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SKY HARBOR
CAPITAL MANAGEMENT

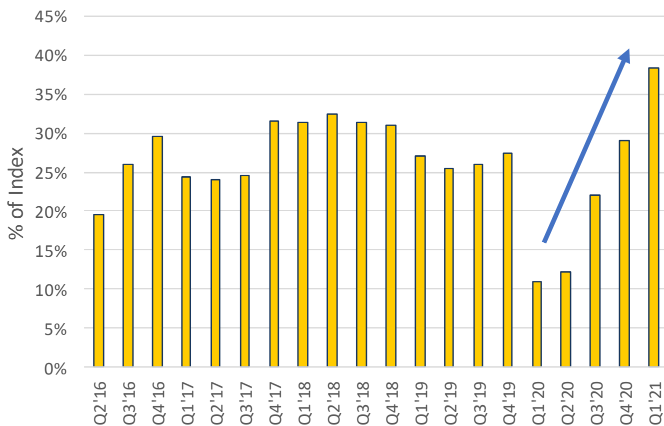
Weekly Briefing

SKYView: Labor Pain

Q1’21 earnings season is now in the books, and although upside earnings surprise was prevalent across all industries, it was talk of cost inflation that dominated management commentary. Supply chain disruptions – stemming from an uneven economic re-opening and Winter Storm Uri – have led to a surge in raw material inputs costs, necessitating price hikes in order for companies to maintain margins. Though such pressures are expected to subside in the coming quarters, upward momentum in wages may prove less transitory. In this *Weekly Briefing*, we examine employment trends, identifying areas of the high yield market likely to face the most significant labor cost inflation as the re-opening progresses.

During Q1’21 earnings season, an estimated 38% of management teams mentioned “inflation” during post-release conference calls, the highest reading going back to at least 2010[1]. While a broad-based spike in raw material costs received the most attention (see our May 3, 2021 *Weekly Briefing* entitled “A Surprisingly Good Start” here), difficulties in attracting and retaining employees, which has led to wage inflation, is an equally important concern for many companies.

S&P 500 Constituents Citing "Inflation" on Earnings Calls
quarterly data, last five years



Wage Pressure More Likely to Endure
management team commentary from Q1'21 calls

"...seasonal labor represents close to 30% of our total operating cost and is an area that is seeing significant pressure in both availability and affordability. While we've had to deal with tight labor markets in the past, this is by far the most challenging labor environment I've seen in my more than 30 years in this business" --- **Amusement Park**

"We expected labor to be a challenge, and we were not disappointed on that." --- **Machinery Company**

"It's never been more difficult to attract and retain employees. As a result, we are also seeing wage rate increases in order to remain competitive." --- **Restaurant**

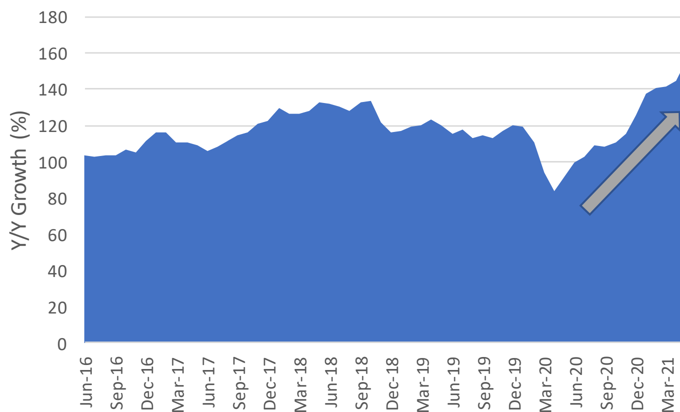
"Stimulus helped topline but has made getting labor more difficult..." --- **Consumer Goods Company**

"Wages have already gone up tremendously, and we expect that to continue. Last year, before the pandemic, it was a challenge. Now, it's a crisis." --- **Hotel**

