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MOUNTAINARIOUS SPORTING CO.

Julie Harvey revised this case, originally prepared by Jeff Murray, under the supervision of Elizabeth M.A. Grasby 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.

It was early February 2007 when Brad MacDougall, account manager at the Canadian Commercial Bank (CCB) in Barron, Ontario, reviewed a loan request for $150,000 from longtime client and friend Steven Donnie. As owner of Mountainarious Sporting Co., an outdoor apparel and sporting goods retailer, Donnie had requested the long-term loan to cover construction costs associated with a major alteration to the store's existing layout. Donnie had also requested an increase in the business's line of credit to $100,000 to fund additional inventory purchases intended for sale in the new store space. The company's financial statements had recently been sent to MacDougall (see Exhibits 1 to 5). He knew he had to be thorough in his analysis and come to a decision quickly because Donnie wanted to have the renovation completed in time for the spring sporting goods season.

COMPANY BACKGROUND

The Early Years

Steven Donnie entered the sporting goods business in 1994 when he purchased Dave's Sport and Camera Shop, located on the main street of Barron, Ontario, a township approximately 100 kilometres northeast of a large metropolitan city. Barron was the largest and fastest growing industrial centre in its region with a current population of 135,000. At that time, Donnie renamed the store, Steve's Outdoor Equipment Co., but maintained a wide-ranging stock of cameras, hunting guns and ammunition, fishing equipment and, in winter months, hockey equipment.

Over the next five years, Donnie continued to carry hockey equipment in the winter months and added other seasonal items such as cross-country skies, snowshoes and winter apparel. In the summer, he shifted his merchandise to mountain bikes, in-line skates, camping equipment and rock-climbing gear. By 1999, Donnie had dropped cameras, hunting guns and ammunition from his store entirely because he thought these products were no longer an appropriate fit for the store.

Donnie also attempted to develop the team sport market by offering uniforms and crested clothing along with sports trophies, but he experienced mixed success with this line of merchandise. To bolster sales, he launched an aggressive promotion campaign in the local sports community through sponsorships of teams and discounts offered to coaches and minor sports organizations; however, sporting equipment and apparel continued to dominate sales.

2002 to Present

In 2002, Donnie faced a significant setback to the establishment of his client base when a fire destroyed his store. By 2003, however, he was able to re-establish the business at a new location, remaining in the busy downtown core of the original store. To supplement the business's income, he rented a 1,100-square-foot area to another independently owned retailer, *Doug's Guns and Ammunition*. The area was partitioned from Donnie's sporting goods store, although it remained connected. Finally, Donnie renamed his own store *Mountainarious Sporting Co.* and brought in a selection of exclusive premium name brands to help define the business as a high-end specialty retailer of outdoor sporting equipment and apparel.

STEVEN DONNIE

Donnie had always had a keen interest in sports, both as a participant and as a coach. Prior to moving back to his hometown of Barron, Ontario, Donnie lived in Alberta for several years and worked in a ski shop, tuning and repairing outdoor sporting equipment. He also coached several youth ski and snowboard teams that competed recreationally across Western Canada and the United States. It was during this time spent in the Canadian Rockies where he became an accomplished outdoorsman and an expert in alpine skiing, rock climbing and mountain biking. Donnie was also well travelled and had skied, climbed and biked all over Canada and various parts of the world. Even in his circle of friends, who were avid sports enthusiasts themselves, Donnie was considered an outdoor sporting fanatic.

Many felt the renaming of his store in Barron was a true reflection of Donnie's own fun-loving personality. During a 10-day mountain biking trek in the interior region of British Columbia with seven other cyclists, Donnie took a major fall on a particularly challenging part of the bike trail. Uninjured and charged by the adrenaline rush, he climbed to his feet and hollered, "That was hilarious!"

A friend made a quick point to correct him, shouting back, "No it wasn't Donnie! That was mountainarious!" Donnie, a witty prankster himself, was especially amused by the play on words and promptly declared Mountainarious Sporting Co. the new name for his store.

As owner, Donnie exhibited an excellent product knowledge that was often sought after by patrons who, on busy days, would wait for his assistance and advice on the best equipment for their needs. He stayed abreast of product developments and industry trends to ensure that his store carried the latest and best selection of merchandise for each season. Donnie's strength was in his personality and in the customer contacts that he had developed in the local market. His expertise concerning outdoor sporting equipment was unquestioned.

