Atlantic Lumber Traders

On April 20, 1989, Lynne Thomas put down the phone and looked at the notes before her. Gad Hall, one of the owners of Atlantic Lumber Traders, had just given Lynne the final details she needed. As credit assistant to Harry Sarson of the Maritime Bank in Saint John, New Brunswick, Lynne had been asked to review the file of Atlantic Lumber Traders. Her job was to decide if Gail Hall's explanation of what had gone wrong was plausible, then to predict risks to the bank under various projections of the company's future. Finally, Lynne was to make recommendations for action by the bank In the worst instance, if a turnaround was not possible, it was Lynne Thomas's job to recommend the best course for the orderly wind-up of Atlantic Lumber Traders.

The file indicated that Atlantic Lumber Traders had been established in 1983 in Saint John to wholesale lumber in the Atlantic provinces. Major shareholders were brother and sister Edward and Gail Hall, members of a wealthy and respected family with a long entrepreneurial history in New Brunswick.

After four years of profitable operations, the company showed an operating loss of $219,666 and a not loss of $174,216 on sales of $17 million for the year ending December 31, 1988. This loss was an urgent concern to the Halls and to the Maritime Bank which had extended the company a $1.3 million revolving line of credit (at prime plus 1%).

When the third quarter results were in, Gaff Han felt she needed to personally take charge of the company. In October of 1988 she therefore put aside her lucrative law practice (she had netted $140,000 in 1988) to devote her full attention to the company. She first had to identify its main problems, then take corrective action.

Company History

Edward and Gaff Hall, both lawyers in their mid-thirties, had set up Atlantic Lumber Traders in 1983 to wholesale lumber. Atlantic Lumber Traders had sales territories in the four Atlantic Provinces, Quebec and Ontario and, secondarily, in the United States. Approximately 80% of sales were generated in the Atlantic Provinces, 19% in Quebec and Ontario and I % in the United States. Shares had been owned by Edward and Gail, and also by David Lawson, who had managed the company until October 1988. At that time he was released and Edward and Gail had purchased his shares for one dollar. Lawson was blamed for the company's poor performance in late 1987 and 1988. The Halls, however, admitted they should have been more involved.

With the exception of 1988, the operation had enjoyed significant sales increases from $3 million for the first year of operation (1984), to $19 million for fiscal 1987 (Exhibit 2). Net income had reached a high of $128,000 (after a $48,000 loss from a rental operation). The rental operation consisted of two sixteen-unit apartment buildings acquired by the company in 1987. The rental operation loss was intended to offset income from the lumber operation. During 1988, due in part to the poor performance of Atlantic Lumber traders, the rental property was sold (at book value) to another company operated by the Halls. According to Gail, the rental operation now broke even because she stepped in, did some refurbishing, changed property managers and thus increased occupancy.

The lumber operation was straightforward. At the end of 1988, Atlantic Lumber Traders had a sales team of four - three full-time traders and a general manager who did some selling - to wholesale lumber to a customer base of 50- 100 large retailers. The sales staff were paid a commission of 1.8% and the mark-up ranged between 4.5% and 5.5%. No inventory for the bulk of sales was required, as orders were placed with the mills as received and wood was transported from the mill directly to the purchaser. Atlantic Lumber Traders had a small administrative staff of two to three people to handle accounting. Terms with most mills were net ten days, with an average collection period on receivables of 22 days in 1987 (37 days for the Industry, see Exhibit 3). The company thus needed to finance about 40 days' sales on average, which required a large capital base. A small inventory of uncommon lengths was maintained for special orders; approximate inventory value was $200,000.

During 1988, David Lawson had speculated on purchases both for resale and inventory, which at one point, exceeded $600,000. In making these purchases, for which there was no firm order, Lawson had attempted to take advantage of swings in market prices.

During 1987 and 1988 the number of employees had reached a high of eleven, with the office staff of six exceeding the sales force of five. To satisfy customers, Lawson had sold lumber in irregular lots, rather than follow the industry practice of requiring customers to buy full lots. As a result, the company was left with a considerable stock of less popular lengths, which required a write-down in inventory once this practice was discovered.

According to Gail Hall, these practices ended when she took over the day-to-day operation of the company. Her efforts produced a small profit of $16,000 for the first quarter of 1989. According to her, this showed that the company had turned around because the first quarter of the year was traditionally the company's worst.