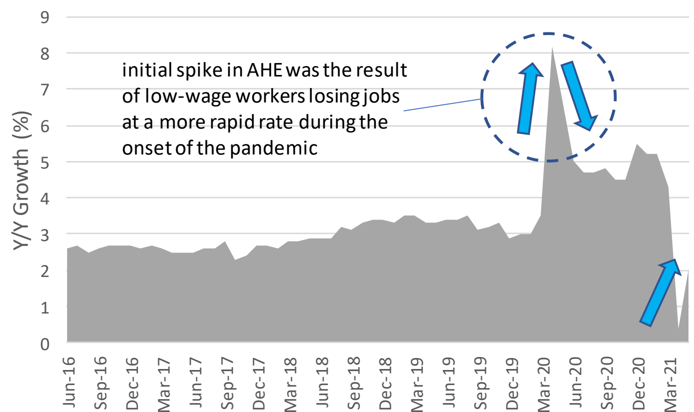
Source: SKY Harbor, FactSet, Bloomberg, company filings

A clear increase in the commodity price environment has been prevalent for a year, but wage pressure is only more recently beginning to show up in data. As demonstrated below, US Average Hourly Earnings spiked at the onset of the pandemic, though this was largely the result of low-paid workers losing their jobs at a more rapid pace[2] (composition effects). It wasn’t until the May ’21 reading that an inflection was reached. In fact, over the last several weeks, wages have been on the rise despite some of the strongest employment growth coming from restaurants and bars,[3] highlighting the challenges mentioned in management team commentaries. And, while raw material prices will normalize (facilities will come back online, new capacity will be built), wage concessions to workers may prove more difficult to reverse in the near term.

IMF World Commodity Price Index
monthly data, last 5 years



US Average Hourly Earnings
monthly data, last 5 years



Source: SKY Harbor, Bloomberg, Bureau of Labor Statistics, International Monetary Fund

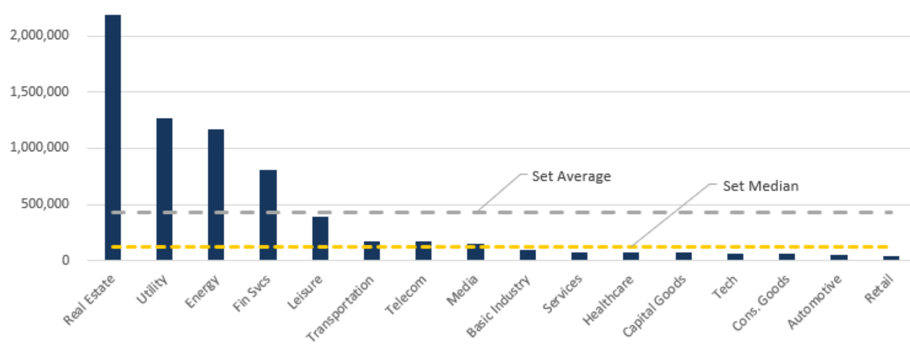
[1] Butters, John. FactSet Earnings Insights, https://insight.factset.com/highest-number-of-sp-500-companies-citing-inflation-on-q1-earnings-calls-in-over-10-years
[2] The White House, https://www.whitehouse.gov/cea/blog/2021/04/19/the-pandemics-effect-on-measured-wage-growth/
[3] Bureau of Labor Statistics, https://www.bls.gov/news.release/empsit.t17.htm

Given a view that wage growth may end up a more persistent component of inflation, we attempted to identify segments of the market where margins may be more susceptible by virtue of greater labor intensity. We first generated a list of ICE BofA US High Yield Index (H0A0) constituents with publicly available financials, leveraging a combination of Bloomberg, Capital IQ, and company filings. We then calculated 2019 EBITDA generation per employee, in an attempt to diminish the negative impact COVID-19 disruptions may have had on company earnings over the last 18 months. While the resulting metrics are not a perfect proxy for labor intensity (companies may outsource a large portion of their labor needs, certain skill sets may prove more/less difficult to source, etc.), we believe it's a viable methodology and one of the few ways to efficiently quantify financials for what turned out to be ~ 70% of a $1.5 trillion universe.

