**Clarkson Lumber Company Case**

**Meiru Zhong**

**1. Summary of Loan Terms**

Clarkson Lumber Company (Mr. Clarkson) had requested a $750,000 revolving secured loan with a 90-day term from the Northrup National Bank(Mr. Dodge) in the spring of 1996. The agreement would involve the standard covenants applying to such a loan:

* Restrictions on additional borrowing would be imposed;
* Net working capital would have to be maintained at an agreed level;
* Additional investments in fixed assets could be made only with the prior approval of the bank;
* Limitations would be placed on withdrawals of funds from the business by Mr. Clarkson;
* Interest would be set on a floating rate basis at 2 percentage points above the prime rate. And the initial rate to be paid would be approximately 11.0% under conditions in effect in early 1996.

This loan would be used for the following purposes:

* Pay off Mr. Holtz’s note for $200,000 due to the purchase of Mr. Holtz’s interest in the company. This note carried an interest rate of 11%, and was repayable in semi-annual installments of $50,000, beginning Jun 30, 1995;
* Invest additionally in working capital associated with the company’s increasing sales volume;
* Help the company to take full advantage of trade discounts, which were 2% for payments made within 10 days of the invoice date.

**2. 5 C’s of Credit Analysis**

* **Capability:**

The company’s sales volume built up mainly on the basis of successful price competition, made possible by careful control of operating expenses and by quantity purchases of materials at substantial discounts.

Base on the analysis of the historical financial statement, its ROS, ROA, and ROE all experienced a downward trend from 1994 to 1995, which indicates that the firm’s profitability became relatively weak. Moreover, its Account Receivable (A/R) turnover ratio and inventory turnover ratio also decreased during the periods, showing that the company’s ability to collect and make money became slower than before. All of these bore out the fact that Clarkson Lumber Company did not have a strong capability.

* **Collateral:**

Clarkson Lumber Company can use its assets, including real estate, equipment, inventory, and account receivables as collateral.

* **Capital:**

The Total Debt ratio was 73%, which means 73% of funds provided by creditors and 27% provided by shareholders.

* **Conditions:**

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 four large storage buildings had been erected on this land.

Besides, significant items of sales, such as moldings and sash and door products, were used for repair work, which would protect sales from fluctuations in new housing construction due to a general economic downturn.

Through the analysis of the bank, it noted that 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 $5.5 million in 1996 and may exceed this level if prices of lumber should rise substantially in the near future.” Although projections beyond 1996 were difficult to make, the prospects appeared good for continued growth in the volume of Clarkson Lumber’s business over the foreseeable future.

* **Character:**

Keith Clarkson, sole owner and president of the Clarkson Lumber Company, was a 49-year-old but energetic man who worked long hours on the job. He set up a conservative operation of his business, including not wasting money in disproportionate plant investment, keeping operating expenses as low as possible, and having personal control over every feature of the business. Besides, Mr. Clarkson had a good personality, kept a close check on his own credits, and possessed sound judgment and a willingness to work harder than anyone. These good character and strategies give him a good turnover.

In addition to owning the lumber business, Mr. Clarkson held jointly equity in their home with his wife. 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 Mrs. Clarkson. Mrs. Clarkson owned independently a half interest in a house worth about $85,000. Otherwise, they had no sizable personal investments. We can see that Mr. Clarkson actually did not have many personal assets and his personal guarantee might be invalid for the loan.

1. **The Five Competitive Forces**

* **Bargaining Power of Buyers:** Buyers’ power was stronger than that of Clarkson Lumber Company, which could be seemed from two aspects. First, the company’s sales volume built up mainly on the basis of successful price competition, which meant consumers would be attracted because of its lower price. If the price went up a little, the company would lose its position in the market. Second, the firm’s A/R turnover ratio went down during these three years, which means customers delayed longer days than before to pay the bill and it proved that the company was in a disadvantaged status.
* **Bargaining Power of Suppliers:** Suppliers’ power was stronger than that of the company since the company was unable to get the advantage of trade discounts because of the shortage of liquid assets. The trade discount was 2% for payments made within 10 days of the invoice date.
* **Rivalry Among Existing Competitors:** The industry that Clarkson Lumber Company was in was highly competitive, which can be seemed from the price competition adopted by this company. High rivalry limits the profitability of the industry. This could explain why the firm’s annual net profit margin was 2.05% in 1993, 1.96% in 1994, and 1.70% in 1995.

