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LAWSONS

Peter Farrell wrote this case under the supervision of Richard H. Mimick solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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"I think I have all the information needed for your request Mr. Mackay. Give me a couple of days to come up with a decision and I'll contact you one way or another — good day!" So said Jackie Patrick, a newly appointed loans officer for the Commercial Bank of Ontario. She was addressing Paul Mackay, sole proprietor of Lawsons, a general merchandising retailer in Riverdale, Ontario. He had just requested a $194,000 bank loan to reduce his trade debt, as well as a $26,000 line of credit to service his tight months of cash shortage. Jackie felt she was fully prepared to scrutinize all relevant information in order to make an appropriate decision. Her appointment as loans officer, effective today, February 18, 2013, was an exciting opportunity for her as she had been preparing for this position for some time.

LAWSONS

Lawsons had been operating in Riverdale for nearly five years. Mackay felt that his store stressed value at competitive prices, targeting low to middle income families. The store offered a wide range of products in various categories such as:

- infants', children's and youths' wear
- ladies' wear
- men's wear
- accessories (footwear, pantyhose, jewellery, etc.)
- home needs (domestics, housewares, notions, yarn, stationery)
- toys, health and beauty aids
- seasonal items (Christmas giftwrap and candy)

To help finance the start up of the business in 2008, Mackay secured a long-term loan from the Commercial Bank of Ontario at the prime lending rate plus 1.5 per cent. As Mackay's personal assets were insufficient for security, the bank loan had been secured by a pledge against all company assets, and by a guarantee from Lawsons' major supplier, Forsyth Wholesale Ltd. (FWL).

Mackay's store, with the exception of its first partial year, had always generated positive earnings. However, after drawings, Mackay's equity in the firm decreased each year to its present level of

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($18,914). Exhibits 1, 2, and 3 present Lawsons' statements of earnings, balance sheets and selected financial ratios. Exhibit 4 presents selected industry ratios.

PURCHASING PROCEDURES

Mackay purchased most of his inventory from FWL, a wholesaler who dealt in the product categories and merchandise that Mackay stocked in his store. Other stock, not supplied through FWL, was purchased directly from local suppliers. Through an arrangement with FWL, Mackay made his merchandising decisions at two annual trade shows in May and October. At the May show, Mackay decided on back-to-school supplies, Christmas merchandise, and fall and winter clothing. Spring and summer merchandise was decided upon at the October show. FWL's purchasing agents accumulated all of the orders from the various retailers it dealt with and, as a large buying group, executed the orders and negotiated prices with the manufacturers. The merchandise was sent to FWL from the individual manufacturers and then was distributed to respective retail outlets, such as Lawsons. FWL required partial payment for this merchandise before the start of the particular selling season. The remainder was due in scheduled repayments throughout the selling season. Mackay was pleased with this arrangement that he had secured with FWL. He was convinced that his product costs were lower as a result.

PAUL MACKAY

Paul Mackay was 40 years old. He had immigrated to Canada in 2007 from his native England, where he had been employed by an insurance company as an accountant. Educationally, Mackay had completed a Business Economics degree at a military academy. When Mackay came to Canada, he admitted that he was unsure about what recognition he would receive for his previous labours, both corporate and educational. Consequently, Mackay embarked upon an entrepreneurial career. Candidly, Mackay expressed, "I knew I wouldn't be satisfied in some corporate hierarchy — I knew I needed to be in business for myself." In May 2008, a retail vacancy became available in Riverdale. Mackay seized this opportunity to turn his dream of independence into a reality, and opened Lawsons with the financial backing of FWL.

Mackay was an active resident of Riverdale, often involving himself in community activities. He worked long hours at his store, performing both managerial and clerical duties. Frequently, Mackay could be seen in his store pricing and stocking goods, or bagging merchandise at the cash register.

THE PROBLEM

Low earnings and necessary owner withdrawals had contributed to Mackay's increasing trade debt. Past due amounts on trade debt were charged a penalty of 13.5 per cent interest. Mackay indicated that of the present $217,236 in trade debt, he was paying penalty interest on $193,668. All of the overdue trade debt was owed to FWL. It was this overdue debt that had prompted his loan request. Mackay knew that, if he could transfer this trade debt to some other form of debt with lower interest charges such as the requested bank loan, profitability could be increased. Mackay indicated that the current portion of the trade debt would be an acceptable amount to carry for this time of year, which he estimated to be 17 days of purchases.