As demonstrated below, sectors such as Real Estate, Utility, Energy, and Financial Services appear to generate far more EBITDA per employee than areas such as Retail, Automotive, and Consumer Goods, leading us to believe the latter are likely more labor-intensive and at-risk in a rising wage environment. Furthermore, as demonstrated in the scatterplot below, sector spread levels show little correlation to our proxy of labor intensity, the market seemingly under-appreciating what we view to be a real margin headwind in the coming quarters.

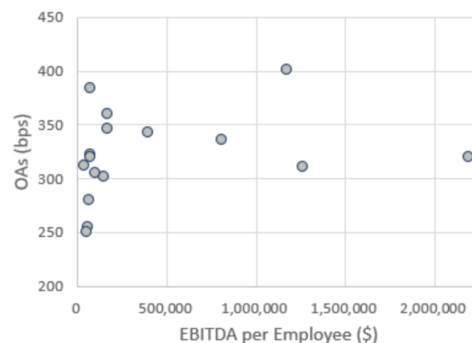
Pre-COVID EBITDA per Employee Varies Tremendously

2019 EBITDA to employee count



Variation Not Evident in Spreads

OAS as of June 9, 2021

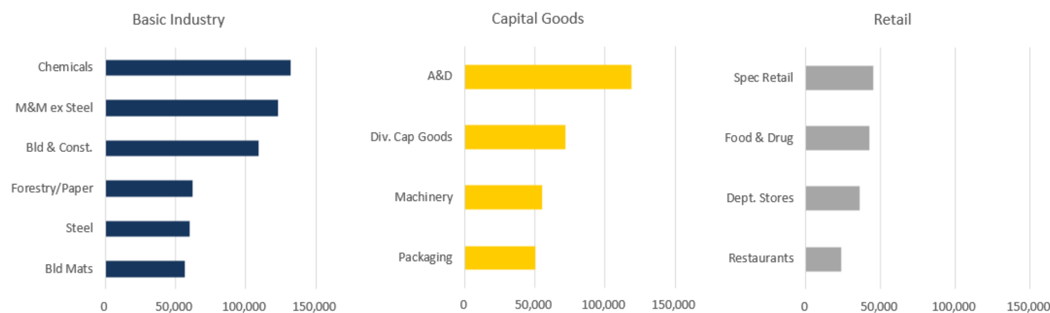


Source: SKY Harbor, Bloomberg, Capital IQ, ICE Data Indices, company filings

Breaking down our data even further at the industry level, we see additional variability. For example, Basic Industry as a sector scores at the median level for EBITDA per employee, though Chemicals – with higher fixed costs and greater capital intensity – scores better than Building Materials once data is limited to industry sub-groups. Across the entire index, Restaurants and Health Facilities appear most vulnerable, while REITs and Energy E&P issuers appear most insulated.

Industry Breaks Show Labor Intensiveness

2019 EBITDA per employee



Least Labor Intensive Industries	EBITDA/employee ($)
REITs	2,584,061
Energy - Exploration & Production	1,884,692
Cons/Comm/Lease Financing	1,450,860
Electric-Generation	1,424,272
Gas Distribution	887,978

Most Labor Intensive Industries	EBITDA/employee ($)
Restaurants	23,351
Health Facilities	26,772
Tech Hardware & Equipment	33,503
Personal & Household Products	38,205
Health Services	42,927

Source: SKY Harbor, Bloomberg, Capital IQ, ICE Data Indices, company filings

Q1'21 earnings season was quite strong, with management teams effectively dealing with one of the more prolific cost inflation environments we have seen. While we think supply chain issue resolution will make most instances of raw material inflation transitory, wage pressure may ultimately be more enduring. Using EBITDA per employee as a proxy for labor intensity, we find Restaurants, Health Facilities, and most other issuers in the Retail space to be most vulnerable in the coming months and quarters, and believe investors should be well-compensated to take on that type of risk in the current market environment.

Note: Consistent with our practice over the last several years, we will temporarily suspend publication of our *Weekly Briefing* during the summer months. We will, however, send out notes on an ad hoc basis should market-moving news materialize. As always, please feel free to reach out to us with any questions or analytical requests in the interim.

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