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**REPORT TO THE SUBCOMMITTEE ON
ACTIVITIES OF REGULATORY AGENCIES
RELATING TO SMALL BUSINESS
SELECT COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES**

**Allegations Of Impropriety Of
Two Proposed Government Loans
To Hillsdale Foundry Company, Inc.**

B-177194

Economic Development Administration,
Department of Commerce
Small Business Administration

**BY THE COMPTROLLER GENERAL
OF THE UNITED STATES**

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JUNE 27, 1973



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-177194

The Honorable John D. Dingell, Chairman
Subcommittee on Activities of Regulatory
Agencies Relating to Small Business
Select Committee on Small Business
House of Representatives

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R Dear Mr. Chairman:

Pursuant to your September 29, 1972, request, we have examined the alleged impropriety of two Government loans to Hillsdale Foundry Company, Inc. As of March 31, 1973, the loans had not been made and approved and neither the Economic Development Administration, Department of Commerce, nor the Small Business Administration had disbursed any funds.

As agreed with your office, we did not obtain written comments from the Department of Commerce, the Small Business Administration, or Hillsdale Foundry Company, Inc.

This report contains information, the disclosure of which may be prohibited by the United States Code (18 U.S.C. 1905). The referred to statute makes it a criminal offense to disclose, among other things, the "amount or source of any income, profits, losses, or expenditures" of any person or firm.

We do not plan to further distribute this report.

Sincerely yours,

Comptroller General
of the United States

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ABBREVIATIONS

EDA	Economic Development Administration
GAO	General Accounting Office
SBA	Small Business Administration

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*COMPTROLLER GENERAL'S REPORT TO THE
SUBCOMMITTEE ON ACTIVITIES OF
REGULATORY AGENCIES RELATING TO
SMALL BUSINESS
SELECT COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES*

ALLEGATIONS OF IMPROPRIETY OF TWO
PROPOSED GOVERNMENT LOANS TO
HILLSDALE FOUNDRY COMPANY, INC.
Economic Development Administration
Department of Commerce
Small Business Administration
B-177194

D I G E S T

WHY THE REVIEW WAS MADE

The Chairman of this Subcommittee asked GAO to make an indepth review of two proposed Government loans to assist the Hillsdale Foundry Company, Inc., in financing construction of a new foundry in Hillsdale County, Michigan, after Detroit area foundrymen made allegations of impropriety.

The loans are to be made by the Small Business Administration (SBA) and the Economic Development Administration (EDA), Department of Commerce.

As of March 31, 1973, neither EDA nor SBA had finally approved the project loans.

In accordance with the Chairman's wishes, GAO did not obtain written comments from Commerce, SBA, or Hillsdale.

BACKGROUND

Faced with serious and expensive environmental control problems, Hillsdale applied in January 1971 to EDA for a loan to assist in financing construction of a new job-casting

foundry. In June 1971 EDA tentatively approved a loan, contingent upon private financing being obtained for a portion of the foundry's cost.

In April 1972, Hillsdale changed its proposal from construction of a job-casting foundry to construction of a combination job-casting and production foundry and applied to SBA for a loan because it could not obtain sufficient private financing.

Hillsdale contemplates obtaining \$2.2 million for the proposed foundry--\$1.4 million from EDA and SBA and the remainder from private sources. (See p. 7.)

A job-casting foundry produces large custom castings to order. These castings may range in weight from less than a ton to many tons. A production foundry mass produces small castings weighing from about 2 pounds to about 75 pounds.

At the Chairman's suggestion, EDA employed an independent consulting engineer in November 1972 to review technical and financial aspects of the proposed project, including Hillsdale's managerial ability. The

consultant submitted his report in December 1972.

FINDINGS AND CONCLUSIONS

Detroit area foundrymen alleged that:

- Government financing of a new foundry was unfair competition.
- The proposed project was technically not feasible and financially not practical.

Allegations of unfair competition

Representatives of various foundries alleged that they would be subjected to unfair competition if EDA and SBA lent money to Hillsdale, primarily because the gray-iron foundry industry was in a depressed state and had excess capacity. (See p. 10.)

As required by the Public Works and Economic Development Act of 1965, EDA made two studies to determine, among other matters, whether the proposed foundry would increase the capacity of the foundry industry enough to create unfair competition. Both studies concluded that it would not. (See pp. 10 to 12.)

Legislation authorizes the Federal Government to provide financial assistance to business firms who meet eligibility criteria.

The legislation states, however, that such assistance should not be provided if it would increase production when the demand is insufficient to use the efficient capacity of existing competitive commercial enterprises.

GAO's review showed that EDA and SBA reasonably considered the question of unfair competition in determining

that the legislative provision was not violated.

Allegations of technical infeasibility and financial impracticality

Hillsdale's proposed construction of a combination job-casting and production foundry led to both technical and financial allegations.

The principal ones were:

- Technically, the proposed project is infeasible because (1) production and job casting cannot be successfully combined and (2) it is questionable whether Hillsdale has the management ability or the highly skilled maintenance force needed to operate a production foundry. (See p. 15.)
- Financially, the proposed project is impractical because (1) initial cost estimates remained the same even though the project's scope was expanded, (2) Hillsdale has not demonstrated a strong financial position in the past, and (3) economic projections of profits in a new field are unreliable. (See p. 15.)