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The total trade debt had increased to its present level in fiscal 2013 when Mackay decided that additional retail space would increase sales volume. Mackay felt that his store size was too small to effectively display product lines and, therefore, decided that the expansion was a necessary step in the store's turnaround. Additional furniture, fixtures, and leasehold improvements totalled $36,000, which was financed by FWL and added to Mackay's trade debt. Mackay explained that FWL financed the improvements at Lawsons because it was interested in Mackay improving to the point where he could start paying off the trade debt owed to it. At the time of the expansion, FWL's financial director stated, "If this expansion is a means towards debt repayment, and I believe it is, FWL is committed to financing the expansion." To go along with this capital expenditure, a greater investment in inventory was needed. Sales results in 2013 indicated to Mackay that the expansion was helping to improve sales volume.

Mackay believed that with his purchasing arrangements with FWL, a seasonal line of credit was necessary, so that he could manage the months with tight cash positions. February through June were months of cash outflows with the total cumulative cash outflows peaking at about four per cent of sales. Lawsons would therefore require the equivalent of four per cent of sales in extra cash during cash outflow periods.

PROJECTIONS

Mackay did not anticipate any additional capital expenditures for some time, given the just-completed expansion. Sales growth of 10 per cent in each of the next two years was projected. With respect to interest charges, Mackay calculated that if less expensive debt could be found, Lawson's interest expense for all debt, including the proposed line of credit, would be $27,500 and $26,920 for 2014 and 2015, respectively. Store salaries were to remain constant as a dollar amount because of improved employee productivity. Mackay realized he had a great deal of money tied up inventory, but he hoped that, as he gained greater experience in handling the added sales volume, inventory could be reduced to pre-2013 levels. With respect to drawings, Mackay explained that due to his depleted savings, future withdrawals from the firm would be at the 2013 level.

JACKIE PATRICK

Patrick had hoped that her first loan request in her new position would be straightforward. However, a closer look indicated that this request would certainly require careful attention and scrutiny. She suspected her superiors would be reviewing her first series of recommendations carefully, given her newness in the position

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Exhibit 1

STATEMENTS OF EARNINGS
for the Years Ending January 31

	2013	2012	2011	2010
Sales	$ 650,210	$ 526,332	$ 507,778	$ 425,398
Cost of goods sold	467,510	383,948	368,356	305,748
Gross profit	$ 182,700	$ 142,384	$ 139,422	$ 119,650
Operating expenses:				
Store salaries	$ 44,578	$ 41,234	$ 38,154	$ 29,818
Heat and utilities	8,888	8,524	7,022	7,324
Building maintenance and repairs	362	508	406	338
Rent and property tax	23,992	24,710	28,364	28,364
Insurance and taxes	6,922	3,454	4,708	5,934
Depreciation:				
Furniture and fixtures	7,828	2,952	3,570	6,374
Leaseholds	3,176	484	160	—
Other operating expenses	27,692	26,112	23,840	14,016
Interest:				
Long-term debt	8,418	9,280	11,332	11,418
Trade debt	29,570	11,476	5,954	4,724
Total expenses	$ 161,426	$ 128,734	$ 123,510	$ 108,310
Net earnings	$ 21,274	$ 13,650	$ 15,912	$ 11,340

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Exhibit 2

BALANCE SHEETS
as at January 31

	2013	**2012**	**2011**	**2010**
ASSETS				
Current assets:				
Cash	$ 9,664	$ 3,960	$ 2,798	$ 2,596
Accounts receivable	12,028	4,824	2,344	2,278
Inventory	199,700	153,628	140,792	121,218
Prepaids	3,760	3,002	3,162	2,786
Total current assets	$ 225,152	$ 165,414	$ 149,096	$ 128,878
Fixed assets:				
Furniture and fixtures, cost	$ 61,200	$ 34,792	$ 32,164	$ 32,164
Less: accumulated depreciation	28,662	20,836	17,884	14,314
Net furniture and fixtures	$ 32,538	$ 13,956	$ 14,280	$ 17,850
Leaseholds, cost	$ 16,174	$ 6,798	$ 1,200	$ —
Less: accumulated depreciation	3,820	644	160	—
Net Leaseholds	$ 12,354	$ 6,154	$ 1,040	$ —
Total fixed assets	$ 44,892	$ 20,110	$ 15,320	$ 17,850
Intangibles	—	—	—	84
Total Assets	$ 270,044	$ 185,524	$ 164,416	$ 146,812
LIABILITIES AND PROPRIETOR'S CAPITAL				
Liabilities				
Current liabilities:				
Accounts payable	$ 217,236	$ 106,494	$ 71,286	$ 43,392
Other current liabilities	2,450	270	934	—
Total current liabilities	$ 219,686	$ 106,764	$ 72,220	$ 43,392
Long-term bank loan	68,872	76,168	$ 83,464	89,836
Total liabilities	$ 288,558	$ 182,932	$ 155,684	$ 133,228
Proprietor's Capital				
Balance, beginning of year	$ 2,592	$ 8,732	$ 13,584	$ 21,152
Add: net earnings	21,274	13,650	15,912	11,340
Subtotal	$ 23,866	$ 22,382	$ 29,496	$ 32,492
Less: drawings	42,380	19,790	20,764	18,908
Balance, end of year	$ (18,514)	$ 2,592	$ 8,732	$ 13,584
Total Liabilities and Proprietor's Capital	$ 270,044	$ 185,524	$ 164,416	$ 146,812

