Industry Top Trends Update

Capital Goods

Pricing power and nimbleness hold credit steady...for now

Don Marleau, CFA
Toronto
donald.marleau@spglobal.com
+1 416 507 2526

What's changed?

Higher costs and snarled supply chains test pricing power and manufacturing agility. Most manufacturers passed through record-high costs to boost earnings so far in 2022, with pockets of profit and cash flow disruption owing to materials constraints. Commodity prices dropped sharply in June and early July.

Backlogs climb but the PMI drops. The Purchasing Managers Index remains positive, but it has dropped steadily from record levels about a year ago. Meanwhile, backlogs keep climbing with robust demand and tight output.

Our outlook bias has shifted modestly negative. Our negative outlooks are clustered around highly indebted financial-sponsor-owned issuers, as well as some investment-grade names that face company-specific strategic or financial pressures, rather than overarching economic concerns.

What to look out for?

Slower demand could reverse a cyclical upswing in profits. Even if commodity costs are easing and supply chains are opening up, elevated labor and logistics costs could persist. In this case, selling, general, and administrative costs probably won't drop as quickly as revenues or gross profits.

M&A aims to boost modest growth. Most issuers will continue supplementing corporate development and revenue growth with bolt-on acquisitions, but capital markets conditions could hold back larger acquisitions or even divestitures.

Highly leveraged issuers are relying on stronger EBITDA in the next 18-24 months to support refinancing. Several financial-sponsor-owned issuers added low-coupon debt during the pandemic for acquisitions or dividends. Improved cash flow also relies on some working capital release if input costs ease.

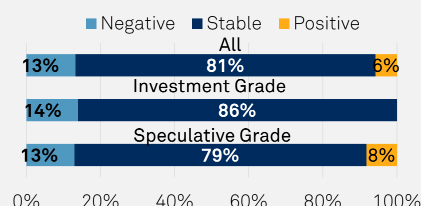
What if there's a recession?

Higher rates could strain demand for capital investment. Capital expenditures quickly resumed their 10-year growth trend in 2021, spurred on by an unprecedented drop in interest rates during the pandemic.

A robust commodity sector might offset a chill in discretionary or capital spending. Multiyear capital investment is usually a late-cycle mover, so a robust pipeline could shrink if industrials defer capital spending in the face of higher interest rates or labor costs and availability for installation and construction.

Credit buffer is generally good, but it's starting to erode. Choppy profits and weaker cash flow are coinciding with elevated debt levels in a few cases. Also, we have very few positive outlooks among speculative-grade issuers, indicating little positive credit momentum industrywide.

Outlook Distribution

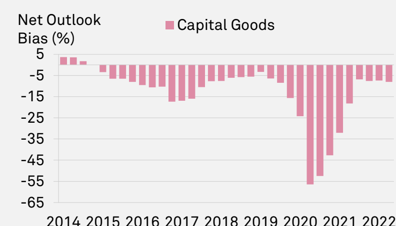


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	36	85	121
Downgrades	0	9	9
Upgrades	0	4	4

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



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