EDA's consultant reported that it was not only feasible but also practical to combine job casting and production. GAO found that a number of independent combination foundries were operating. (See p. 16.)

EDA's consultant disagreed that a highly skilled labor force was needed. He reported that the production equipment manufacturer trains maintenance personnel, operators, and foremen on all possible operating and maintenance problems.

The consultant concluded that Hillsdale's management could handle production operations. An official of one of Hillsdale's prospective customers told GAO that his company, which operates a large production foundry, would be willing to offer technical assistance to Hillsdale, if needed.

Two banks in the Detroit area said they were concerned about Hillsdale's management because the owner and president was in his sixties and they were unable to discern adequate backup management.

EDA asked its consultant to determine if Hillsdale would be able to construct and equip the proposed combination job-casting and production foundry for the stated \$2.2 million cost and whether it would be able to operate the new foundry profitably. The consultant concluded that the foundry could be constructed for \$2.2 million and could be operated profitably at prevailing prices.

On the basis of GAO's confirmation of land acquisition and building construction costs and major equipment purchase prices, it appears that the project could be constructed and equipped for \$2.2 million, subject to GAO comments on the contingency cost. However, the allowance for contingencies included in the estimate leaves little margin for error or unforeseen circumstances. (See p. 19.)

Hillsdale's sales steadily increased from \$1.07 million for the year ended April 30, 1962, to \$3.32 million for the year ended April 30, 1970. Sales decreased in 1971 and 1972; these are regarded as recession years for the foundry industry.

For the 9 months ended January 31, 1973, Hillsdale's sales exceeded its total sales for the year ended April 30, 1972. (See p. 21.)

GAO computed the more commonly used financial ratios for Hillsdale and compared them with ratios for the iron and steel foundry industry. This comparison indicated that Hillsdale was not financially strong as of January 31, 1973. (See p. 21.)

EDA and SBA concluded that Hillsdale's estimates of production sales potential were reasonable. Executives of companies which were Hillsdale customers told EDA that Hillsdale was pricing competitively, supplying castings of excellent quality, and providing superior delivery service.

SBA also concluded that Hillsdale had been price competitive in the job-casting market and should be able to sell production castings competitively. (See p. 25.)

GAO confirmed the reasonableness of the average selling price of production castings and selected costs used by EDA's consultant to conclude that Hillsdale's new foundry could operate at a profit. (See pp. 25 to 26.)

EDA and SBA have considered all pertinent aspects in evaluating the feasibility of the proposed loan to Hillsdale. Favorable factors are:

- The proposed combined job-casting and production foundry appears technically feasible.
- The market potential for the foundry's planned production appears good.

--The proposed foundry has the potential for operating profitably.

--Hillsdale's reputation among its customers seems excellent.

Unfavorable factors are Hillsdale's:

--Poor financial position and earnings record during 1971 and 1972.

--Lack of experienced backup management.

GAO believes, however, that the most important factor in granting or denying these loans is judgment--whether the risk of possible failure

of the project is acceptable.

EDA and SBA have acquired expertise and experience in granting loans. GAO has no basis for concluding that EDA and SBA should not make the loans.

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CHAPTER 1

INTRODUCTION

By letter dated September 29, 1972, the Chairman of the Subcommittee on Activities of Regulatory Agencies Relating to Small Business, House Select Committee on Small Business, requested that we make an indepth review of two proposed Government loans to assist the Hillsdale Foundry Company, Inc., in financing the construction of a new foundry in Hillsdale County, Michigan. The Small Business Administration (SBA) was to make one loan, and the Economic Development Administration (EDA), Department of Commerce, was to make the other.

The Chairman requested the review because foundrymen in the Detroit area had alleged that:

- Government financing of a new foundry was unfair competition.
- The proposed project was technically not feasible and financially not practical.

The Chairman also stated that he had been unable to obtain an explanation from EDA and SBA why local banks would not participate in financing the project.

At the Chairman's suggestion, EDA hired an independent consulting engineer in November 1972 to review technical and financial aspects of the proposed project, including Hillsdale's managerial ability. The consultant submitted his report in December 1972.

ROLES AND RESPONSIBILITIES OF EDA AND SBA

The Public Works and Economic Development Act of 1965, as amended (42 U.S.C. 3121), was enacted to help depressed areas build diversified, viable local economies primarily by creating jobs for the unemployed and by raising the income and capabilities of the underemployed. The act, in part, authorized EDA to make business development loans to private enterprises for starting or expanding businesses that will provide new jobs and new income in distressed areas. A project for which financial assistance is sought should provide

more than a temporary alleviation of unemployment in a redevelopment area. A loan may be made for up to 65 percent of the cost of a project for a term not exceeding 25 years, provided funds are not available on reasonable terms from private lenders or other Federal agencies. EDA requires 15-percent local participation in the cost of a project.

SBA was created by the Small Business Act of 1953 (15 U.S.C. 631 et seq.). Its fundamental purposes include making loans to small businesses and to State and local development companies.