The Principals in the Company

Although Atlantic Lumber Traders was founded in 1983, the Hall family had been involved in the wood/lumber industry for more than half a century. Hall Investments Ltd. a holding company set up in 1984 by Edward and Gail, had two wholly owned subsidiaries, one in transportation and the other in a lumber related business. The companies dealt with all the major banks. The Halls felt they knew the lumber industry, and that they had the required contacts to generate substantial sales. Edward Hall had never taken an active role in the business and Gail agreed she neglected it in favour of her law practice. Gail appeared knowledgeable and was prepared to assist in a sales effort if necessary.

Because the Halls were very influential in the Now Brunswick marketplace, Lynne knew that her boss, Harry Sarson, wished to maintain their goodwill. However he also wanted to ensure the safety of the bank's investment.

The Banker's Risk Assessment of the Company in April 1989

Lynne Thomas identified four areas where the company significantly risked the bank's capital: (1) operating losses sustained to date; (2) debt to equity at 17:1 for year-end 1988, down to 4:1 when subordinated loans[1] and liquid security were included for the first quarter of 1989; (3) competition; and (4) inability to sustain any further losses.

[1] Subordinate to the bank debt. Also called a postponement of shareholders' claims. In this case the Halls had injected $200,000 (a subordinated shareholders' loan) into the company since year-end 1988.

According to Lynne, there were mitigating circumstances for each risk factor. The improvement in performance since year-end 1988 seemed to indicate that problem areas had been identified and corrected. In-house financial statements were monitored closely by Gaff Hall. Lynne did not consider the Canada-US Free Trade Agreement a significant risk; Gail assured her it would have little impact on the 1% of company sales to the US.

Personal guarantees in the amount of $316,000 from the Halls partly offset the debt to equity position.

Atlantic Lumber Traders had an established client base.; the Hall name had been synonymous with lumber for over fifty years. Lynne felt that reluctance to tarnish the Hall family name would prompt Gail to cooperate with the bank. Gaff had indicated that to forestall losses, she would close down operations if there was any sign of a downturn.

Economic Forecast

As part of her background analysis of the business, Lynne had reviewed the economic forecast prepared by the bank's Economics Department in early 1989. The forecast surveyed leading economic indicators, and showed that the economy would begin to slow down during the second quarter. Ile bank's economists believed that interest rates would remain high as long as John Crow, Governor of the Bank of Canada, tried to reduce inflation.

The economic report argued that the Canadian dollar was overvalued relative to the US dollar as a result of high interest rates, and the unusually wide spread in interest rates between the two currencies. The Canadian dollar was expected to fall to around 81 cents US by the end of 1989.

An economic slowdown was also forecast for the Atlantic region. This would have a negative effect on Atlantic Lumber Traders' sales. The Goods and Services Tax (GST) was to come into effect in January 1991, and because of additional record keeping costs, was expected to have a significant impact on this low margin industry.

Industry Scan

Lumber traders' customers were usually independent supply stores, general contractors working on large projects (cutting out the middleman), or large end users such as mobile home manufacturers.

Without the service that a lumber trader provided, the customer (wholesaler or retailer) would have to go through a time consuming process to purchase lumber. Wholesalers and retailers avoided the time necessary to purchase directly from the sawmill or to purchase partial loads by giving up a percentage of gross margin (usually 5% to 6%) to have the purchasing done by lumber traders.

Lumber traders needed experience. to buy at low cost and to know which sawmills were producing given species, dimensions and grades of lumber at any given time. It was also important to know the reputation for quality and reliability of each mill. The trader also had to arrange for transportation of lumber from the mill to its destination. If a purchaser did not want a full load, as was often the case, the cost of transporting a partial load could make the order uneconomical. Low cost was a critical factor in the lumber business because it operated on low margins.

There were risks inherent in the lumber trading business; the most significant was bad debts. The trader was responsible for paying the mill regardless of whether the customer paid on time, late or not at all. If the customer did not pay, the resulting loss could bankrupt the trader. The trader also had the responsibility to deliver the stated quantity and quality of product on time. Buying off-grade lumber or having late deliveries could hurt customer relations and affect receivables collection.

Ile Atlantic provinces constituted the major market of Atlantic Lumber Traders; this market consumed approximately 1.2 billion board feet of lumber per year. The company's market share was about 5% in a fiercely competitive industry where they competed with other well established families and interests such as the Irvings, another influential New Brunswick family. Atlantic Lumber Traders had to recover quickly if they were to maintain their competitive position.