SPORTING GOODS INDUSTRY

Big-box Retailers

The sporting goods business was extremely competitive. The gross profit achieved from the sale of sports equipment, or "hard goods," such as hockey sticks, bicycles and racquets, had declined through the years as a result of competitive pricing. Since the advent of big-box retailers and powerful "megachains," competition within the Canadian sporting goods industry had increased significantly. Big-box retailers, such as Wal-Mart, Canadian Tire and Sport Chek, had opened stores from 3,500 square metres to 15,000 square metres in size and boasted large hard-good sports departments. Not only did these retailers offer lower prices, but they also provided a wide variety of recreational equipment and apparel across all mainstream sporting categories for both winter and summer sports. At present, there were three of these major retailers in Barron with a fourth scheduled to open in the coming months. Although these retailers generally did not carry a vast selection of premium brands, expert-rated equipment, or specialized products for "lifestyle" or non-team sports such as mountain biking, skiing, camping and climbing, they did offer a wide variety of the major equipment and apparel brands that lead the sporting goods industry.

Specialty Stores

Higher-end and specialty products were often sold in independently owned specialty stores such as Mountainarious Sporting Co. These boutique-style stores often featured dedicated areas of service to gain a competitive advantage, and they offered a large selection of merchandise for either one single sport or for a few sports rather than for a broad range. *Circuit Sports* was an independently owned specialty store located in the south end of Barron. It carried quality lines of sporting goods similar to those carried by Mountainarious but specialized primarily in alpine skiing and golf. Donnie considered this store to be Mountainarious Sporting Co.'s direct competitor.

Online Sales

Donnie believed the rapid growth of Internet-based selling had become a growing source of competition. Many competitors, including *Circuit Sports*, now had websites with online ordering and e-commerce capabilities that provided added convenience and quick service to customers looking to purchase sporting goods over the Internet. Online selling also reduced the need for customers to shop locally, potentially vastly increasing Donnie's pool of competitors. Although Mountainarious Sporting Co. did have a company website, the site was purely informational.

For all competitors, merchandise in the industry was subject to seasonal demands. This put pressure on the purchasing skills of retailers because the inventory for each season had to be sold to allow enough space and funding for the purchase of the new season's stock. This led to end-of-season price-cutting and a further reduction of margins for retailers. A growing opportunity in the industry, however, was the expanding market for higher margin "soft goods" such as sports footwear, clothing and casual wear made by such companies as Adidas, Nike, New Balance and Reebok.

SOFT GOODS SALES GROWTH

In order to increase the gross profit of his store, in 2005, Donnie initiated a plan to sell premium brand-name soft goods lines of outdoor sport footwear and apparel. He was convinced that the only way to maintain profitability was to further delve into the soft goods market.

Donnie was successful in securing a deal with a major buying group that sourced and distributed premium rated outdoor sporting footwear and apparel brands. Through this arrangement, he had received better purchasing discounts and longer terms of payment. The store's regular payment terms were three per cent to four per cent if payment was made early, with full charges due in 30 days. Better terms were extended only if orders were placed three months in advance. This new agreement gave discounts of five per cent to seven per cent with early payment and full charges due in 60 days.

Donnie knew that the soft goods business required a different strategy for success. For instance, soft goods were much more fashion-oriented than sporting equipment lines. As a result, he found that women were frequenting his store more often because of this new merchandise. Consequently, Donnie had begun promotions with local gyms and running clubs in order to increase his sales of athletic clothing for women. He was somewhat concerned, however, that the clientele and merchandise found next door in *Doug's Guns and Ammunition* might adversely affect his efforts to attract the appropriate consumers for his soft goods business.

EXPANSION PROPOSAL

Deviltech Outfitters

Donnie's proposal to overcome this problem was to terminate the lease and create a separate store for clothing in the space now rented to Doug's Guns and Ammunition. The new store was to be called Deviltech Outfitters and, in preparation for the coming season, a series of radio advertisements had already been arranged for the spring. The new store would be connected to the existing store by an entrance that would be constructed as part of the expansion. A separate staff would be hired, and operations would be managed by Donnie's wife, Allison.[1] Allison had previously worked on a part-time basis at Mountainarious Sporting Co., and she had some retail experience in hardware and at a local flower shop but no management experience in retail sporting goods or apparel; however, Donnie was confident that his wife was well suited to the job.