The Small Business Investment Act of 1958, as amended (15 U.S.C. 661), authorizes SBA to make loans to local development companies made up of local citizens whose primary purpose is to promote and assist the development of small businesses in the area.

The act limits the amount of a loan to such companies to \$350,000 for each identifiable small business for a term not exceeding 25 years. A local development company is required to provide 10 percent of the land and building costs of a project. Loans to a development company may be used to finance the acquisition of land or equipment, the construction of a plant, or the expansion of existing facilities, provided the project assists a specific small business.

PROJECT BACKGROUND

Hillsdale was incorporated in 1941 and is located about 90 miles west of Detroit in Hillsdale County. Its current president purchased the company in 1951 and was the sole owner until June 1972, when his son-in-law, the plant manager, acquired a one-half interest.

Hillsdale is a gray-iron job-casting foundry; that is, it produces large castings made to order, primarily for the automotive industry. Hillsdale's records show that its castings weigh from 100 pounds to 30 tons each and that it can produce about 60 tons daily.

Because foundries produce considerable dust, noise, and smoke, they have been subjected to many ecological restrictions, laws, and ordinances. When the Hillsdale foundry started operating, it was in a rural area. The town of

Hillsdale, however, has expanded into the rural area so that the foundry is now in the center of a residential area. In July 1970 Michigan's air pollution control agency decided that the Hillsdale foundry would have to correct its pollution problems or cease operating.

Faced with serious and expensive environmental control problems, Hillsdale applied for a loan from EDA in January 1971 to assist in financing the construction of a new job-casting foundry. The proposed foundry is to be located in an industrial park in Litchfield, Hillsdale County, which is in the same redevelopment area as the existing foundry; this was a condition to EDA financing. Also, the proposed foundry's planned annual maximum producing capacity was about 11,000 tons of castings more than the existing foundry.

In June 1971 EDA tentatively approved a loan, contingent upon private financing being obtained for a portion of the cost of the foundry. At the same time, EDA was receiving allegations from various foundrymen about the impropriety of making a loan to Hillsdale. These allegations were essentially the same as those made in October 1972 by the foundrymen to the Chairman of the Subcommittee on Activities of Regulatory Agencies Relating to Small Business.

In April 1972 Hillsdale changed its proposal from the construction of a job-casting foundry to the construction of a combination job-casting and production foundry. A production foundry produces small castings weighing from about 2 pounds to 75 pounds each. About the same time, Hillsdale also requested a loan from SBA because it could not obtain sufficient private financing. The proposed foundry is expected to yearly produce about the same tonnage of job castings as the existing foundry and about 23,000 tons of production castings.

Hillsdale contemplates obtaining financing of \$2.2 million from five sources, as follows:

EDA	\$1,100,000
SBA	281,800
Associates Capital Company of Delaware, Inc.	488,200
Litchfield Industrial Development Corporation	110,000
Hillsdale	<u>220,000</u>
Total	<u>\$2,200,000</u>

The funds are to be used for land acquisition and improvement, construction of buildings, acquisition of machinery and equipment, interim financing, and contingencies.

The EDA and SBA loans, at interest rates of 6-3/8 percent and 5-1/2 percent, respectively, and repayable over a term of 17 years, are to be made to the Litchfield Industrial Development Corporation. This corporation is a nonprofit organization established to promote economic development in the Litchfield, Michigan, area where the new foundry is to be located.

The Associates Capital Company of Delaware, Inc., is a private company. Its loan, at a 13-percent interest rate, is to be made also to the Litchfield Corporation. Hillsdale's share of the financing is to be comprised of machinery and equipment that it presently owns.

All loans are being made to the Litchfield Corporation because EDA and SBA require local participation in all projects. EDA officials told us that making all loans to one borrower will make it easier to administer the project.

After the proposed foundry is constructed, the Litchfield Corporation will lease it to Hillsdale for 17 years, after which Hillsdale will become the owner.

In addition, as of February 28, 1973, Hillsdale had obtained two loans for operating capital--one from the Litchfield State Savings Bank and the other from Mercantile Financial Corporation of Chicago.

As of March 31, 1973, neither EDA nor SBA had finally approved the project loans. They are deferring approval until Hillsdale is able to acquire additional operating capital.

SCOPE OF REVIEW

We reviewed the legislation, regulations, policies, and procedures pertaining to EDA's and SBA's lending of funds to private enterprises; the project files at SBA's Detroit office and at EDA's and SBA's Washington, D.C., offices; and a copy of the consultant's report.

We discussed the project with (1) EDA and SBA officials in Washington, D.C., (2) Hillsdale officials, (3) several of the foundrymen who made allegations to the Chairman of the Subcommittee on Activities of Regulatory Agencies Relating to Small Business, and (4) officials of two large banking institutions in Detroit and a small bank in Hillsdale County.

We met with EDA's consulting engineer to discuss his report. To a limited extent we obtained information from other sources, including foundries throughout the United States, to confirm data in the consultant's report.

Also, we observed the operations of the existing foundry and visited the site of the proposed foundry.

