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Global Case Writing Competition 2011 Social Entrepreneurship Track

3rd Place

Tropical Salvage: From Recession to Expansion

Free Online Copy

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“[Tropical Salvage] demonstrates that business can adjust its values and practices to become a part of the solution to social and environmental challenges, while remaining responsible to the financial bottom line.” – Tim O’Brien, Founder and President

Tim O’Brien, founder of Tropical Salvage, was preparing for another warehouse clearance sale of his unique, handcrafted hardwood furniture. It had been an enormously challenging year and it was important to reduce inventory before the next container arrived from Indonesia. The market for fine furniture had begun to decline steadily in early 2008 following the stock market crash of the prior September. The company survived a difficult period, but not without suffering a decline in sales. O’Brien had spent ten years building a sustainable business model based on environmental stewardship, worker empowerment and unique, high quality product. As the economy recovered, O’Brien believed Tropical Salvage needed to pursue an aggressive expansion strategy.

Although the warehouse clearance sale was occupying O’Brien’s mind, he was excited about the prospect of implementing a bold growth strategy for the coming years. The two most significant strategies for growth focused on diversifying product offerings beyond hardwood furniture and opening branded retail stores in the United States. Many fundamental business challenges, including brand awareness, financing and operational efficiency, had to be overcome to make these strategies effective. However, O’Brien was confident that the highly vertically integrated structure, unique product designs, cost-competitive sourcing and deeply engrained social mission of Tropical Salvage provided the leverage to overcome these challenges.

As O’Brien considered how best to expand, he prepared to markdown the remaining inventory from his last shipment. Are his growth plans overly ambitious while the economy is so uncertain? Does it make sense to extend his product line beyond the hardwood furniture for which Tropical Salvage is known and has experience manufacturing? Is it financially sound to expand into branded retail at this time? Perhaps most importantly, are the trends in ‘conscientious’ consumerism significant enough to support the growth of a values-driven, sustainability-inspired business like Tropical Salvage?

Introduction to Tropical Salvage

Headquartered in Portland, Oregon, Tropical Salvage is a private manufacturer of distinctive handcrafted furniture made from salvaged, or rediscovered, hardwoods. O’Brien established the company in 1998 to utilize underemployed, yet highly skilled Javanese woodworkers and a nearly inexhaustible supply of salvageable (non-virgin) tropical timber from around Indonesia. Combining these resources provided O’Brien the capability to create unique furniture products whose sale can profitably advance positive social and environmental change.

Tropical Salvage has become largely vertically integrated. The company operates timber salvaging operations and designs and builds furniture in Indonesia and markets and wholesales the furniture in North America. In addition to selling its products to wholesale customers, Tropical Salvage invites consumers to purchase goods directly from its Portland shipping and receiving warehouse. Despite the business challenges of bootstrapping a young

company and operating in Indonesia, for over ten years Tropical Salvage has steadily added to its production capacity and may now be poised for expansion.

Indonesia: Systemic Connections of Economy, Communities and the Forest

Indonesia has extremely high levels of biodiversity. It is home to about 10 percent of the world's flowering plant species, 12 percent of the world's mammals, 16 percent of the world's reptile and amphibian species, 17 percent of the world's birds, and at least 25 percent of all of the world's fish species¹. On the islands of Borneo and Sumatra are the last remaining Sumatran tigers, orangutans, pygmy elephants and Sumatran rhinos and are a key source of freshwater to Borneo and Sumatra's 56 million people. It is not possible to overstate the extent to which the long term viability of Indonesians, the archipelago's flora and fauna and the country's economy are systemically linked and delicately balanced.

It has been conservatively estimated that at least 20 million people depend on Indonesia's forests for their livelihoods². Wood-based industries' contributions to Indonesia's GNP rank second to petroleum, generating approximately US\$7 billion in formal revenues and perhaps another US\$1 billion in informal revenues associated with illegal logging and unreported exports³.

Logging in Indonesia's forests played a significant part in boosting the country's economic status from the late 1960s until the Asian Financial Crisis in 1997. Commercial and illegal logging practices during President Suharto's "New Order" drove Indonesia's economy but severely diminished a substantial portion of its tropical forests, placing the country's environment and economy in jeopardy. Although a number of regulations mandated government control of Indonesia's forests during Suharto's presidency, it was not until more recently that forest conservation became seriously regarded. Illegal logging practices have decreased as a result of this frame of mind, but they are still responsible for much of Indonesia's forest loss and violent crime rate.