Environmental factors could negatively affect the supply of lumber. Spruce budworm damage and the controversial forest spraying program had hurt the public image of the forestry industry and the profits of individual companies. Also, sawmills recognized the need to control pollution and the costs of doing so would be passed on to customers. This would put additional pressure on lumber traders' margins, and might cause some customers to deal directly with mills to reduce costs.

The Situation in April 1989

Since year-end 1988 the Halls had injected an additional $200,000 into Atlantic Lumber Traders and the bank had reduced the available line of credit from $1.3 to $1 million. The availability of funds under the operating line of credit was subject to a maximum of: 75%

of the bank's valuation of assigned accounts receivable after deducting receivables 60 days or more past due; plus 50% of the bank's valuation of free and clear assigned inventory to a maximum value of $125,000. 'Me bank asked for, and received, a Section 178 lien over inventory in March 1989. The lein effectively meant that if the company failed, the goods covered by the loin could be liquidated only against the debt owed by the company to the bank, and not to other creditors. The bank also had an assignment of book debts (accounts receivable).

Action taken by Gail Hall included reducing staff from eleven to six. The inefficient in-house accounting system was replaced by a simple, effective computer program. Sales personnel were put on commission only and lost their commission on accounts unpaid after 60 days. Inventory levels were cut from the $500,000-$850,000 range to below $ 150,000. According to Gail, these changes went a long way toward reestablishing profitability.

With its reduced staff, the company expected to sell about $10 million of lumber in 1989, compared to $16.9 million in 1988. A gross margin of 5% was expected for 1989. Based on past performance, on the company's budget for 1989 and on industry benchmarks, Lynne projected variable costs for a wholesale lumber company at about 3% of sales. She also estimated that fixed costs for the company were between $14,000 and $15,000 per month. She used her estimates to calculate breakeven sales levels and then prepared a spreadsheet to determine the combined effect (on breakeven sales and net income) of changing each of her estimates in turn - recalculating with gross margin, variable costs, and fixed costs above and below the expected values.

The Alternatives for Management and the Bank

At their last meeting, Gail had given Lynne a proposal. Based on the improvements since year end, Gail hoped to negotiate an increase in the line of credit from $1 to $1.4 million. This would allow for increased sales to about $14.5 million rather than the $10 million expected. Based on historical sales and the improvements in the first quarter, Gail felt this figure more clearly reflected the ability of the company. According to Gail there was space available in the office for another trader, and the administrative capacity to support the added business. She pointed out that past history had shown the market could support the higher sales. Therefore, if the main constraint of working capital was overcome, Gail felt that Atlantic Lumber Traders was a viable operation.

A more conservative plan, already in the back of Lynne's mind, consisted of two parts: (1) increase the interest rate by I % (cost to the company $10,000 per year) to cover additional monitoring costs, and (2) eliminate the margin available on inventory (50% up to $ 125,000). Besides covering the additional costs incurred in monitoring the account, this plan would reduce the bank's exposure. The lost margin on inventory would have a direct effect on the sales potential for Atlantic Lumber Traders.

Lynne knew that at worst, she could recommend that the Halls close down their operations in an orderly fashion, one sales territory at a time, so that they and the bank would recover their investments.

Final Preparations

Lynne took a mouthful of coffee and turned to her computer to prepare the report Harry needed before tomorrow morning's meeting with Gail Hall. She knew that since Gail Hall's efforts had resulted in some improvement in company performance in the first quarter of 1989, and Gail had cooperated with the bank in its review, calling the loan was not an option at this point.