Donnie was extremely optimistic about the possible sales growth from the expansion. He believed the new layout would help the merchandising of both the sports equipment and the soft goods. He thought that overall sales growth of both stores would be about 15 per cent for 2008. He expected sales growth for 2009 to reach up to 30 per cent above projected 2008 levels as the Deviltech Outfitters store became more established. For both years, Donnie anticipated cost of goods sold to decrease to 65 per cent of sales with improved purchasing management and the prospect of better margins on high-end soft-good merchandise. Lastly, he did not plan to increase the advertising budget significantly for the new store and projected spending the same percentage of sales in 2008 and 2009 as was spent in 2007, but with an added message to "Visit Deviltech Outfitters next to the Mountainarious Sporting Co."

[1] *Donnie expected the wages and benefits expense to remain roughly the same percentage of sales.*

Loan Requests

In the past, Donnie had arranged an $80,000 line of credit to cover his working capital needs to help finance growth and to cover seasonal peak purchases of inventory in May and November, prior to the two major sporting seasons[2]. Donnie was requesting a $20,000 increase on the company's current line of credit, bringing total available funds to $100,000. In addition, he estimated that renovations and capital improvements required for the new *Deviltech Outfitters* store would cost $150,000, and he had requested a loan to fund the expansion.

If the loan was approved, annual principal payments would be $15,000 and annual interest payments would be approximately $8,500 for each of the first two years. Donnie would also resume payment on the store's mortgage by 2009 at $3,600 each year. He also expected the loan payable account to be increased to $74,608 in 2008 but reduced to $58,617 in 2009. Additionally, the "other assets" account on the balance sheet would be eliminated in 2009. Other items on the statement of earnings would remain roughly the same percentage of sales as was experienced in fiscal 2007.[3]

To accompany his review of Donnie's loan applications, MacDougall had requested an indication of the size of Donnie's present soft-goods inventory as well as a breakdown of the margins Donnie had achieved from these items. Unfortunately, Donnie's records did not contain this information; however, because clothing was a high-margin item, he anticipated that this inventory may not move as quickly as his hard-goods stock and, therefore, he might have to carry an additional 20 days of inventory.

Donnie had become excited about the expansion when he and MacDougall had recently discussed the proposal over lunch. He clearly believed that the expansion was a critical step to improve the profitability and, as a result, the value of the business. Donnie also indicated that, after 13 years, he was considering selling at least part of his interest in the business to reduce the amount of stress he was feeling from day-to-day operations.

THE DECISION

MacDougall needed to make a decision on whether to grant the loan to finance the construction of Deviltech Outfitters and further extend Mountainarious Sporting Co.'s working capital financing. Although the store had shown acceptable results in past years, financial performance had been hurt by the fire in 2002. In addition, MacDougall had to examine how the move to open Deviltech Outfitters, and the subsequent loss of rental income from Doug's Guns and Ammunition, would affect Donnie's financial position. MacDougall was also unsure about whether he wanted to risk putting the bank's money into a business in which Donnie and his wife appeared to have limited experience (namely, soft goods). Finally, if he were to reject the proposal, McDougall wondered what would happen to the frequent golf games he had enjoyed with Donnie in the summers.

[2] During these peaks, working capital needs generally increased by $20,000 to accommodate additional inventory purchases.
[3] Donnie estimated income taxes to be 23 per cent.

Exhibit 1

STATEMENTS OF EARNINGS
(for years ending January 31)