1. **Financial Analysis**

Based on the historical financial statement, Profitability Analysis, Liquidity Analysis, and Leverage Analysis charts are created as below:

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| --- | --- | --- | --- | --- | --- | --- |
| **Profitability Analysis** | **1993** | **1994** | **1995** | **1st Quarter 1996** | **Low-Profit Outlet** | **High-Profit Outlets** |
| COGS ratio | 75.4% | 75.8% | 75.8% | 75.2% | 76.9% | 75.1% |
| Operating expense ratio | 21.3% | 20.6% | 20.8% | 23.0% | 22.0% | 20.6% |
| Return on sales (ROS) | 2.1% | 2.0% | 1.7% | 0.5% | (0.7%) | 4.3% |
| Return on assets (ROA) | 6.5% | 5.9% | 4.7% | 0.3% | (1.8%) | 12.2% |
| Return on equity (ROE) | 11.9% | 18.3% | 17.1% | 1.1% | (14.3%) | 22.1% |

* **COGS ratio and operating expense ratio**: These two indicators remained stable around 76% and 21% respectively during these three years, which showed the company’s conservative policy was useful and effective.
* **ROS and ROA**: These two indicators both experienced a downward trend, decreasing by 0.4% and 1.8% from 1993 to 1995 respectively.
* **ROE**: After increasing by 6.4% between 1993 and 1994, this figure dropped by 1.2% one year later. It shows that the firm’s profitability became relatively weak in 1995 compared with that in 1993.

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| **Liquidity Analysis (Short term)** | **1993** | **1994** | **1995** | **1st Quarter 1996** | **Low-Profit Outlet** | **High-Profit Outlets** |
| Current ratio | 2.5 | 1.6 | 1.2 | 1.16 | 1.31 | 2.52 |
| Cash to sales ratio | 1.5% | 1.5% | 1.2% | 5.0% | 1.3% | 1.1% |

The company’s liquidity also deteriorated during this period.

* **Current ratio**: This figure dropped from 2.5 to 1.2, indicating that the firm’s ability to convert all the current assets to pay off the current liabilities was impaired.
* **Cash to sales ratio**: This value was low at 1.2% in 1995. It’s obvious that Clarkson Lumber Company would face a serious cash flow issue, especially it was in an expansion stage needed substantial investment to support the huge sales.

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| --- | --- | --- | --- | --- | --- | --- |
| **Activity Analysis (Short term)** | **1993** | **1994** | **1995** | **1st Quarter 1996** | **Low-Profit Outlet** | **High-Profit Outlets** |
| Inventory turnover rate | 6.5 | 6.1 | 5.8 | - | - | - |
| Inventory turnover period (days) | 56 | 60 | 63 | - | - | - |
| A/R turnover rate | 9.6 | 8.5 | 7.5 | - | - | - |
| A/R turnover period (days) | 38 | 43 | 49 | - | - | - |

*PS: Credit terms of net 30 days on open accounts were usually offered to customers.*

Clarkson Lumber Company’s efficiency worse off at the same time.