CHAPTER 2

ALLEGATIONS OF UNFAIR COMPETITION

Representatives of various foundries in the Detroit area alleged that they would be subjected to unfair competition if EDA and SBA lent money to Hillsdale, primarily because the gray-iron foundry industry was in a depressed state and had excess capacity. They alleged that EDA and SBA loans to finance the construction of a new foundry for Hillsdale would not only increase its production capacity but also improve its competitive position.

Section 702 of the Public Works and Economic Development Act of 1965, which deals with unfair competition, provides that EDA give no financial assistance for any project that would increase production when the demand is insufficient to use the efficient capacity of existing competitive commercial enterprises. Before providing assistance, EDA conducts studies to determine if a proposed project would result in an oversupply of products.

The complaining foundrymen believed EDA did not adequately consider the following aspects in determining that unfair competition would not result from the loan.

- The new foundry will increase Hillsdale's production capacity while the gray-iron foundry industry already has excess capacity.
- The capacity of present producers of mechanical- and disc-brake castings can be used and expanded to meet the expected increased demand for disc brakes.
- Hillsdale proposed to sell its production castings for 8 cents a pound, which would undercut the current market price of about 18 cents.

CAPACITY OF THE FOUNDRY INDUSTRY

EDA made two studies--one after Hillsdale's proposal to construct a job-casting foundry and one after Hillsdale's proposal to construct a combination job-casting and production foundry--to determine whether the increased production would result in unfair competition. Both studies concluded

that providing financial assistance for the project would not be contrary to section 702 of the Public Works and Economic Development Act of 1965.

EDA's first study dated March 1971 concluded that:

"The project [a job-casting foundry] is a new facility which would enable the applicant to retain and expand employment within the Hillsdale County, Michigan redevelopment area. * * * The projected expansion of the relocated foundry would represent only a small percentage of the average annual output increment of the gray iron casting industry. * * * approval of this project would not run contrary to the provisions of Section 702 * * *."

The above determination was based, in part, on the fact that EDA's study had shown that the number of gray-iron foundries in Michigan had increased between 1963 and 1967, although nationwide the number of such foundries had decreased. The average annual increment of gray-iron castings from 1963 through 1969 was 415,000 tons, which was much larger than the planned annual increase (10,800 tons) in the production capacity of the proposed job-casting foundry.

In February 1972 EDA received a letter from one of the complaining foundrymen disagreeing with EDA's conclusion that excess capacity did not exist in the gray-iron, job-casting foundry industry. As a result, EDA reviewed its March 1971 determination and in March 1972 stated that there was a national downward trend in the number of gray-iron foundries but that most of the foundries going out of business were marginal operations and were unable to compete. EDA noted that section 702 requires a review of the market impact of proposed projects on existing efficient competitive enterprises. EDA also said that the decline in the number of foundries did not reflect market trends because the market for products of Michigan's gray-iron foundry industry has steadily increased at an annual rate well exceeding the projected increase for Hillsdale's new foundry.

In April 1972 Hillsdale changed its proposed construction of a job-casting foundry to a combination job-casting and production foundry. In December 1972 EDA made another

study to determine the effect that the increased production would have on competition.

EDA again concluded that providing financial assistance for the foundry would not conflict with section 702. EDA's study reported that a significant portion of the gray-iron foundry industry was becoming obsolete. Competition and ecological restrictions had resulted in a continued decline in the number of foundries, and, as the industry's production capability was declining, the demands upon it were increasing.

EDA projected a 3-percent annual rate of industry growth from 1971 through 1980 and noted that the industry's projections--30-percent growth from 1972 through 1976--were even more optimistic. EDA concluded that, although the annual increase in the Midwest area demand would be at least 210,000 tons a year, the maximum annual additional production capacity resulting from EDA's assistance to Hillsdale would be about 26,000 tons a year, or less than 13 percent of the total regional increase. EDA summed up its study by stating:

"This factor [regional growth], supported by the anticipated decline in present capacity, the recognized existence of inefficient capacity, and the present claims of capacity shortage, all lead to the conclusion that the proposed project will not be in conflict with the provisions of Section 702 of the Act."

CAPACITY OF PRESENT PRODUCERS

Allegations of adequate capacity to meet the expected increased demand for disc brakes were apparently made because Hillsdale, in its applications for EDA and SBA loans, stated that it would produce disc-brake castings.

However, Hillsdale officials and EDA's consulting engineer told us that Hillsdale does not intend to produce only disc-brake castings. The consultant reported that the equipment proposed for the new foundry is capable of producing a number of different small castings. He also stated that, even if present producers of brake-drum castings start producing disc-brake castings, a sufficient market would be available to absorb Hillsdale's anticipated production.

Officials of a major producer of brake drums and supplier of disc brakes to the automotive industry told us that they would like to see Hillsdale construct its proposed foundry because they were having difficulty in ordering production castings.

EDA officials told us that EDA does not consider that financing a new capacity would result in unfair competition when the market is expanding because a present producer does not have any exclusive right to the expansion. They said that EDA would not finance a new capacity if it were likely to reduce a producer's share of the present market, thereby causing unused or excess efficient capacity. As pointed out previously, EDA has concluded that its financial assistance to Hillsdale will not result in excess production capacity or in unfair competition.

