

Lumber company essay sample



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Key questions and concepts that your team should address:

1. Why has Clarkson Lumber Company borrowed increasing amounts despite its consistent profitability?

In order for Clarkson to keep up with an increase in sales, they need to borrow additional funds to increase their purchase order sizes.

2. How has Mr. Clarkson met the financing needs of the company during the period 1993 through 1995? Has the financial strength of Clarkson Lumber improved or deteriorated?

During the last 3 years, Clarkson has used its line of credit with Suburban National Bank (\$400k) and cash flow from operations to support its operations in addition to paying off its Holtz loan and term loan. During this period, Clarkson's financial strength has deteriorated significantly. Below are a few examples of their declining strength:

Current liabilities 29.9% 66.5%

Long-term liabilities 45.2% 72.6%

Equity 54.8% 27.4%

Current ratio 249.5% 27.4%

3. How attractive is it to take the trade discount?

On a net basis, the trade discount of 2% is offset by the borrowing rate of 11%. However, since Clarkson's profits are driven by volumes, their line of credit allows them to continue their growth in sales. Based on our calculations, for Clarkson to achieve \$5.5 million in sales in 1996, they

would only be able to purchase 95% of their cost of goods sold from their \$750k credit line.

In the long term, growth in sales will be inhibited by Clarkson's cash balance to purchase Cost of Goods sold. The net income from its sales is not enough to support the requirement to pay the Holtz loan and account for their upward increase in sales.

4. Do you agree with Mr. Clarkson'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 take all the trade discounts?

To achieve \$5.5 million of sales in 1996 and take advantage of all trade discounts, Clarkson will need to borrow approximately \$800k. However, this will impair Clarkson's financials as depicted by the ratios in question 2.

5. What is the "plug" in your financial model? Why did you choose this variable as the plug? Describe in a few sentences and/or equations how you implemented the plug

Debt, because the operating cash flow is not sufficient to generate enough cash for the business.

6. As Mr. Clarkson's financial advisor, would you urge him to go ahead with, or to reconsider, his anticipated expansion and his plan for additional debt financing? As the banker, would you approve Mr. Clarkson's loan request, and, if so, what condition would you put on the loan?

The trade discount will help Clarkson's profitability and allow it to maintain competitiveness with its peers. However, Clarkson's expansion plans seem to be too aggressive based on its balance sheet and ability to provide enough cash on an ongoing basis. We suggest lowering their 1996 sales targets to XXXXXXXXXXXX. The future prospects are good as its net worth continues to increase based on higher profitability through the trade discounts.

From an operational aspect, they should watch the cycle for receipt of payment versus their ability to pay early and enjoy the trade discount. This will allow them to maintain lower inventories and receivables.

As his banker, we would not approve Mr. Clarkson's request unless he agreed to not take additional debt, because his personal net worth is only \$66.5k, so his personal guaranty is not worth much.