

Working capital

Business



Identify the key problem in the case and explain why it is the key problem.

Clarion Lumber Company sales have been growing quickly over the last couple of years.

Growth in working capital necessities has surpassed the capacity of the company to produce funds by itself. Also, part of the finances was used to buy out a partner, further raising the pressure. The company couldn't appreciate discounts on accounts payable and started borrowing larger funds from the bank in order to keep up its development. The issue Mr.

Clarion is facing is how can he raise capital necessary to support the expansion.

In order to achieve that he needs a higher line of credit, which he is trying to get from a different bank. The Northrop National Bank has to evaluate the risks associated with lending money to the lumber company, as well as what amount is needed and what repayment schedule is appropriate. 2. Why has Clarion Lumber borrowed increasing amounts despite its consistent profitability? Clarion Lumber Company had to increase borrowings because its net income is growing at a slower rate than its operating expenses.

The need for additional funds is also required for the purchasing power of goods to match the increased demand. The pressure is even higher because Mr.

. Clarion has a financial obligation towards Mr. Holt. Another reason is the difference we notice between the end of the year 1993 and 1995 in extended collection period.

Considering the current ratio and quick ratio declines, the firm's situation could easily get worse if its profitability was to drop and the funds would shrink further. 3. How has Mr. Clarion met the financing needs of the company during the period 1993 through 1995?

Has the balancing strength of Clarion Lumber improved or deteriorated? In 1993, Mr.

Clarion used mostly accounts payable to his suppliers and employees and a term loan as ways of financing. In 1994, the company borrowed from a bank in form of a \$60,000 note payable, while still mostly utilizing an increased amount of accounts payable to shorten the cash conversion cycle. In 1995, we notice that Mr.

Clarion started to take advantage of trade credit in form of notes payable, also notes payable to the bank increased significantly amounting to \$390,000 and almost reaching the limit allowed by Suburban National Bank.

In order to judge the financial strength of the firm, we look at the financial ratios to see the trends created over the 3-year period and compare numbers to the industry average:

	1993	1994	1995	Industry Average
Current Ratio	2.49	1.58	1.15	2.00

Return on Sales	2.10%	2.00%	1.70%	-0.74%	3.00%
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Return on Assets	6.50%	5.90%	4.70%	12.2%	5.53%
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83 Days Sales Outstanding 38. 25 43. 13 48. 95 Based upon that data we clearly see that Clarion Lumber Company's financial condition has weakened.

We notice a steady decline in the current ratio, return on sales, return on assets, and inventory turnover.

Collection period increased. The cash deficit Mr.. Clarion is experiencing in his company is due to large inventory and loan payments. 4.

How attractive is it to take the trade discounts? Trade discounts are most certainly beneficial. Clarion Lumber Company is offered a two percent discount on payments completed within ten days of a transaction. Based on projections for the rest of 1996, if the firm takes advantage of all the trade discounts it will save \$69, 000.

It is a significant amount that Mr.. Clarion could substantially benefit from.

5. Do you agree with Mr.. Clarion's estimate of the company's loan requirements? How much will he need to finance the expected expansion in sales to \$5. 5 million in 1996, and to take all trade discounts? In order to answer this question we need to create a pro formal income statement (Exhibit 1) and balance sheet (Exhibit 2). Mr.

. Clarion estimates that he will need \$750, 000. After adding up the amounts of bank which is bigger than the initially estimated amount. 6. As Mr.

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Clarion's financial adviser, would you urge him to go ahead with, or to reconsider, his anticipated expansion and his plans for additional debt financing? I would encourage Mr.. Clarion to avoid reaching the level of expansion he anticipates in such a rapid matter. His company will be better off taking it step by step as he will guarantee a stable and secure development.

It seems that he relies too significantly on debt, which is a result of combination of increased sales and buy out of his partner. Interesting observation this case reveals is that sales going through the roof isn't always improve firm's financial condition.

Mr.. Clarion should possibly consider slightly raising his prices.

Given its one of his main competitive advantage, he shouldn't raise them too much as he may easily loose customers; however, a small price raise would increase his profit margin without having to rely so much on debt. 7. What do you think Mr.. Dodge should do and why do you think so. If you were the banker, would you approve Mr.

. Clarion's loan request, and if so, what conditions would you put on the loan? Due to Clarion Lumber's past financial performance, which is declining, I would have to advise Mr..

Clarion to limit his planned sales expansion. Only upon the agreement to set the sales goal lower I would feel comfortable lending the requested amount of \$750, 000 having faith in Mr.

. Clarion's managerial skills. Thanks to great references received from the firm's suppliers I could expect Mr.. Clarion to become a valuable long-term customer of my bank. In order to be absolutely safe that my money will be repaid in time I would set limitations on aspects of the business such as inventories, accounts receivable, and net working capital.