The butler lumber essay sample

The Butler Lumber company is facing cash difficulties due to the buyout of Henry Stark's share and because it is operating a high growth rate. Thus, it is imperative to analyze the various options available to Mark Butler in order to meet the cash needs of the Butler Lumber Company. In order to support the reasoning for our recommendation, we constructed a ratio analysis (Appendix I; Exhibit 1). Even though the firm has realized increasing sales and decreased its operating and cash cycle, other factors were found to have contributed to the shortage of funds. From the analysis, we were able to conclude that the main reasons for the firm's insufficient funds were due to its slower collection of accounts receivable, higher costs of goods sold, heavy reliance on debt financing and most importantly a growth rate that is not sustainable. From Exhibit 1 in the Appendix, the current and quick ratios have been declining since 1988; furthermore, the quick ratio is less than 1, which indicates that the firm is deeply reliant on its inventory to meet the payments of its current liabilities.

This is a problem since more inventory means more cash tied up in less liquid assets, which decreases the firm's cash. Secondly, when analyzing the firm's profitability, ROA increased by 3% from 1989 to 1990, but this was mainly due to the increase in total asset turnover which increased from 3. 03 to 3. 23 (Exhibit 1). Another component of ROA, net profit margin, declined from 1. 69% to 1. 63% (Exhibit 1). This is indicative of the fact that, asset turnover is higher due to higher sales. However, net profit margin indicates that in addition to the increase in sales, cost of goods sold increased at a greater rate than sales. This is an important factor because both higher sales and higher costs lead to diseconomies of sales, which is another reason for the shortage of funds that the company is facing. Thirdly, an important part of the assets that contributed to the shortage of funds is the firm's accounts receivables.

The firm's receivables turnover decreased from 10. 24 to 10 between 1989 and 1990, which means that the firm is not collecting it receivables as quickly as it used to, and hence the shortage of funds (Exhibit 1). Lastly, the firm has been taking on more debt in order to finance its assets. The debt ratio increased by 7% from 1989 to 1990, and the equity multiplier also increased which states that the firm has become dependent on debt (Exhibit 1). Even though more debt provides higher tax shield, it is not beneficial for the firm as it is increasing the risk of default and the probability of not being able to pay its debt. Furthermore, the firm's interest coverage decreased by 21. 7%, which means that the firm is less capable of paying its interest expense on its debt (Exhibit1). Our first task was to find the sustainable growth rate of the firm because the current rate is too high to sustain in the long run. Computing the sustainable rate provides a rate of 14. 5%, whereas current growth rate is 34% (Exhibit 2).

Furthermore, the firm should take the 2% trade discounts because the APR earned is 37. 2% which is higher than the rate offered by the bank. Taking these requirements into consideration, we conducted Proforma statements (Appendix). The purpose of doing so was to calculate external funds needed, which was found to be $509. 46 (Exhibit3). It was then understood that factoring accounts receivables at a discount of 3% would cause current assets to decrease by $8. 02. By deducting this amount from the $509. 46 EFN, we obtain net EFN of $501. 44. We analyzed various options to achieve this level of EFN and found that a combination of factoring accounts receivables and maximizing our bank loan with Suburban National Bank was the viable solution. As stated in the case, the maximum loan is $250. Deducting this amount from EFN gives us the amount to be factored which is $267. 49, taking into account the 3% discount this will bring in a cash inflow of $259. 46. Using this new cash inflow with the maximum loan of $250 will allow us to meet our EFN need of $509. 46.

In addition to the requirements stated above, Butler will have to put up collateral to obtain the loan. We are not worried of his capability to do so because he can put up his house (assuming he convince his wife) at a market value of $110. As well, he can put up his life insurance which is worth $70. In order to maintain the sustainable growth rate Butler must adopt more conservative policies. For example, more conservative marketing, restrict credit terms to clients, and reduce the amount of employees. Lastly there are few restrictions to the recommendation provided. To begin, it would hinder the potential growth of the firm and it would not be sustainable in the future years because the firm will lack the ability to factor accounts receivables once they are completely depleted.

On the contrary, the benefits largely outweigh the cons. Firstly Butler will foster greater relationships with his suppliers as he pays them within the discount period. Furthermore, the new loan comes with a number of covenants that would considerably affect the growth of the company such as limits on investments in fixed assets and net working capital. Finally, Butler would not need to sever its loan agreement with Suburban national Bank and break this long term relationship. Thus, for the reasons mentioned in this report, the decision to factor accounts receivables and keep the Suburban loan is un-doubtfully the correct course of action.