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Fresatrice Bertone Group: financing in times of crisis

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Product and Market

Fresatrice Bertone Group[1] (FBG) produces mid-size milling machines (with prices ranging from €200,000 to €500,000). Milling machines are used to produce the molds necessary for serial manufacturing of almost any kind of industrial product like cars, trains, aircrafts, wind generators, etc. The customer is usually a large manufacturer of components for the automotive, rail, aeronautics, energy and oil industries (hard in the negotiation but financially sound).

The milling machine industry is very fragmented, with many manufacturers around the globe. For example, a Japanese manufacturer can sell machines in Europe and an Italian in China. The bigger manufacturers are Japan, Germany, Korea, Italy and Spain. The competition in price, quality and service is enormous, and increases in times of recession. For example, a machine tool manufacturer with losses may be tempted to sell the machines at cost, just to keep the plant working, pay salaries and reduce losses produced by the lack of activity.

With the economic crisis of 2009-2013, the trend toward globalization increased and many local providers disappeared. You need a certain size to compete in the global arena. Only the two or three biggest suppliers worldwide reach sales of around €1 billion. Most of the domestic leaders in every country have sales of around €100 million. FBG, with €50 million in sales, could be considered a medium-size company in the Italian milling machine industry, but leader in its category of medium-size machines. FBG has always enjoyed a good reputation as one of the leaders in the Italian market based on its history, reliability and service. Nevertheless, the trend toward delocalization of manufacturing to Eastern Europe and China has diminished the size of the domestic market. FBG reacted, developing an extensive network of sales representation across

[1] This case is based on a real business situation. The names and some numbers have been changed for confidentiality reasons and pedagogical purposes.

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Europe. In fact, in 2019 exports represented 70% of sales (mostly to Germany and Eastern Europe), up from 30% in 2010.

The industry is extremely cyclical. The customer buys new machines (increases capacity) only when he or she has the orders for bigger manufacturing. When it comes to cost reduction, the first savings always come from a reduction of investment in capital goods. On top of that, in times of recession, some mold makers close and put their second-hand machines on the market, competing with the new ones. FBG and the other main competitors try to escape the cyclicality with worldwide exports.

Production

FBG has 183 employees, half in the plant and half in design, sales and administration. During the recession, the company reduced the labor force from 185 to 155. The management team has an average age of 55 with 30 years of professional experience in the industry. As in most machine tool companies, engineers predominate in numbers and influence.

The production process is complicated. It starts with the design of the machine by the Engineering Department to make a final offer to the customer. Although FBG produces standard machines, every customer wants a certain level of customization that really complicates the process. At that point the Engineering Department must contact the supplier of components to get prices and delivery dates. On average, components represent 70% of the production cost of the machines; the other 30% is labor. The only suppliers of the electronic components are two very powerful German companies.

A perfect planning of the manufacturing process is essential. Delays usually cause penalties from the customer (common in the industry) and extra hours (extra salaries) required to finish the machines on time. The assembly of the machines can be delayed for many reasons: late arrival of a component, error in the design, sudden changes required by the customer, etc.

Once the machine is finished, it is shipped with a group of workers for the final setup at the customer's facilities. Only when the machine works correctly will the customer officially "receive" the machine. If there is any problem, the machine will not be "received" (accepted) and paid until the customer is satisfied. Any delay in the production process or in the acceptance of the machines may change the level of inventories substantially and the COGS attached to the machine. In 2020, with an expected production of 120 machines per year, the plant would be working at full capacity.

P&L and Balance Sheet

For the P&L and balance sheet up to 2019 plus a forecast of 2020, see **Exhibits 1** and **2**. The P&L reflects the cyclicality[2] of the industry. During the 2009-13 crisis, sales fell by half. In the following years, FBG had difficulty recovering sales and margins and was only able to do so thanks to its introduction into the German market. In 2019, recovery was already clear, with orders worth 66 million euros (about 5-6 million each month).

[2] Usually, cyclical industries like machine tools manufacturing are the first ones to be hurt by a recession and the last ones to get out of it.

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Investments. The business of FBG requires a substantial investment in receivables, inventory and fixed assets. FBG had made an effort to finish the machines and the delivery on time in order to reduce inventories. The forecast of inventories for the year 2020 is showed in **Exhibit 3**.

Financing. It is common in the industry to receive prepayment when the order is firm. The cyclicality of the industry (high operational risk) doesn't allow having too much debt. At the end of 2018, FBG maintained several lines of credit and credit to export, with a maximum limit of €5 million. At the end of 2018, FBG also had €6 million of outstanding long-term debt, with payments of principal of €1 million per year. On average, the interest rate was Euribor +4%.

In 2019, FBG took advantage of the ebullient credit market and asked for a five-year loan of €5 million, with payments of principal of €1 million per year and a Euribor interest rate of +2%. The purpose of the loan was to finance the expected sales growth plus an investment of €1 million in a new factory in China that the company considered strategic. FBG also wanted to pay a symbolic dividend (probably in the region of €1 to €1.5 million) to reward the shareholders after several years without dividends. To support its request, FBG presented the financial statements of 2017-2019 together with the forecast for 2020 (**Exhibits 1** and **2**).

In the loan request FBG explained the three legs of its strategic plan: sales growth, already confirmed with firm orders; moderate improvement of the gross margin; and punctuality in the days of production and delivery of the machines. Cassa di Risparmio di Varese, a local saving bank, granted the loan to FBG based on the good perspectives of the company and the long relationship with it.

The Crisis Comes

At the beginning of 2020, the Covid crisis broke out, resulting in an almost total halt in orders, which went from an average of 5-6 million per month to an average of just 1 or 2 million per month. The atmosphere of uncertainty around the world was total.

At the beginning of 2021, FBG contacted the bank to announce that it would not be able to pay the principal of €1 million due in December 2020. The effects of the deepest economic crisis since World War II were already visible. FBG asked for an extension of the loan from five to seven years with a grace period of two years. FBG accompanied the request with the financial statements of 2020 (**Exhibits 1** and **2**, last column, and **Exhibit 4**).

A summary of the situation of the company, as described by management, follows:

- We expect sales of €25 million for 2021 with a gross margin of 28%, all of them based on firm orders. The decline in sales is a direct consequence of the serious economic crisis we are in, but the quality and competitiveness of our machines are still firm. For 2022 we expect to be back on track after two years of crisis, and we could sell around €35 to €40 million, although we don't have firm orders yet. The gross margin could increase one point up to 29%.

- Our cost reduction plan will start in March 2021. Partial results will be visible only at the end of December with total Opex of €8.6 million (a reduction of €3 million over year 2020). For 2022, we will have Opex of €6.6 (a further cost reduction of another €2 million).

- Despite these cuts, we expect losses of about €2 million in 2021 and a return to "black numbers" in 2022.