In April 1972, when Hillsdale changed its proposal to include production casting, it also requested a loan from SBA. As a result, SBA made a market study as part of its evaluation of the feasibility of the project.

SBA's July 12, 1972, report concluded that castings of the type to be produced by Hillsdale were needed. However, SBA concluded that adequate job-casting facilities were available and that Hillsdale would be extremely fortunate to reach \$2 million in sales of job castings during the year May 1972 through April 1973. Hillsdale's sales of job

castings during the 9 months from May 1972 through January 1973, however, totaled about \$1.7 million.

VALIDITY OF INDICATED SELLING PRICE

The complaining foundrymen took issue with Hillsdale's statement that it would sell production castings for 8 cents a pound. One of these foundrymen said that the current market price was about 18 cents a pound.

Hillsdale officials told us that the only reason they used 8 cents was to show that they could make a profit even at such a low price. They said that they did not intend to sell their production castings at that price and told us about one prospective customer who had said that he would pay 11 cents to 12 cents a pound for disc-brake castings. They said also that they have always been price competitive.

CONCLUSIONS

Legislation authorizes the Federal Government to provide financial assistance to business firms which meet the eligibility criteria. The legislation also provides, however, that such assistance not be provided if it would increase production when the demand is insufficient to use the efficient capacity of existing competitive commercial enterprises.

Our review showed that EDA and SBA reasonably considered the question of unfair competition in determining that the legislative provision was not violated.

CHAPTER 3

ALLEGATIONS OF TECHNICAL INFEASIBILITY

AND FINANCIAL IMPRACTICALITY

Hillsdale's proposed construction of a combination job-casting and production foundry led to many technical allegations, including:

- No evidence exists of any independent foundry--one not controlled by another company which assures it of a guaranteed market--successfully serving both the production and job-casting foundry markets. The differences in operations could not be successfully combined into one.
- It is questionable whether Hillsdale has the highly skilled maintenance force and the management ability to operate a production foundry.

The complaining foundrymen also raised a number of allegations concerning financial aspects of the proposed project. They pointed out that:

- Hillsdale originally proposed to build only a job-casting foundry costing \$2.2 million, whereas the revised proposal calls for a combination job-casting and production foundry with no increase in costs.
- Hillsdale's past operations have not demonstrated a strong financial position. The foundry rates poorly in its profit record, working capital position, and key financial ratios.
- Economic projections on sales, costs, and profits for a company entering a new field should be taken with a grain of salt. It is highly questionable whether the new foundry can earn profits sufficient to repay the loans.
- EDA and SBA have very little collateral should the project fail.

FEASIBILITY OF A COMBINATION JOB-CASTING AND PRODUCTION FOUNDRY

EDA directed its consulting engineer "to determine whether it is feasible to combine a job shop foundry operation with a production shop casting operation." The consultant reported that:

"* * * it is not only possible but practical for foundries to consider production casting and job foundry operations."

The consultant's report included a list of 41 foundries in the United States and Canada which were using the production equipment that Hillsdale plans to acquire and stated that a number of these foundries were combination job-casting and production foundries.

To determine how many of these foundries were independent combination foundries, we contacted the production equipment manufacturer, a foundrymen's association, and several foundries. We learned that seven independent combination foundries were operating.

The consultant also reviewed the need for a highly skilled labor force and reported that workmen, not skilled technicians, could operate the production equipment. He also said that an official of the production equipment manufacturer had told him that the manufacturer had competent engineers who trained maintenance personnel, operators, and foremen in all possible operating and maintenance problems. The consultant reported also that such training is one of the services that the manufacturer provides to all production equipment purchases.

HILLSDALE'S MANAGEMENT ABILITY

The foundrymen alleged that a production foundry requires a skilled management team. They questioned Hillsdale's management ability because it has had no experience in production casting. In addition, officials of two financial institutions which had refused to make loans to Hillsdale told us that the refusals stemmed, in part, from a concern about the foundry's management.

EDA directed its consulting engineer to determine "whether management has the capability to operate a production shop casting operation." The consulting engineer concluded that Hillsdale's management could handle production operations using the proposed equipment. His report contained the following statements on Hillsdale's management.

- The Hillsdale owner held various engineering positions from 1925 to 1946, and from 1946 to 1951 he was a part owner in a firm of consulting engineers.
- In 1951 the owner purchased Hillsdale and since then has been active in the foundry field as a producer. He is now ready to diversify and expand; this could be taken as an example of good management.
- Under the management of the present owner, Hillsdale's sales have increased from \$437,000 in 1952 to \$3.3 million in 1970. Sales decreased in 1971 and 1972; the consultant noted that these years were a recession period for the foundry industry. (Hillsdale sales during the first 9 months of the year ended April 30, 1973, exceeded the total annual sales for the year ended April 30, 1972.)

An official of a company that is one of Hillsdale's prospective customers told us that his company, which also operates a large production foundry, would be willing to offer technical assistance to Hillsdale, if necessary.