Exhibit 1
Atlantic Lumber Traders
Balance Sheet($000s) – December 31

	1985[1]	1986[2]	1987[2]	1988[2]
Assets				
Current				
Cash	$ 0	$ 0	$ 0	$ 0
Trade Receivables (Net)	645	938	1,174	688
Other Receivables (Net)	2	39	79	101
Inventory	99	184	570	262
Prepaid Expenses	0	0	12	5
Due from Shareholders	0	33	0	0
Income Tax Refund	0	0	1	71
Total Current Assets	746	1,194	1,836	1,127
Fixed Assets				
Land & Buildings	0	0	1,150	0
Equipment & Machinery	6	6	58	19
Leasehold Improvements	9	9	10	13
Accumulated Depreciation	(4)	(6)	(69)	(20)
Total Fixed Assets	11	9	1,149	12
Other Assets				
Intangible Assets	18	0	0	0
Investments in/Due from	0	60	180	0
Deferred Gtee Charges	0	0	11	0
Notes Receivable	0	0	0	328
Total Other Assets	18	60	191	328
Total Assets	$ 775	$1,263	$3,176	1,467
Liabilities & Shareholder Equity				
Current Liabilites				
Bank	$ 471	$ 668	$ 985	$ 886
Trade Payables	207	425	933	467
Income Tax Payable	14	11	0	0
Current Portion LTD	12	12	44	0
Total Current Liabilities	704	1,116	1,962	1,353
Long Term Liabilities				
Bank LTD	29	17	501	0
Other LTD to related Co. 1	0	0	225	0
Other LTD to related Co. 2	0	0	200	0
Due to Shareholders[3]	0	0	30	30
Total LT Liabilities	733	1,133	2,918	1,383
Total Liabilities				
Shareholder Equity				
Common Shares	1	1	1	1
Retained Earnings	41	129	257	83
Total Shareholder Equity	42	130	258	84
Total Liabilities & Shareholder Equity	$ 775	$1,263	$3,176	$1,467

[1] Unaudited.
[2] Audited.
[3] Deferred.

Source: Company records and bank files.

Exhibit 2
Atlantic Lumber Traders
Income Statement ($000s)
Year Ended December 31

	1985[1]	1986[2]	1987[2]	1988[2]
Sales	$ 7,507	$12,540	$19,049	$16,853
Cost of Goods Sold	7,148	11,936	18,121	16,095
Gross Profit	359	604	928	758
Operating Expenses				
Depreciation	2	2	4	9
Bad Debt Expense	12	3	2	16
Interest Expense	31	54	82	130
Salaries	102	237	419	489
Telephone	42	60	94	100
Travel	25	46	80	66
Rent	12	16	18	20
Start-up Costs (Amortization)	18	0	0	0
Other[3]	29	76	85	46
Total Operating Expenses	273	494	784	876
Operating Income (Loss)	86	110	144	(118)
Other Income (Expense)				
Rental Division Loss	0	0	(48)	(102)
Affiliated Company	0	0	54	22
Miscellaneous	4	0	0	0
Income (Loss) Before Tax	90	110	150	(198)
Income Taxes (Recovery)	14	22	32	(46)
Extraordinary Gain (Loss)	0	0	10	(22)
Net Income (Loss)	$ 76	$ 88	$ 128	$ (174)
Opening Retained Earnings	(35)	$ 41	$ 129	$ 257
Closing Retained Earnings	$ 41	$ 129	$ 257	$ 83

FINANCIAL STATEMENT COMMENTS: Sales down $2,200M from previous year due to internal management problems and restructuring. Loss incurred ($174M), after Income Tax recovery ($46M) and extraordinary loss on sale of investment in associated company ($22M). This loss attributed to drop in gross margin of 0.4% ($75M) due to inefficient purchasing by previous manager, i.e. inventory purchased on speculation, then disposed at less than normal margin. This area now under control of owners, who now manage. Total expenses up 1.1% ($185M) due to excessive spending on nonessential items (expense accounts, administration staff, etc). Since year end, five staff released and all expense items reduced to essential (sales do not seem to have suffered to date).

[1] Unaudited.
[2] Audited.
[3] Selling, general and administrative expenses.

Source: Company records and bank files.

Exhibit 3
Atlantic Lumber Traders
Selected Industry Ratios

	Industry Ratios 1987
Liquidity	
Current Ratio	1.50
Quick Ratio	0.70
Average Collection Period	36.80
Average Payment Period	10.55
Sales/Working Capital	14.90
Leverage Ratios	
Debt to Equity	2.10
Debt to Tangible Net Worth	2.10
Net Fixed Assets /TNW	0.51
Coverage Ratios	
EBIT/Interest	2.50
Profitability Ratios (%)	
Gross Profit/Sales	5.00
Gross Cash Profit/Sales	3.00
Profit Pre-Tax/Sales	2.58
Net Profit/Sales	2.30
Profit Pre-Tax/Total Assets	5.30

Source: Bank files

This case was prepared by Gordon S Roberts, of Montreal Professor of Finance and Linda P Hendry, Finance Lecturer at Dalhousie University for the Atlantic Entrepreneurial Institute as a basis for classroom discussion, and is not meant to illustrate either effective or ineffective management. Some elements of this case have been disguised.