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IM experiencing greater inflation-induced disruption than other industries

2022 KPMG Inflation Survey

Inflation is affecting industrial manufacturing (IM) businesses' volume volatility given the well-documented supply chain disruptions. Many are finding that their customer pricing has not been able to keep pace with escalating input, labor, energy, and transportation/logistics costs.

Many IM companies are seeking to realign price and cost, both prospectively with new and renegotiated contracts, as well as retrospectively with customer concessions. In some cases, IM leaders are finding that official measures of inflation, such as the Consumer Price Index, are also not sufficiently targeted to capture the true economic changes their companies are experiencing.

Despite these challenges, IM companies believe they will be able to maintain profitability, even if the level might be slightly lower than in past years.

A more important survey finding, particularly in the interest of ensuring long-term growth, is that companies expect to increase their technology spending over the next year in an effort to mitigate the impact of inflation and adapt to a new business environment. In particular, we believe IM companies need to accelerate digital transformation and replace outdated technology if they want to keep pace with an increasingly volatile world.

In late May, we surveyed 300 finance executives—chief financial officers (CFOs), heads of Finance, comptrollers, treasurers—across five industries, including 60 IM executives, about their views regarding inflation. Of these, more than half had annual revenue of more than $1 billion.

Other industries represented

- Consumer and Retail
- Banking
- Insurance
- Energy, Natural Resources & Chemicals

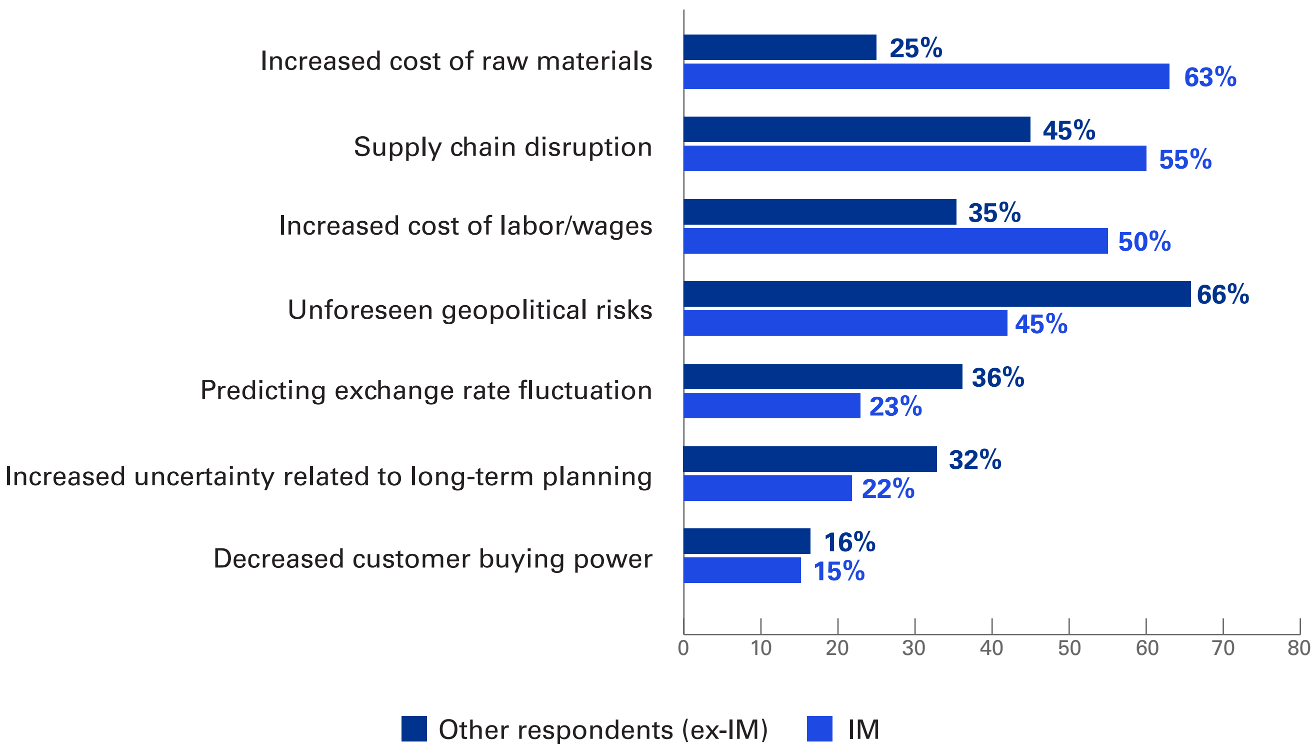
Key findings

Top challenges: supply chain disruption, rising labor and material costs

It is important to point out that across IM value chains, these companies are both customers of and vendors to other manufacturers. Therefore, leaders are often in a position of negotiating both with their customers, to reset pricing going forward, and simultaneously with their vendors to address inflationary cost for their inputs, creating even greater uncertainty and risk.

