdowns that hamper the economic recovery.

Weaker ability to pass on cost increases. Persistent inflation and lingering cost increases into 2022, coupled with weaker demand, could lead to meaningful margin pressure, particularly if supply chain disruption is prolonged.

Shifts in financial policy could add ratings pressure. We expect an increase in M&A or share repurchases given improving outlook and low financing costs. Meaningful debt-financed M&A or share repurchases could drive lower ratings or outlook revisions despite an improving operating environment.

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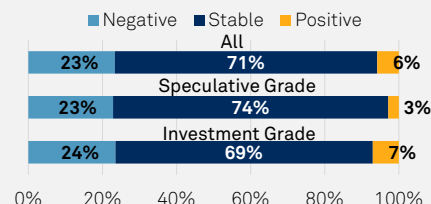
- Capital Goods Sector 2021: Credit Quality Is Stabilizing, March 2, 2021

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Outlook Distribution



Ratings Statistics (YTD)

	IG	SG	All
Ratings	35	86	121
Downgrades	0	4	4
Upgrades	0	11	11

Ratings data as of end-June, 2021

COVID-19 Heat Map

Capital Goods		
Estimated Recovery To 2019		2022
Credit Metrics		
Potential Negative Long-Term Industry Disruption		--
2020 v. 2019		
Revenue Decline	EBITDA Decline	Incremental Borrowings
10% to 15%	15% to 25%	<5%
2021 Estimates v. 2019		
Revenue Decline	EBITDA Decline	
0% to 10%	10% to 20%	