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Exhibit 3

RATIO ANALYSIS

	2013	2012	2011	2010
PROFITABILITY				
Vertical analysis:				
Sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	71.9%	72.9%	72.5%	71.9%
Gross profit	28.1%	27.1%	27.5%	28.1%
Operating expenses:				
Store salaries	6.9%	7.8%	7.5%	7.0%
Heat and utilities	1.4%	1.6%	1.4%	1.7%
Building maintenance and repairs	0.1%	0.1%	0.1%	0.1%
Rent and property tax	3.7%	4.7%	5.6%	6.7%
Insurance and taxes	1.1%	0.7%	0.9%	1.4%
Depreciation:				
Furniture and fixtures	1.2%	0.6%	0.7%	1.5%
Leaseholds	0.5%	0.1%		
Interest:				
Long-term debt	1.3%	1.8%	2.2%	2.7%
Trade debt	4.6%	2.2%	1.2%	1.1%
Other operating expenses	4.3%	5.0%	4.7%	3.3%
Total operating expenses	25.1%	24.6%	24.3%	25.5%
Net earnings	3.3%	2.6%	3.2%	2.6%
Return on equity	N/A	241.1%	142.6%	83.5%
LIQUIDITY				
Current ratio	1.02:1	1.55:1	2.06:1	2.97:1
Acid test ratio	0.10:1	0.08:1	0.07:1	0.11:1
Working capital	$5,466	$58,650	$76,876	$85,486
EFFICIENCY (Based on 365-day year)				
Age of receivables	7 days	3 days	2 days	2 days
Age of inventory	156 days	146 days	140 days	145 days
Age of payables[1]	154 days	98 days	67 days	55 days
Fixed asset turnover	20.0X	29.7X	30.6X	23.8X
STABILITY				
Net worth/total assets	N/A	1.4%	5.3%	9.3%
Interest coverage	1.6X	1.7X	1.9X	1.7X

	2012-13	2011-12	2010-11
GROWTH			
Sales	23.5%	3.7%	9.4%
Net profit	55.9%	(14.2%)	40.3%
Total assets	45.6%	12.8%	12.0%
Net worth	N/A	(70.3%)	(35.7%)

[1] *Aging is based on purchases, which are equal to cost of goods sold plus ending inventory less beginning inventory.*

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Exhibit 4

DUN & BRADSTREET CANADIAN NORMS & KEY BUSINESS RATIOS
Industry: Retail — Miscellaneous Products

	2012
PROFITABILITY	
Net earnings	2.1%
Return on equity	31.6%
LIQUIDITY	
Current ratio	1.8:1
Acid test	1.1:1
EFFICIENCY	
Age of receivables	9.1 days
Age of inventory	125.7 days
STABILITY	
Net worth: Total assets	61.5%

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Exhibit 5

STATEMENT OF CASH FLOWS
for the year ending January 31

	2013	2012	2011
OPERATIONS:			
Net Income	$ 21,274	$ 13,650	$ 15,912
Adjustments to Cash Basis:			
Depreciation – Furniture and fixtures	7,828	2,952	3,570
Depreciation – Leasehold improvements	3,176	484	160
Accounts receivable	(7,204)	(2,480)	(66)
Inventory	(46,072)	(12,836)	(19,574)
Prepaids	(758)	160	(376)
Accounts payable	110,742	35,208	27,894
Net cash flow from operations	$ 88,986	$ 37,138	$ 27,520
FINANCING ACTIVITIES:			
Other current liabilities	$ 2,180	$ (664)	$ 934
Long term bank loan	(7,296)	(7,296)	(6,372)
Drawings	(42,380)	(19,790)	(20,764)
Net cash flow from financing activities	$ (47,496)	$ (27,750)	$ (26,202)
INVESTING ACTIVITIES:			
Furniture and fixture purchases	$ (26,410)	$ (2,628)	$ 0
Leasehold improvements	(9,376)	(5,598)	(1,200)
Intangibles	0	0	84
Net cash flow from investing activities	$(35,786)	$ (8,226)	$ (1,116)
Net cash flow	$ 5,704	$ 1,162	$ 202
Beginning cash	$ 3,960	$ 2,798	$ 2,596
Ending cash	$ 9,664	$ 3,960	$ 2,798

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