	2007	**2006**	**2005**	**2004**	**2003**
Sales	$724,271	$645,102	$586,732	$652,779	$420,966
Cost of goods sold	493,567	406,930	395,638	482,909	300,001
Gross profit	$230,704	$238,172	$191,093	$169,870	$120,965
Operating expenses					
Wages and benefits	$115,475	$99,527	$82,854	$103,289	$65,866
Advertising	14,814	14,053	15,833	12,118	11,277
Amortization	9,851	15,016	7,619	8,428	18,155
Vehicle expenses	13,567	13,442	9,112	16,342	12,091
Administrative expenses	34,600	44,215	36,817	33,109	23,324
Miscellaneous expenses	9,130	5,229	5,866	7,157	6,125
Total operating expenses	$197,437	$191,482	$158,101	$180,443	$136,838
Operating profit	$33,268	$46,690	$32,992	$(10,573	$(15,872)
Less: Interest and bank charges	24,307	21,497	26,208	34,259	30,566
Plus: Rent[1]	9,898	14,224	15,773	12,697	13,356
Insurance claim re: fire	-	-	-	-	25,515
Other income	-	-	-	-	4,140
	$9,898	$14,224	$15,773	$12,697	$43,011
Net income before tax	$18,859	$39,416	$22,558	$(32,135	$(3,427)
Income tax	–	–	–	–	–
Net income (loss)[2]	$18,859	$39,416	$22,558	$(32,135	$(3,427)

Source: Company files.

[1] *Rental income was based on a percentage of the tenant's sales.*
[2] *Income tax had not been charged due to the carry-forward of previous losses. All losses to be carried forward had been applied by the end of fiscal 2007.*

Exhibit 2

STATEMENTS OF RETAINED EARNINGS
(for years ending January 31)

	2007	2006	2005	2004	2003
Beginning retained earnings	$116,320	$76,903	$54,346	$86,481	$89,908
Add: net income	18,859	39,416	22,558	(32,135)	(3,427)
Less: dividends	–	–	–	–	–
Ending retained earnings	$135,178	$116,320	$76,903	$54,346	$86,481

Source: Company files.

Exhibit 3

BALANCE SHEETS
(for years ending January 31)

ASSETS	**2007**	**2006**	**2005**	**2004**	**2003**
Current assets:					
Cash	$180	$1,021	$1,647	$2,426	$1,496
Accounts receivable	9,882	14,519	7,484	12,078	5,877
Inventory	189,000	129,600	126,000	191,966	125,725
Prepaid expenses	–	1,188	6,543	6,723	1,472
Other current assets	–	–	–	–	3,868
Total current assets	$199,062	$146,327	$141,674	$213,194	$138,438
Fixed assets:					
Land	$54,945	$54,945	$54,945	$54,945	$54,945
Building and store fixtures	220,588	220,588	193,343	189,013	179,012
Less: accumulated amortization	89,203	79,351	64,336	56,716	48,287
Net fixed assets	$186,331	$196,182	$183,953	$187,241	$185,670
Other assets	33,770	33,770	33,770	33,770	33,770
TOTAL ASSETS	**$419,162**	**$376,279**	**$359,397**	**$434,205**	**$357,878**
LIABILITIES					
Current liabilities:					
Accounts payable	$71,456	$42,637	$62,818	$80,608	$20,156
Notes payable	–	–	–	5,627	2,803
Line of credit, $80,000 limit[1]	64,022	79,641	55,759	145,444	72,000
Loan - National Trust	–	–	–	8,437	–
Current portion long-term debt	–	–	3,600	3,600	17,683
Other current liabilities	17,329	20,342	7,547	3,467	3,496
Total current liabilities	$152,807	$142,619	$129,724	$247,181	$116,138
Long-term liabilities					
Mortgage[2]	$54,000	$54,000	$72,000	$75,600	$90,144
Shareholder loan[3]	14,749	27,079	26,509	2,817	10,854
Loan payable[4]	62,167	36,000	54,000	54,000	54,000
Total long-term liabilities	$130,916	$117,079	$152,509	$132,417	$154,998
Shareholder's equity					
Common stock	$261	$261	$261	$261	$261
Retained earnings	135,178	116,320	76,903	54,346	86,481
Total shareholder's equity	$135,439	$116,581	$77,164	$54,607	$86,742
TOTAL LIABILITIES AND EQUITY	**$419,162**	**$376,279**	**$359,397**	**$434,205**	**$357,878**

Source: Company files.

[1] In 2004, the line of credit limit was increased to accommodate a temporary cash shortage.
[2] The building and store fixtures were used as collateral for the mortgage.
[3] Shareholders loan was from Steven Donnie, unsecured.
[4] Loan payable referred to a long-term loan Donnie had from several family members. This was an unsecured loan.