As IM companies look to manage the impacts of inflation, they are facing significant challenges from the effects of volume volatility given supply chain disruption, increasing labor costs, and rising material prices. IM companies see these challenges as even greater than unforeseen geopolitical risk, which was the top pick among all survey respondents.

Biggest challenges in managing inflation



Respondents were permitted to choose multiple answers.

IM companies plan to pass increased costs on to customers

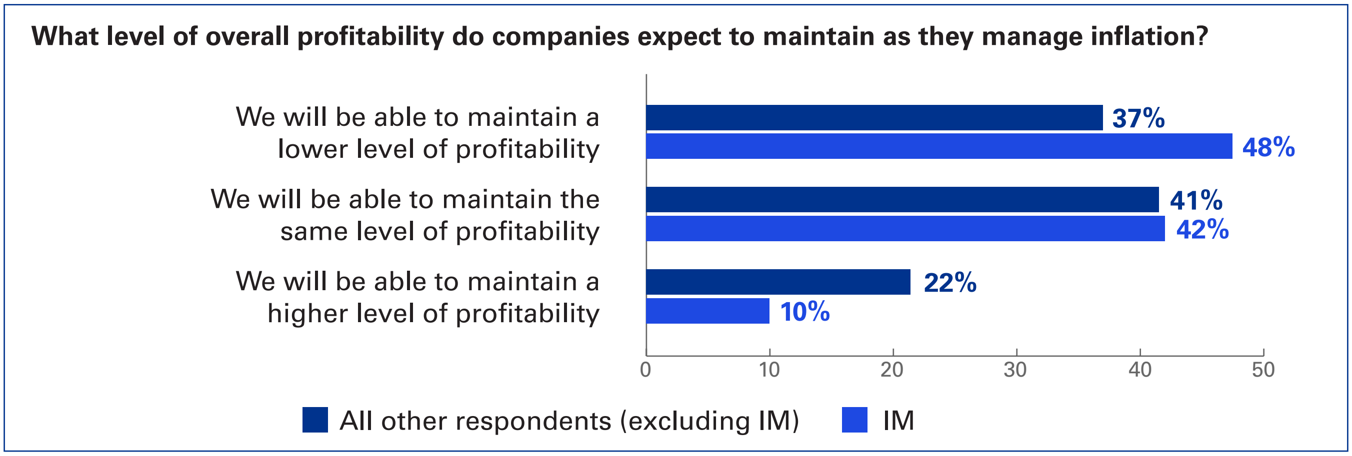
News headlines over the past year have made it clear that inflation is not impacting the industry evenly. Chip shortages, spiking prices of commodities like nickel and lithium, and inconsistent labor availability are affecting manufacturers in different ways. While nearly 80 percent of IM companies expect to pass along their increased costs by at least as much as the rate of inflation, that rate will vary widely from company to company. Understanding the cost mix of each manufacturer will be critical during this period of instability and renegotiation.

What is not reflected in the survey but appears to be a consistent issue with IM firms is that global supply chain disruptions are temporarily increasing costs elsewhere in their organization. For example, a number of companies are air freighting goods that were never intended to be delivered in that manner because of significant raw material shipment delays, as well as overall capital and labor underutilization given sporadic and volatile production schedules. Where there are strong relationships, these temporary cost increases are being shared by customers and suppliers.

How much of inflation-related costs will be passed on to customers?	All other sectors (excluding IM)	IM
Equal to the rate of inflation	52%	52%
More than the rate of inflation	30%	30%
Less than the rate of inflation	10%	13%
Not planning to pass on increased costs due to inflation	8%	5%

IM companies mostly expect to remain profitable

Compared with other industries, considerably more IM companies expect profitability to fall. Even faced with inflation and rising costs, slightly more than 50 percent of the IM companies surveyed expect to maintain the same level of profitability or higher.



Unlike consumer goods and retail companies, or even financial firms, most IM companies typically don't have the agility to rapidly implement new efficiencies or shift to lower-cost products. One reason more than half of IM respondents feel they will see the same or a higher level of profitability as they manage inflation may be that, for some, much of the revenue projected for the next several years is from contracts already on the books.

However, for some IM companies longer-term contracts may actually be a profitability inhibitor. Looking at the automotive industry, for example, not all suppliers to OEM contracts have mechanisms for passing on rising input costs. Many of these firms need to quantify the inflationary impact in order to approach their OEM customers about requesting price increases. Historically, OEMs have held a high standard for granting price increases outside of contracted terms, although more appear to be open to it, with the right level of documentation, to ensure the financial health of their suppliers.