We visited two large banks in Detroit which had refused Hillsdale's requests for loans to learn their reasons for the refusals. Each bank had refused to make a construction loan, and one had also refused to make a working capital loan. Both banks said that they were concerned about Hillsdale's management because the owner and president was in his sixties and they were unable to discern adequate backup management.

Hillsdale officials told us that the president's son-in-law (who is 35 years old) acquired one-half interest in the company in June 1972, that he had worked at the foundry since 1965, and that he is actively engaged in management responsibility.

COSTS OF CONSTRUCTION

EDA requested its consulting engineer to determine if Hillsdale would be able to construct and equip the proposed foundry for the stated \$2.2 million costs. A breakdown of Hillsdale's estimated costs for constructing a job-casting foundry only, its revised cost for constructing a combination job-casting and production foundry, and the consultant's estimated costs follow.

	<u>Hillsdale's cost estimates</u>		<u>Consul- tant's cost estimate</u>
	<u>Job- casting foundry</u>	<u>Combination foundry</u>	<u>Combination foundry</u>
Land	\$ 147,500	\$ 47,500	\$ 47,500
Main building	802,000	^a 804,500	^a 802,000
Bag House:			
Building	^a 181,000	-	-
Equipment	268,000	268,000	237,000
Other equipment:			
Job casting	531,076	322,000	364,000
Production	-	488,500	631,232
Total land, building, and equip- ment	<u>1,929,576</u>	<u>1,930,500</u>	<u>2,081,732</u>
Financial during con- struction	80,000	80,000	80,000
Contingency	<u>190,424</u>	<u>189,500</u>	<u>38,268</u>
	<u>\$2,200,000</u>	<u>\$2,200,000</u>	<u>\$2,200,000</u>

^aIn the original construction cost estimates, the Bag House was shown as a separate item; in subsequent estimates, its building cost was combined with other building costs.

We spoke with Hillsdale officials and EDA's consultant to learn the reasons for the major differences shown above.

The cost of land was reduced by \$100,000 by deferring the/paving of a parking lot.

When the proposal was revised to include a combination foundry, a bid of \$804,500 was received for constructing both the main foundry building and the Bag House. The bid was considerably less than the total of the estimates for these items in the original proposal. The consultant reduced the estimated cost for equipment in the Bag House by \$31,000 because a lower bid than expected was received.

The cost of job-casting equipment in the combination foundry was less due to the reduction of large die-casting capacity and the deletion of other equipment not considered absolutely essential. The consultant increased the production equipment costs because he believed additional equipment was needed and because quotations received were higher than anticipated.

To remain within \$2.2 million, the consultant reduced the amount available for contingencies. This reduction to \$38,000, or less than 2 percent of the total project cost, seems questionable. According to the EDA loan officer now responsible for the project, a 10-percent contingency factor is generally provided; a contingency factor of \$220,000 would be proper for this loan.

We do not have the expertise to confirm the validity of the equipment requirements. However, on January 26 and February 5, 1973, we contacted two manufacturers which will be supplying major equipment items costing about \$623,000. Both manufacturers said that their quotations were current and would remain so for the near future.

Both we and the consulting engineer confirmed the quotations received for land acquisition and building construction. On December 6, 1972, Hillsdale officials told us that the option on the land had been verbally extended at the same price and that the president of the Litchfield corporation had told Hillsdale that there would be no problem in acquiring the land. On February 1, 1973, the low bidder for the construction of the buildings told us that his bid was still good but that, if construction did not begin fairly soon, he might have to increase the price because of rising steel prices.

On the basis of our confirmation of land acquisition and building construction costs and major equipment purchase prices, it appears that the project could be constructed and

equipped for \$2.2 million. However, the lower contingency allowance leaves little margin for error or unforeseen circumstances.

CONCLUSIONS

We believe that EDA and SBA have considered all the pertinent aspects in evaluating the feasibility of the proposed loan to Hillsdale. Favorable factors are:

- The proposed combined job-casting and production foundry appears technically feasible.
- The market potential for the planned production of the foundry appears good.
- The proposed foundry has the potential for operating profitably.
- Hillsdale's reputation among its customers seems excellent.

Unfavorable factors are Hillsdale's:

- Poor financial position and earnings record during 1971 and 1972.
- Lack of experienced backup management.

We believe, however, that the most important factor in granting or denying these loans is judgmental--whether the risk of possible failure of the project is acceptable. EDA and SBA have acquired expertise and experience in granting loans. We have no basis for concluding that EDA and SBA should not make the loans.

Ratio	Financial ratios			Interpretation of ratios
	For the iron and steel foundry industry as published by RMA		For Hillsdale as of	
	Median	Lower quartile	January 31, 1973	
Quick ratio: The short-term liquidity available to meet current debt.	1.0	0.8	0.6	Any value of less than 1 to 1 implies a reciprocal dependency on inventory or other current assets to liquidate short term debts.
Current ratio: The ability of a company to meet its current debt.	1.6	1.2	0.8	A low current ratio indicates that less current assets are free from debt claims of creditors and that debt payments may be slow.
Fixed/worth: The proportion between investment in capital assets and the owners' capital.	0.8	1.0	2.4	The higher this ratio, the less liquid is the net worth and the less effective is the owners' capital as a liquidating protection to creditors.
Debt/worth: The relationship between capital contributed by creditors to owners' capital.	0.9	1.5	5.3	The higher the ratio, the more debt pressure and thus less protection for the creditors.
Sales/receivables: The relationship of the volume of business to the outstanding receivables.	9.5	7.4	5.1	A low ratio indicates less rapid collection of sales during the period and less liquid receivables.