* **Inventory turnover rate/ period**: It’s clear that the company kept a lot of inventory. Its inventory turnover rate had decreased from 6.5 to 5.8 times and the inventory turnover period had increased from 56 days to 63 days between 1993 and 1995. This was a bad sign especially since the sales volume built up mainly on the basis of successful price competition. If the lower price could not attract customers anymore, it’s easy for the company to have substantial backlogs of products, which was also a sign of bankruptcy since it failed in the market.
* **A/R turnover rate/ period**: Clarkson Lumber Company had credit terms of net 30 days, indicating that the client needs to pay up to 30 calendar days (not business days) after they have been billed. But in 1995 its A/R turnover rate was about 7.5 times and the account receivables turnover period was about 49 days, which was longer than not only the net 30 days but also that figure in previous years (38 days in 1993 and 43 days in 1994). This indicates that the company had a slow collection, long aging, and time mismatch issues, which were not conducive to the company’s future production and operation activities and may even impact its ability to repay the loan on time.

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| **Leverage Analysis (Long term)** | **1993** | **1994** | **1995** | **1st Quarter 1996** | **Low-Profit Outlet** | **High-Profit Outlets** |
| total debt ratio | 45% | 68% | 73% | 72% | 88% | 45% |
| debt-equity ratio | 0.82 | 2.11 | 2.65 | 2.58 | 7.00 | 0.82 |

It’s apparent that the company’s financial situation had deteriorated, and its financial risk was very high since its total debt ratio increased from 45% to 73% and its debt to equity ratio went up from 0.82 to 2.65 during 1993-1995.

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| **Cash Flow Statement (thousands of dollars)** | | |
| **CFO** | **1994** | **1995** |
| Net income | 68 | 77 |
| Depreciation | 0 | 0 |
| Change in Account Receivables | -105 | -195 |
| Chang in Inventory | -95 | -155 |
| Chang in Accounts Payables | 127 | 36 |
| Chang in Accured Expenses | 3 | 30 |
| Change in Notes Payables | 0 | 0 |
| Change in Trade Payables | 0 | 127 |
| Total CFO | -2 | -80 |
|  |  |  |
| **CFI** |  |  |
| Change in PP&E | -29 | -126 |
| Total CFI | -29 | -126 |
|  |  |  |
| **CFF** |  |  |
| notes payable from bank | 60 | 330 |
| term loan | -20 | -20 |
| notes payable from Mr. Holtz | 0 | -100 |
| Dividend paid to shareholders | 0 | 0 |
| Total CFF | 40 | 210 |
|  |  |  |
| **Change in CF** | **9** | **4** |
| Beginning Cash | 43 | 52 |
| Ending Cash | 52 | 56 |

Based on the historical balance sheet and income statement, the cash flow statement from 1994 to 1995 is created as above. Although Clarkson Lumber Business experienced rapid growth during recent years, its total cash flow from operation was negative in this period, indicating that the firm just burned the money and its business was not sustainable. The net cash flow for these two years was positive because the company had a large amount of accounts and notes payable in the past two years, especially in 1995 and in the spring of 1996.

1. **Recommendation**

As a banker, I will not approve Mr. Clarkson’s loan request. Although Clarkson Lumber Company had a long history and Mr. Clarkson was a good talent, the company had a lot of issues that needed to fix before the loan was made, especially the problems about the deteriorated financial situation. Even though sales are expected to reach $5.5 million in 1996 increased by 22% compared with that figure in 1995 and even exceed this amount, its return on sales might still decrease due to the stable cost proportion and more interest expenses if the loan is permitted. From the past two years' cash flow statement, we can see the firm doesn’t make money from operations to sustain its business and expansion but mainly get money from the short-term loan (Note Payable), which represents its poor cash management.

Although the firm can use its fixed assets, account receivables, and inventory as collateral to mitigate the credit risk, the net property values ($384,000 in 1995) are lower than the loan value ($750,000). The collection and conversion of account receivables and inventory include lots of uncertainty and even will be impaired, leaving the asset values far less than the original one.

The company plans to expand the scale and invest more in its working capital but the industry is very competitive and its growth is very slow, which shows the company’s poor operation management. Besides, Mr. Clarkson actually does not have many personal assets and his personal guarantee may be invalid for the loan. Therefore, the bank shouldn’t take the risk of giving the company a loan.