2-222-011
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Butler Lumber Company (Abridged)

After a rapid growth in its business during recent years, the Butler Lumber Company in early 1991 anticipated a further substantial increase in sales. Despite good profits, the company had experienced a shortage of cash and had found it necessary to increase its borrowing from the Suburban National Bank to $233,000 at the end of 1990. The maximum loan that Suburban National would make to any one borrower was $250,000, and Butler had been able to stay within this limit only by relying very heavily on trade credit. In addition, Suburban was now asking that Butler secure the loan with its real property. Mark Butler, sole owner and president of the Butler Lumber Company, was therefore looking elsewhere for a new banking relationship where he would be able to negotiate a larger and unsecured loan.

Butler had recently been introduced by a friend to George Dodge, an officer of a much larger bank, the Northrop National Bank. The two men had tentatively discussed the possibility that the Northrop Bank might extend a line of credit to Butler Lumber up to a maximum amount of $465,000. Butler thought that a loan of this size would more than meet his foreseeable needs, but he was eager for the flexibility that a line of credit of this size would provide. After this discussion, Dodge had arranged for the credit department of the Northrop National Bank to investigate Mark Butler and his company.

The Butler Lumber Company had been founded in 1981 as a partnership by Mark Butler and his brother-in-law, Henry Stark. In 1988 Butler bought out Stark's interest for $105,000 and incorporated the business. Stark had taken a note for $105,000, to be paid off in 1989, to give Butler time to arrange for the financing necessary to make the payment of $105,000 to him. The major portion of the funds needed for this payment was raised by a loan of $70,000, negotiated in late 1988. This loan was secured by land and buildings, carried an interest rate of 11%, and was repayable in quarterly installments at the rate of $7,000 a year over the next 10 years.

The business was located in a growing suburb of a large city in the Pacific Northwest. The company owned land with access to a railroad siding, and two large storage buildings had been erected on this land. The company's operations were limited to the retail distribution of lumber products in the local area. Typical products included plywood, moldings, and sash and door products. Quantity discounts and credit terms of net 30 days on open account were usually offered to customers.

Sales volume had been built up largely on the basis of successful price competition, made possible by careful control of operating expenses and by quantity purchases of materials at substantial discounts. Much of the moldings and sash and door products, which constituted significant items of sales, were used for repair work. About 55% of total sales were made in the six months from April

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through September. No sales representatives were employed, orders being taken exclusively over the telephone. Annual sales of $1,697,000 in 1988, $2,013,000 in 1989, and $2,694,000 in 1990 yielded after-tax profits of $31,000 in 1988, $34,000 in 1989, and $44,000 in 1990.[1] Operating statements for the years 1988-1990 are given in **Exhibit 1**.

Mark Butler was an energetic man, 39 years of age, who worked long hours on the job. He was helped by an assistant who, in the words of the investigator of the Northrop National Bank, "has been doing and can do about everything that Butler does in the organization." Other employees numbered 10, 5 of whom worked in the yard and drove trucks and 5 of whom assisted in the office and in sales.

As part of its customary investigation of prospective borrowers, the Northrop National Bank sent inquiries concerning Mark Butler to a number of firms that had business dealings with him. The manager of one of his large suppliers, the Barker Company, wrote in answer:

> The conservative operation of his business appeals to us. He has not wasted his money in disproportionate plant investment. His operating expenses are as low as they could possibly be. He has personal control over every feature of his business, and he possesses sound judgment and a willingness to work harder than anyone I have ever known. This, with a good personality, gives him a good turnover; and from my personal experience in watching him work, I know that he keeps close check on his own credits.

All the other trade letters received by the bank bore out this opinion.

In addition to owning the lumber business, which was his major source of income, Butler held jointly with his wife an equity in their home. The house had cost $72,000 to build in 1979 and was mortgaged for $38,000. He also held a $70,000 life insurance policy, payable to his wife. She owned independently a half interest in a house worth about $55,000. Otherwise, they had no sizeable personal investments.