Exhibit 4

FINANCIAL RATIOS

PROFITABILITY	2007	2006	2005	2004	2003	2007 Selected Industry Ratios (Where available)
Sales	100%	100%	100%	100%	100%	
Cost of goods sold	68.1%	63.1%	67.4%	74.0%	71.3%	60%
Gross profit	31.9%	36.9%	32.6%	26.0%	28.7%	
Operating expenses						
Wages and benefits	15.9%	15.4%	14.1%	15.8%	15.6%	
Advertising	2.0%	2.2%	2.7%	1.9%	2.7%	1.3%
Amortization	1.4%	2.3%	1.3%	1.3%	4.3%	1.5%
Vehicle expenses	1.9%	2.1%	1.6%	2.5%	2.9%	
Administrative expenses	4.8%	6.9%	6.3%	5.1%	5.5%	
Miscellaneous expenses	1.3%	0.8%	1.0%	1.1%	1.5%	
Total operating expenses	27.3%	29.7%	26.9%	27.6%	32.5%	26.5%
Operating profit	4.6%	7.2%	5.6%	-1.6%	-3.8%	
Less: Interest and charges	3.4%	3.3%	4.5%	5.2%	7.3%	0.8%
Plus: Rent	1.4%	2.2%	2.7%	1.9%	3.2%	
Other income	0.0%	0.0%	0.0%	0.0%	6.1%	
Insurance claim re: fire	0.0%	0.0%	0.0%	0.0%	1.0%	
Net income (loss)2	2.6%	6.1%	3.8%	-4.9%	-0.8%	12.5%
Return on average equity	15.0%	40.7%	34.2%	n/a	n/a	
LIQUIDITY						
Current ratio	1.30	1.03	1.09	0.86	1.19	1.9
Acid test	0.07	0.11	0.07	0.06	0.06	1.2
Working capital	$46,255	$3,708	$11,950	$(33,988)	$22,300	
EFFICIENCY 365-day year						
Age of receivables	5.0	8.2	4.7	6.8	5.1	
Age of inventory	139.8	116.2	116.2	145.1	153.0	
Age of payables	47.2	37.9	69.5	53.6	17.3	
STABILITY						
Net worth to total assets	32.3%	31.0%	21.5%	12.6%	24.2%	45%
Interest coverage	1.8	2.8	1.9	0.1	0.9	
GROWTH	**2006 - 07**	**2005 - 06**	**2004 - 04**	**2003 - 04**		
Sales	12.3%	9.9%	-10.1%	55.1%		
Net income	-52.2%	74.7%	-	-		
Total assets	11.4%	4.7%	-17.2%	21.3%		
Equity	16.2%	51.1%	41.3%	-37.0%		

Source: Company files.

Exhibit 5

STATEMENTS OF CASH FLOWS
(for years ending January 31)

	2007	2006	2005	2004
OPERATIONS				
Net income	$18,859	$39,416	$22,558	$(32,135)
Adjustments to cash basis:				
Amortization	$9,851	$15,016	$7,619	$ 8,428
Accounts receivable	4,637	(7,034)	4,594	(6,201)
Inventory	(59,400)	(3,600)	65,966	(66,242)
Prepaid expenses	1,188	5,355	180	(5,251)
Other current assets	–	–	–	3,868
Accounts payable	28,820	(20,182)	(17,789)	60,451
Other current liabilities	(3,013)	12,794	4,081	(29)
Net cash flow from operations	$941	$41,765	$87,208	$(37,111)
FINANCING ACTIVITIES				
Notes payable	$ –	$–	$ (5,627)	$2,824
Line of credit	(15,619)	23,882	(89,685)	73,444
Loan - National Trust	–	–	(8,437)	8,437
Current portion long-term debt	–	(3,600)	–	(14,083)
Mortgage	–	(18,000)	(3,600)	(14,544)
Shareholder loan	(12,330)	571	23,692	(8,037)
Loan payable	26,167	(18,000)	–	–
Net cash flow from financing	$(1,782)	$(15,147)	$(83,657)	$48,040
INVESTING ACTIVITIES				
Fixed assets	$ –	$(27,245)	$ (4,331)	$(9,999)
Net cash flow from investing activities	$ –	$(27,245)	$ (4,331)	$(9,999)
Net cash flow	$ (841)	$ (626)	$ (779)	$931
Beginning cash	1,021	1,647	2,426	1,496
Ending cash	$ 180	$1,021	$ 1,647	$ 2,426

Source: Company files.