Financial institutions' comments

We discussed Hillsdale's proposed foundry with officials of two large banks in Detroit. Officials of one bank said that they refused a working capital loan to Hillsdale in January 1973, in part, because

- Hillsdale was operating at a loss when it requested the loan;
- Hillsdale's net worth at November 30, 1972, was only \$107,000, which did not justify a loan of \$250,000; and
- Hillsdale's loan request was for 3 years and the bank normally will not commit itself to a working capital loan that exceeds 1 year.

Officials of the other bank said that they declined to assist in financing the construction of the proposed foundry (job-casting foundry only) in November 1971 because

- Hillsdale's ability to show a profit appeared too poor and

--Hillsdale had no firm commitments from prospective customers to support its projected sales.

Hillsdale had also requested two small banks in the Hillsdale area to provide construction financing. One bank was interested; however, both refused primarily because of their limited lending authority.

EDA headquarters officials tentatively approved the loan on February 23, 1973, pending Hillsdale's acquisition of additional working capital. As of February 28, 1973, Hillsdale had obtained an operating capital loan from a small bank in the Hillsdale area and an accounts receivable loan from a financial institution in Chicago.

REASONABLENESS OF PROJECTED
SALES, COSTS, AND PROFITS

EDA's contract with its consultant required the consultant to determine if Hillsdale would be able to operate the new foundry profitably.

The consultant, in his report to EDA, stated that in his judgment "the new foundry can be operated profitably on the basis of the prevailing prices." His report included the following table projecting the potential profits of the foundry if the foundry operated at full-rated capacity.

EDA Consultant's Projection
of Profits

Estimated annual sales (net):		\$11,368,000
Direct labor and material	\$8,877,500	
General operating expenses	1,269,902	
Interest	189,334	
Depreciation	<u>175,000</u>	<u>10,511,736</u>
Income before taxes		856,264
Income tax		<u>470,945</u>
Net profit		<u>\$ 385,319</u>

The above sales estimate included \$7 million based on 23,500 tons of production castings to be sold at an average price of 15 cents a pound and about \$4.4 million based on 16,860 tons of job casting at an average price of about 13 cents a pound. The consultant noted that retirement of debt principal would require \$100,000.

The consultant reported that, although 23,500 tons of production castings was a high goal, it was within the capability of the equipment planned for the new plant.

The consultant stated that he had surveyed the market potential for production castings and that he agreed with Hillsdale's conclusion that there was a demand for production castings which would endure throughout the foreseeable future. The consultant stated also that he obtained the job-casting

financial data from records released by Hillsdale's accountant, and he made no further explanation in his report as to the reliability of the data. EDA and SBA also surveyed the market potential for production castings, and each concluded that Hillsdale's estimates of potential sales were reasonable.

Both EDA and SBA study reports concluded that Hillsdale's 1st-year sales projection for job castings seemed overly optimistic. Hillsdale officials told us that their sales of job castings from May 1972 through January 1973 tended to disprove EDA's and SBA's conclusions. The SBA study report stated that (1) Hillsdale had been extremely price competitive in the job-casting market, (2) with a modern, more automated facility, it should be able to sell production castings competitively, and (3) the market for production castings was growing.

An EDA report on its evaluation of Hillsdale's proposed foundry stated that executives of companies which were customers of Hillsdale had told EDA that Hillsdale was extremely price competitive, supplied castings of excellent quality, and provided superior delivery service. The report stated also that contacts with several firms using production castings indicated that another qualified supplier was needed.

One of Hillsdale's prospective customers told us that it could use the production castings proposed by Hillsdale and would place an order "today" if Hillsdale were producing. Hillsdale officials also said they had received requests for small production castings from companies with which they had never done business.

We also examined the reasonableness of the consultant's use of 15 cents a pound as the average selling price of production castings. The consultant told us that the equipment to be purchased was capable of producing a number of different type castings and that the current prices for such castings range from 11 cents to 25 cents a pound. He said that he used a price at the lower end of the range to be "conservative."

An official of the manufacturer of the production equipment that Hillsdale plans to buy told us that he understood that small castings used by the automotive industry were selling for 10 cents to 12 cents a pound and that other type

castings were selling for 18 cents to 25 cents a pound. The assistant technical director of a foundry industry association told us that he thought 10 cents to 12 cents for automotive castings was low and that he believed the prices were more likely to be 15 cents to 17 cents a pound. We also contacted several foundries, but only one would give us information on prices. This foundry said that small production castings were selling for 18 cents to 22 cents a pound. We also noted that one of the complaining foundrymen stated that the average price for castings was 18.7 cents a pound.

The consultant told us that his estimate of direct costs of \$8.9 million consists of labor costs of \$2 million and material costs of \$6.9 million and that again he was trying to be "conservative."

