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Industry News
Archives
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Columns
Classifieds
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Supplier Marketplace

‹ Back to Columns

LEADING A SMALL TO MID-SIZED FOUNDRY? IT'S TIME FOR A PROFITABILITY PULSE-CHECK

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In the January 2022 edition of Modern Casting, the foundry industry outlook was provided. While in 2020 we saw a decrease in revenue of 17% largely due to the COVID-19 pandemic, 2021 was a bounce-back year with $43.4 billion in revenue or 18% growth—only $928 million off pre-pandemic 2019 numbers. The industry revenue forecast for 2022 is $47.3 billion, or 9% growth, with the number of foundries growing to 1,770, or 2.6% growth, with each foundry averaging $26.7 million in revenue. All great news for companies in the foundry industry!

As you can see from the average revenue per company, this industry is comprised of several small to mid-sized foundries. One of the unfortunate statistics was that in 2020, 43% of all foundry companies were unprofitable on average. The average foundry revenue for these unprofitable foundries was $21.2 million per facility translating into an average loss of $1.2 million. Obviously, a decrease in revenue of 17% in 2020 contributed to the losses experienced by some foundries. However, we all know foundries are notorious for what we call "leaky" financials. Scrap, rework, deferred maintenance, delayed capital expenditures to improve operations, and inefficient core, sand, melt and mold operations can all lead to additional expenses and operating losses.

As we enter 2022, small to mid-sized foundries are facing new headwinds not seen in 40 years, including inflation (price increases from suppliers), supply chain shortages (metal, materials, additives, etc.), labor shortages, and hourly wage increases to secure necessary workers. All these issues put pressure on small to mid-sized foundries' gross margins, profitability, and cash flow. Maintaining margins relative to cost increases will be extremely important for survival. If your customer base consists of large OEMs, there will be incredible pressure to not raise prices, as they are trying to maintain their margins as well. Small to mid-size foundries typically get caught in the middle and reluctantly do not increase prices to their large OEM customers, which has a severe financial impact on the business. A small or mid-sized foundry that is undercapitalized and utilizing a working capital or asset-based line of credit to finance its working capital (inventory, accounts receivable, accounts payable), cannot afford a major hit to its gross margin and gross profit dollars, as it will result in an operating loss and decreased cash flow that most likely will trigger bank covenant violations.

Inflation's Impact

Take a look at the cost of materials and supplies. One can assume almost every year that costs of supplies and materials used in production are going to increase on par with the inflation rate. In recent years, that rate has averaged around 2%. However, we know that inflation today has reached 7+%, a 40-year high! We can also assume other manufacturing overhead costs could increase by that same inflation rate. You may have already received supplier letters indicating significant price increases for 2022. In addition, you will see fuel surcharges reappearing as they are tied to the increase in gas and oil prices that we have seen in 2021 and expect will continue throughout 2022 and potentially 2023.

How are you adjusting for these increases in your customer pricing?

Are you providing the right wages and benefits to attract and retain workers? The $15 per hour minimum wage target seemed high a few years ago. Now it may not be enough to keep certain workers. Unfortunately, labor shortages are causing all businesses to pay much higher hourly wages to attract and retain workers. Labor costs (hourly wages, salaries, and fringe benefits) used in production typically will rise annually, as well. Most companies will target a 2%-3% increase in wages to ensure they remain competitive in the marketplace. Given these annual increases, a company will need to increase its overall customer prices to maintain an acceptable gross profit margin. If not, you will experience "gross margin erosion" and a real decline in the profitability and cash flow of your company. The cost of employee turnover is extremely high and is often overlooked by small to mid-sized foundries. It can erode your bottom line quickly. If you are paying much more in hourly wages, how are you adjusting for these increases in your customer pricing?

Prices, costs, and product margins are a big deal for foundries. There is constant pressure from customers to "lower or maintain your prices." It's typically "David versus Goliath" and David is reluctant to upset Goliath with price increases in fear of losing him as a customer. However, your customer needs you to be a profitable and viable business to ensure their supply chain has no "weak links." You will need to be firm with customers in 2022 and increase your prices to keep pace with supplier cost increases and hourly wage increases.

No More Federal Safety Net

Over the past two pandemic years, companies were provided a significant lifeline from the federal government in the form of forgivable PPP loans, EIDL Loans and Employee Retention Credits (ERC) to bolster their cash flow during the pandemic to offset expected business losses. Businesses have been able to hide several financial and operating issues with the increased cash positions on their balance sheets. As we see companies exhausting the remainder of these funds in early 2022—if they have not already—we expect to see many foundries this year running into financial difficulty due to the pressure on margins from rising costs cited above and the lack of liquidity on their balance sheets.

When an undercapitalized small to mid-sized foundry also using a line of credit to finance its working capital needs (inventory, Accounts Receivable, Accounts Payable) becomes unprofitable and its cash flow is thereby reduced, bank agreement covenants such as EBITDA performance and fixed charge coverage ratios (ability to meet principal and interest payments with operating cash flow) can be triggered. When covenant violations occur, lenders become concerned and want an explanation from ownership/management as to how the foundry will get back into compliance. Foundry owners and management teams typically are not well versed in how to deal with bankers and their concerns. In our work advising foundry clients, we often find ownership/management has told the banker "what they want to hear" without really having a plan to get back into compliance. Telling your banker you will fix the problem (i.e., improve your financial results in short order) and then have the same discussion 60 days down the road only exacerbates the situation. Often, we are brought in at this point to help a foundry deal with the bank issues and help them execute a plan to return to profitability. If you find yourself in this situation at some point, know there are folks out there who can help you.

Good luck to all in the foundry industry navigating through some unexpected head winds in 2022!

About the Authors

Bob Silhacek and Michael Wise co-founded Turning Point Management Advisors, LLC (www.turningpointmgmt.com), a Minneapolis-based management consulting firm providing turnarounds/business recovery solutions, interim executive management, ownership transitions, and sale and acquisition advisory services to companies and their stakeholders that have reached a critical juncture. Turning Point has worked with several small to mid-sized metalcasting businesses.

Click here to see the column in the March 2022 digital edition of Modern Casting.