The bank gave particular attention to the debt position and current ratio of the business. It noted the ready market for the company's products at all times and the fact that sales prospects were favorable. The bank's investigator reported: "Sales are expected to reach $3.6 million in 1991 and may exceed this level if prices of lumber should rise substantially in the near future." On the other hand, it was recognized that a general economic downturn might slow down the rate of increase in sales. Butler Lumber's sales, however, were protected to some degree from fluctuations in new housing construction because of the relatively high proportion of its repair business. Projections beyond 1991 were difficult to make, but the prospects appeared good for a continued growth in the volume of Butler Lumber's business over the foreseeable future.

The bank also noted the rapid increase in Butler Lumber's accounts and notes payable in the recent past. The usual terms of purchase in the trade provided for a discount of 2% for payments made within 10 days of the invoice date. Accounts were due in 30 days at the invoice price, but suppliers ordinarily did not object if payments lagged somewhat behind the due date. During the last two years, Butler had taken very few purchase discounts because of the shortage of funds arising from his purchase of Stark’s interest in the business and the additional investments in working capital associated with the company's increasing sales volume. Trade credit was seriously extended in the fall of 1990 as Butler

[1] Sales in 1986 and 1987 amounted to $728,000 and $1,103,000, respectively; profit data for these years are not comparable with those of 1988 and later years because of the shift from a partnership to a corporate form of organization.

strove to hold his bank borrowing within the $250,000 ceiling imposed by the Suburban National Bank. Balance sheets at December 31, 1988-1990 are presented in **Exhibit 2**.

The tentative discussions between George Dodge and Mark Butler had been about a secured line of credit with a $465,000 limit.[2] The specific details of the loan agreement had not been worked out, but Dodge had explained that it would involve the standard covenants applying to such a loan. He cited as illustrative provisions the requirement that restrictions on additional borrowing would be imposed, that net working capital would have to be maintained at an agreed level, that additional investments in fixed assets could be made only with prior approval of the bank, and that limitations would be placed on withdrawals of funds from the business by Butler. Dodge indicated he expected the initial interest rate to be paid would be about 10.5%. Both men also understood that Butler would sever his relationship with the Suburban National Bank if he entered into a loan agreement with the Northrop National Bank and would, thus, use the proceeds from the new loan to repay his existing loan balance of $233,000 and his long-term debt of $57,000 (= $50,000 + $7,000).

Mark Butler wondered whether he could fund his business with the new $465,000 loan if sales were to grow to $3.6 million in 1991 and increase 25% annually thereafter. For this pro forma analysis, he planned to use a constant, blended tax rate of 25%.

[2] So long as the drawn balance remained below $465,000, this line of credit could be drawn on and paid down repeatedly as long as the loan agreement remained in effect.

Exhibit 1 Operating Statements for Years Ending December 31, 1988-1990.

	1988	1989	1990
Net sales	$1,697	$2,013	$2,694
Cost of goods sold	1,222	1,437	1,950
Gross profit	$ 475	$ 576	$ 744
Operating expense[a]	425	515	658
Interest expense	13	20	33
Net income before taxes	$ 37	$ 41	$ 53
Provision for income taxes	6	7	9
Net income	$ 31	$ 34	$ 44

[a] Operating expenses include a cash salary for Mr. Butler of $75,000 in 1988, $85,000 in 1989, and $95,000 in 1990. Mr. Butler also received some of the perquisites commonly taken by owners of privately held businesses.

Exhibit 2 Balance Sheets at December 31, 1988-1990.

	1988	1989	1990
Cash	$ 58	$ 48	$ 41
Accounts receivable, net	171	222	317
Inventory	239	326	418
Current assets	$468	$596	$776
Property, net	126	140	157
Total assets	$594	$736	$933
Notes payable, bank	$ --	$146	$233
Notes payable, Mr. Stark	105	--	--
Accounts payable	124	192	256
Accrued expenses	24	30	39
Long-term debt, current portion	7	7	7
Current liabilities	$260	$375	$535
Long-term debt	64	57	50
Total liabilities	$324	$432	$585
Net worth	270	304	348
Total liabilities and net worth	$594	$736	$933