He said that the labor cost of \$2 million was based on a labor force of 190 men but that he believed the proposed foundry could be efficiently operated with about 143 men. (The difference of 47 men represents an annual cost of about \$500,000.) He also stated that he purposely overestimated (by about 21,000 tons) the required raw materials, scrap iron and pig iron. The overestimate of 21,000 tons times the price per ton used by the consultant (\$29 for scrap iron and \$82.75 for pig iron) represents an overestimated direct material cost of \$1,176,000.

The above information indicates that the consultant overestimated costs by as much as \$1.7 million. On the basis of the additional information furnished to us by the consultant and Hillsdale officials, we projected income and expenses and found that the sales price for production castings would have to drop below 10 cents a pound before a net loss would result and before a \$135,000 retirement of debt principal could not be met.

The following table shows Hillsdale's latest (as of January 1973) estimate for the 2d year of operations of the new foundry.

Hillsdale's Projection
of Profits

Estimated annual sales (net):		\$11,377,000
Direct labor and material	\$8,877,500	
General operating expenses	1,269,902	
Interest	189,334	
Depreciation	<u>175,000</u>	<u>10,511,736</u>
Income before taxes		865,264
Income tax		<u>475,000</u>
Net profit		<u>\$ 390,264</u>

The above estimate is based on sales of production castings of \$6,336,000 and job castings of \$3,750,000. Hillsdale also noted that retirement of debt principal would require \$135,000.

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In our opinion, the various assumptions inherent in the above two projections of profit are reasonable. However, because they are estimates of future events no one of the projections can be viewed as "correct."

ADEQUACY OF COLLATERAL

The terms of the loans, as tentatively developed, show that the lenders will receive as collateral:

- Mortgages on all new lands and buildings.
- Security agreements on all new machinery, equipment, furniture, and fixtures.
- Mortgages on all land and buildings and security agreements on machinery and equipment presently owned by Hillsdale and Earl Enterprises.
- Personal guarantee of all loans by the Hillsdale owners.
- Assignment of a life insurance policy of \$1.5 million on the life of Hillsdale's president.

The Associates Capital Company of Delaware, Inc., which is providing a loan of \$488,200, has first priority on all the above collateral until construction of the foundry is completed. After completion, Associates will have a first mortgage on the new foundry.

During construction SBA, with a loan of \$281,800, and EDA, with a loan of \$1.1 million, will have second and third priority, respectively, on all the above collateral. After completion they will be subordinate only on the mortgage of the new foundry. An SBA report of the proposed project stated that second priority provided SBA with adequate collateral. EDA officials told us that their loans are made on a going-concern basis and that they are not too concerned with collateral.

We evaluated the adequacy of the project on a liquidation basis. We believe that the value of a company that is forced to sell will always be less than that of an ongoing concern. In our opinion, any estimates of the amounts for which the secured assets might be sold would be highly speculative and of little value in deciding whether the project is feasible and whether EDA and SBA should provide financing. Nevertheless, Hillsdale officials told us that a professional engineer, who had appraised the present foundry, had told them that the new foundry would be worth much more than \$2.2 million when completed.

CONCLUSIONS

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Select Committee on Small Business
House of Representatives of the United States
Ninety-second Congress
Washington, D.C. 20515

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HOWARD GREENBERG
STAFF DIRECTOR

MILLARD V. OAKLEY
GENERAL COUNSEL

September 29, 1972

Honorable Elmer B. Staats
Comptroller General of the
United States
General Accounting Office
Washington, D. C. 20548

Dear Mr. Staats:

In December 1971 your office, at my request, conducted a review of documents supplied to the Subcommittee by the Economic Development Administration of the Department of Commerce concerning a loan to Hillsdale Foundry Company, Inc. Since that time, financing of the construction of a new foundry has been divided into two projects, one to be primarily funded by a \$1.1 million loan from EDA, and the other to be primarily funded by a \$281,800 direct loan from the Small Business Administration.

Numerous questions have been raised concerning the propriety of either EDA or SBA participating in this matter. Neither governmental agency has been able to provide satisfactory answers to these very serious questions, especially including an explanation of why local banks will not participate even on a guaranteed loan basis, thereby necessitating Hillsdale's securing a \$440,000 loan from an out-of-state corporation at an interest rate of 12 percent.

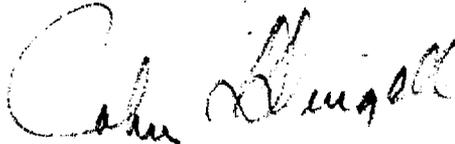
I would appreciate your immediately conducting an in-depth review of both SBA's and EDA's participation in financing this questionable project. Please have your staff

APPENDIX I

Honorable Elmer B. Staats
September 29, 1972
Page 2

contact my Subcommittee Counsel, Thomas G. Powers, who may
be reached at 225-4881, to obtain further information.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "John D. Dingell". The signature is written in dark ink and is positioned above the typed name.

John D. Dingell, Chairman
Subcommittee on Activities
of Regulatory Agencies
Relating to Small Business