As a further hedge against inflation, companies may look to renegotiate existing longer-term agreements to secure more favorable terms. One strategy is matching expense and revenue timings, including evaluating the possibility of indexing cost inputs upstream with IM customers and downstream with IM suppliers. In other words, striving for longer-term cost agreements and shorter-term pricing agreements, so prices are able to move up faster than costs.

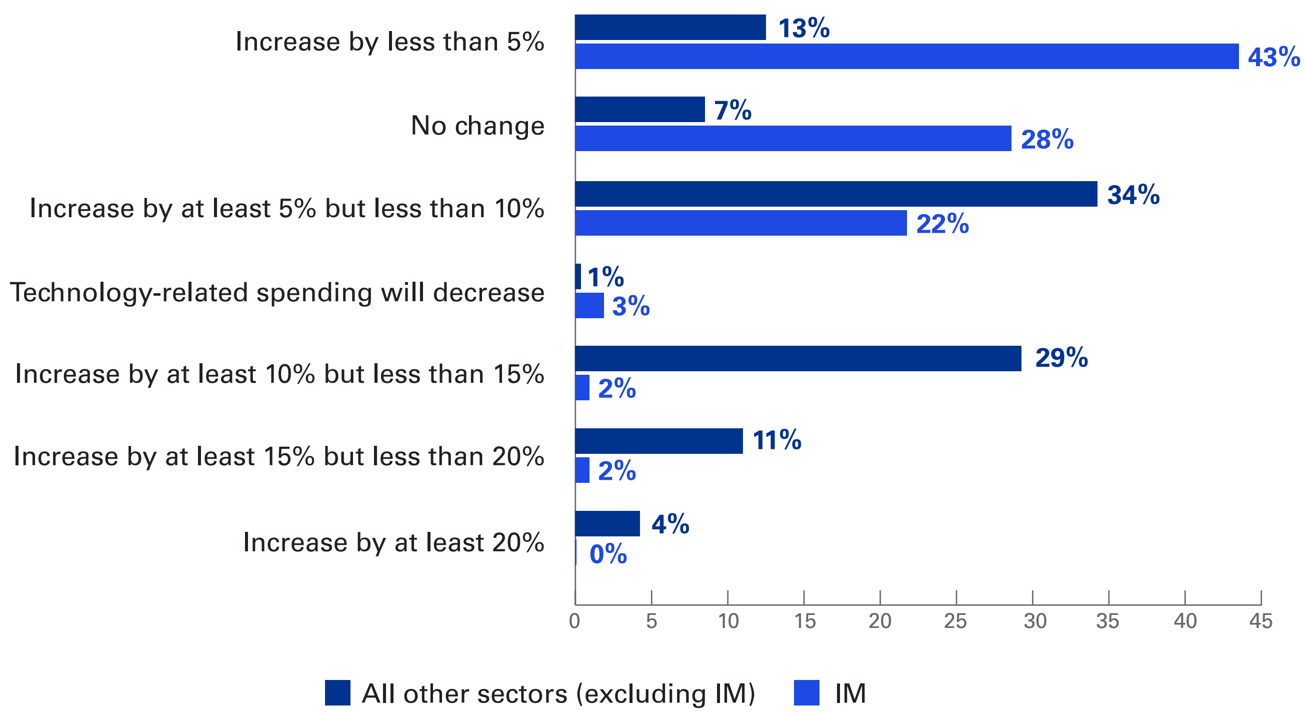
Increasing technology spend to enhance agility

If the past two-and-a-half years have revealed anything, it's that the world has become consistently more volatile. Notwithstanding Black Monday in 1987, the Great Financial Crisis of 2007–2009, and Brexit in 2016, among other less-famous periods of instability, the pandemic caused structural shifts in our economy that will continue to intersect with other factors like climate change and heightened geopolitical risks. This dynamic is likely to create considerable volatility over the next decade. Companies will need to increase their technology spending to enable the flexibility and agility needed to adapt to quickly changing business conditions.

Although many IM companies need to modernize their technology infrastructure, 71 percent expect either no change in tech spending or an increase of less than 5 percent. Nonetheless, they will need to step up their digital transformation agendas in an effort to retrieve and analyze more data to make faster and better decisions.

IM companies remain cautious of inflationary pressures and are increasing their focus on data systems and analytics in efforts to identify input drivers on margin compression faster and at levels that might better support recovery discussions with customers.

How technology spending is expected to change as companies work to mitigate the impact of inflation (this year versus last year)



Amounts do not add up to 100% due to rounding.

KPMG perspective

In this fluid environment, it's more critical than ever for IM companies to reevaluate their customer and vendor contracts. These leaders will need to determine what is transitory (e.g., air freight due to supply chain disruption) and what is structural (e.g., increasing scarcity for certain raw materials).

Every CFO and corporate development professional should assess whether or not their business units—and the businesses they may be looking to acquire—have realistic plans to maintain and grow their margin. These analyses will determine how and where to invest for the future most effectively.

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