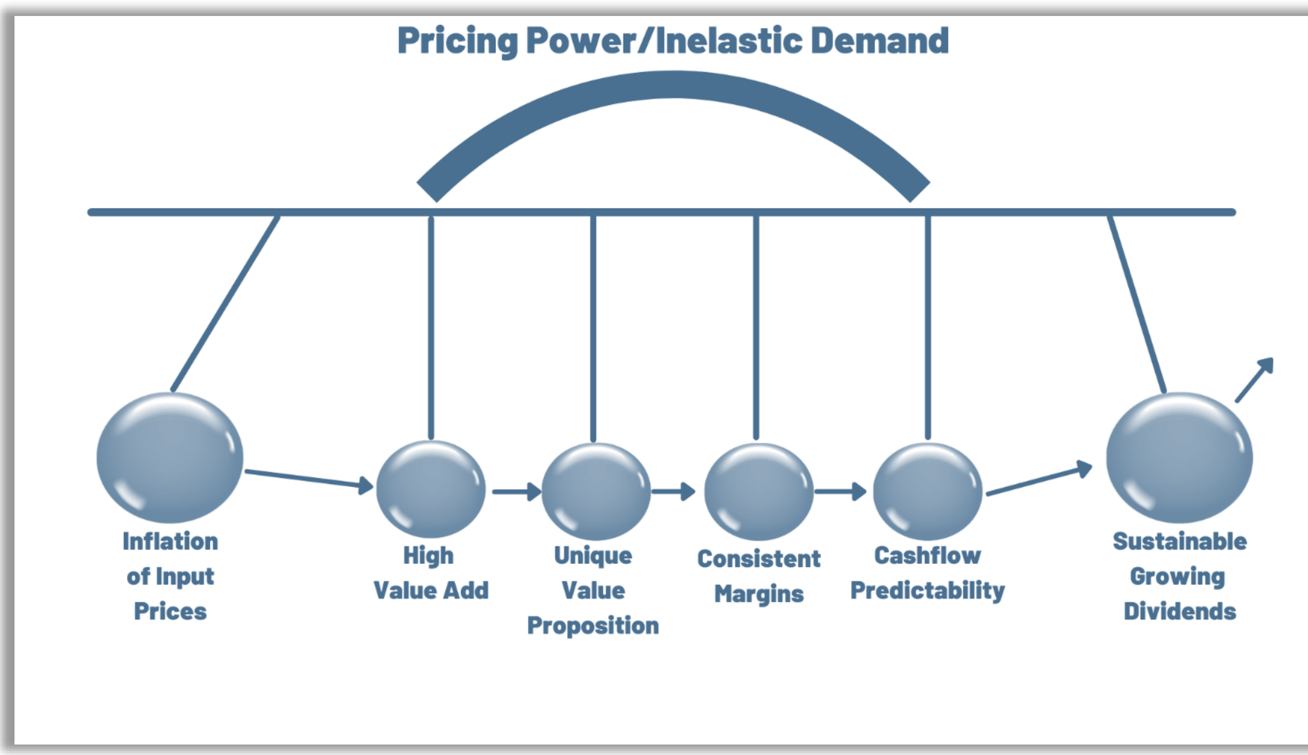
Inelasticity of Demand and Pricing Power Reduces Inflationary Pressures

Since the pandemic, inflationary pressures have risen. With loose monetary and fiscal policy, supply chain bottlenecks, and pent-up demand, the consumer price index (all items) has risen 4.15% in May. This has resulted in commodity prices and input costs rising. Whether this inflationary pressure is sustained or not, it is still important to analyze how a business responds to increases in input prices. Pricing power is the key for fighting inflation. Pricing power is created via relatively inelastic demand for a company's product/service, which allows the company to raise prices without reducing demand for their products. Strong pricing power is important during an inflationary environment as the increased costs of production are passed to the customer, resulting in more predicable cashflows and sustainable growing dividends to equity investors.

Pricing power is reflective of a unique value proposition. This differs from company to company and even intracompany from product to product. It is evidence of high value-add leading to inelastic demand which, in turn, results in consistent margins and, as a result, predictable cash flows. Companies with strong pricing power can consistently grow their dividend during inflationary periods, and throughout the full business cycle; companies that do not have pricing power will see their margins squeezed which will result in the less money available for distribution to shareholders.



Examples of Inelastic demand and Pricing Power

Home Depot

Lumber prices have increased ~300% over 2020 and into 2021. Lumber is the third largest of Home Depot's 14 merchandising departments. The company has been able to pass on the majority of these cost increases due to the strength of their market position and by being proactive in pricing actions. Home Depot essentially operates in a duopoly within the home improvement space; this results in very inelastic demand, especially from professionals which are the largest consumer of lumber. As a result, Home Depot can maintain its gross margins through their pricing actions without sacrificing a significant portion of sales. This was shown in the most recent quarter where this isolated hyperinflationary pressure only impacted the company's gross margin by 35 basis points (1Q21 Gross Margin: 34.0%).

United Parcel Service

UPS has strong pricing power due to its essential solutions and, relative to commodity inflation, its standardized fuel surcharge structure. UPS operates one of the largest airlines in the world and a ground fleet of approximately 127,000 vehicles. As a result, oil and fuel prices have a significant impact on its expenses. Though changes in fuel price affect average CPP (cost per piece), fuel surcharges ensure a proportionate impact on average RPP (revenue per piece), resulting in essentially a net zero impact on the bottom line. UPS' recent emphasis on end-to-end logistics offering to small/medium business makes their customer base reliant on their solution despite the prices they pay for shipping reflecting increased commodity costs.

Example of Poor Pricing Power

It is important to differentiate between price inflation vs rate inflation, although the two typically go hand in hand. However, given the bloated balance sheets of global monetary policy entities, we believe rate inflation will lag price inflation relative to historic norms. Utilities are a sector that is poorly positioned for both rate and price inflation. Utilities are capital-intensive companies; they borrow large sums of money to finance general operations and as rates increase their borrowing costs increase, reducing profitability. Additionally, most electric utilities in the U.S. use either coal or natural gas for most of their power generation. As commodity prices rise utility input costs rise. Most utilities are regulated by state governments with the requirement that before the company can increase rates, it must first be submitted as a request and then approved by the relevant regulatory office. As a result, they cannot automatically pass higher input costs along to customers. In response to these external pressures Utilities typically cut their dividend payments to equity investors to conserve cash.

*The Dividend Growth Strategy has one utility name (Evergy, Inc.) and is underweight 3.62% of the sector benchmark
*The Core Dividend Strategy has one utility name (Sempra Energy) and is underweight 3.72% of the sector Benchmark
*The Quality Growth Strategy has no utility exposure and is underweight the sector benchmark by 2.51%
*As of 5/24/2021

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