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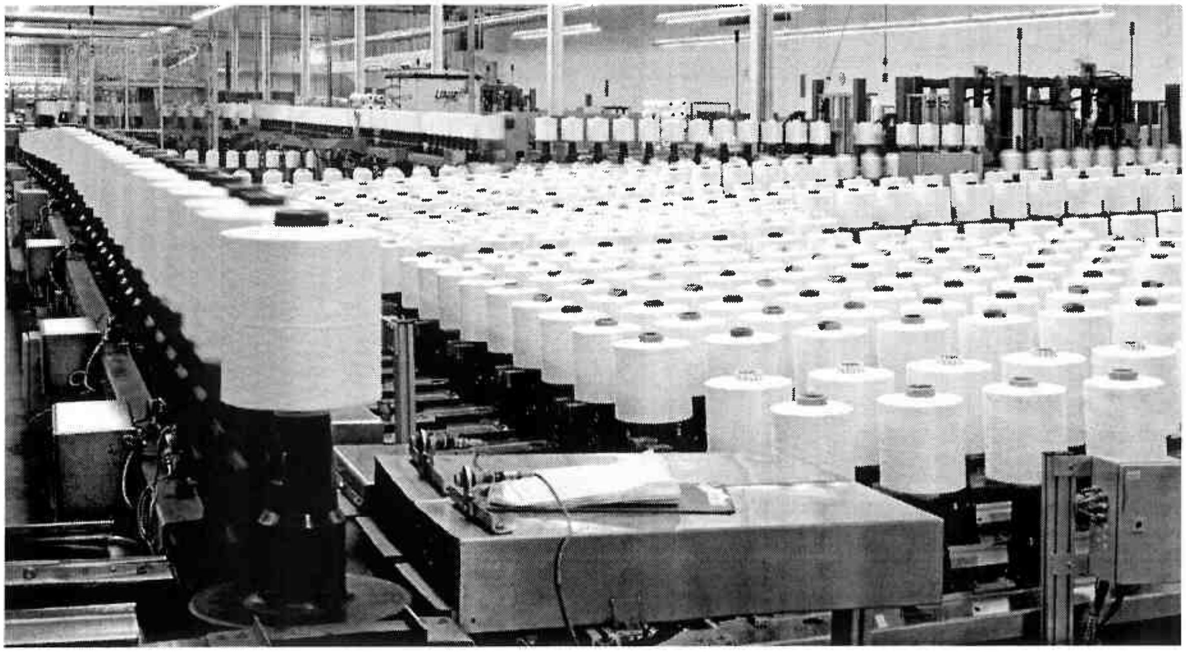
Higher Raw Material Prices Reverberating Through the Supply Chain

By Arthur Friedman



Raw material costs have increased in recent months. CREDIT: Unifi

Rising raw material costs are being felt along the supply chain, from fiber and fabric producers to apparel manufacturers and brands.

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Deep in the supply chain, the cost of ingredients that go into making man-made materials such as polyester and nylon, many of them petroleum-based, have increased just like consumers have seen prices spike at the gas pump to about $3 a gallon nationwide.

According to WTRG Economics, the price of one barrel of light sweet crude oil closed at $69.72 on Friday, up from $42.50 a barrel on July 1, 2017. The Producer Price Index for polyester, collected by the Federal Reserve Board, rose to 81.9 in April from 77.9 in November.

Kevin Hall, chairman and CEO of fiber and yarn manufacturer Unifi Inc., said on a call with analysts that the company's 3 percent revenue growth in the third quarter did not translate into increased profitability. Hall said this was primarily due to the acceleration of raw material costs that "moved higher at a much faster rate than our ability to take responsive pricing actions."

"We continue to believe that the investments we're making to drive long-term growth across the globe are important and are working. That said, we have some work to do to navigate this complex and challenging cost environment," Hall said. "The price of our input costs are directionally correlated with trends in the price of oil."

Hall noted that, as a point of reference, the price of oil rose from the mid-$40 per barrel range where Unifi first released its 2018 outlook to the mid-$50 per barrel range in the second quarter to reach the mid-$60 per barrel range in the third quarter.

"It has been several years since polyester raw materials have also increased persistently for so many months on end," he said. "We are chasing these cost increases with price increases, but our pricing actions naturally lag cost changes."

Hall said he believed "this difficult environment can be overcome once costs stabilize and our pricing actions catch up with the cost increases."

"We have a global supply chain and we will leverage it to try to adapt to the current environment," Hall said. "Importantly, we continue to believe our differentiated PVA (premium value added) fiber strategy will allow us to grow profitably longer-term."

Hall also noted that Unifi's Repreve brand of polyester made from recycled plastic bottles is also subject to raw material cost pressure, adding, "Our prices for bale and plastic bottles for the year have increased 20 percent to 30 percent versus the prior year."

The Lenzing Group said Tuesday in reporting first quarter financials that the wood-based cellulose fiber segment used in producing its fibers saw rising pressure on commodity viscose prices in the period and is seeing further increases in the second quarter.

Lenzing said a number several key raw materials, such as caustic soda, remain at a high level and are expected to lead to a challenging market environment in the commodity viscose fiber business in coming quarters.

Cotton prices have also been on the upswing. Spot cotton prices averaged 80.22 cents per pound for the week ending May 3, which was up from 80.07 cents per pound a week earlier and 75.69 cents in the corresponding period in 2017, according to the U.S. Department of Agriculture. The Cotlook A Index of average global prices stood at 93 cents per pound this week compared to about 85 cents a pound a year ago.

For vertical brands such as Gildan Activewear and HanesBrands that rely on cotton for the bulk of their product offerings, the increases are difficult to swallow.

In reporting its first-quarter results last week, Gildan said they were impacted by higher raw material and other input costs. Gross margin in the first quarter totaled 27.2%, reflecting a 120 basis-point decrease over the same period last year, which Gildan said was mainly due to the impact of higher raw material and other input costs.

Glenn J. Chamandy, president and CEO of Gildan, said on a conference call that, "Prices have gone up and I think they've been well supported. Business is very strong. So that also is a big positive. But we don't see any signs of not being able to pass through these raw material increases. I think it's already in place, and as we go through the year, we'll have a better equilibrium between price and cost."

In reporting its quarterly results last week, as well, HanesBrands also cited raw material inflation and short-term higher distribution costs as hurting the activewear segment's operating profit, which fell 12 percent.

Barry A. Hytinen, chief financial officer of HanesBrands, speaking with analysts on a call, said gross margin declined 10 basis points over last year in part due to higher input costs.

"We experienced $14 million of raw material inflation in the quarter," Hytinen said. "Absent this inflation, our gross margin would have been up 80 basis points. Operating margin declined 60 basis points compared to last year. Absent the impact from raw material inflation, operating margin would have been up 30 basis points."

He added, "As we look out into 2019, we've begun communicating the pricing actions that we'll take to offset the rest of this inflation and we would expect to have those in place in early 2019. I would note if you think about the total net impact that we're incurring this year as compared to our cost of goods sold for the company, it's a relatively small impact. but we will be pricing for it."

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Adidas AG, with a broader range of material inputs, said its gross margin is expected to increase up to 0.3 percentage points to a level of up to 50.7% in the second quarter. Adidas said gross margin will benefit from the positive effects of a more favorable pricing, channel and regional mix. These improvements will be partly offset by the negative impact from unfavorable currency movements, as well as higher input costs.

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