In addition to logging jobs with commercial firms, residents rely on the forests for fuel, construction materials, water supply, soil nutrients for farm systems, and shelter and shade for crops and animals. Non-Timber Forest Products (NTFPs) such as game, medicines, fruits, and nuts have deep cultural significance and other NTFPs, such as rattan, charcoal, resin, and seeds are traded locally and internationally⁴. Indonesians rely on income and benefits from over ninety other NTFPs.

Indonesia's widespread deforestation (Appendix 1) has led to massive environmental, social and economic disruption. The intense deforestation rates that have occurred over the years

¹ Case, M., Ardiansyah, F. and Spector, E. 2007. *Climate Change in Indonesia: Implications for Humans and Nature*. World Wildlife Fund.

² Sunderlin, W.D., Resosudarmo, I. A. P. 1996. *Rates and causes of deforestation in Indonesia. Towards a resolution of the ambiguities*. CIFOR Occasional Paper No. 9. Bogor, Indonesia: CIFOR.

³ CIFOR. 2004. *Generating economic growth, rural livelihoods, and environmental benefits from Indonesia's forests: A summary of issues and policy options*. Report prepared for the World Bank. Bogor, Indonesia: CIFOR.

⁴ The World Bank. (December 2006). *Sustaining Economic Growth, Rural Livelihoods, and Environmental Benefits: Strategic Options for Forest Assistance in Indonesia*. The World Bank Office, Jakarta Indonesia.

pose a significant threat to the country's economy and its residents' livelihoods. Most employees in the wood products industry will face unemployment if the area can no longer sustain commercial forestry. Forest loss is also diminishing the area's biodiversity; aside from the direct endangerment of native trees and plants, wild orangutans, sun bears, and clouded leopards are only a few of the species that face extinction in the next ten to twenty years⁵. Of course, the aforementioned NTFPs are also threatened by forest loss; without forest products, Indonesians would experience increased poverty and health risks. Because of these systemic connections, the effects of forest loss are becoming more severe and compound the difficult economic and social conditions in Indonesia. Unfortunately, in the minds of most Indonesians, the immediate benefit of income from logging still outweighs its negative long-term effects.

The town of Jepara⁶, on the north coast of Central Java, is well known globally for its handcrafted hardwood furniture and woodworking. Over 15,000 furniture workshops, showrooms, log parks, sawmills, warehouses and ironmongers are located in Jepara, making it a localized network, or "industrial cluster"⁷. The industry's success garnered political support to accommodate the growing volume of furniture exports. For instance, roads were paved and are maintained in order for container trucks to move wood and furniture in and out of the area from other significant parts of the island. At its height, Jepara's hardwood furniture industry employed about 170,000 workers⁸ and firms competed fiercely for both inputs and markets.

There are a number of companies and organizations responding in numerous ways to Indonesia's deforestation. Home Depot, for example, cut its purchases of Indonesian lumber by more than three-quarters since 2000. Many companies, including IKEA, require that their hardwood supplies be harvested from Forest Stewardship Council (FSC) certified forests. As O'Brien sees it, FSC-certification is a step in the right direction but still ultimately results in trees being cut down. So, Tropical Salvage is addressing deforestation concerns through its own unique business model. In time, it seems likely that other large companies will follow suit and discontinue the purchase of illegally obtained wood.

Tropical Salvage: The Inspiration and Start-Up

Having lived in and visited Indonesia over the course of nine years, O'Brien was familiar with the archipelago and felt personally attached to its culture when he became inspired to start Tropical Salvage. During a week of trekking in 1998, O'Brien encountered stunning biodiversity juxtaposed with wasteful exploitation of natural resources and underutilization of craft traditions. O'Brien saw that the impressive array of wildlife and fantastically diverse population of trees was, quite unfortunately, offset by vast areas of recently clear-cut primary, or old-growth, forest. More than once he came upon areas that had been among the most biologically diverse locations on earth, reduced to an eerie, silent ruin of power-saw litter. For O'Brien, the experience was ominous and affecting.

⁵ Clifford et al., 2003.

⁶ Jepara's sprawling population is nearly 1,000,000; the wide majority of people in Jepara are Javanese.

⁷ An industrial cluster consists of production, processing and distribution enterprises along the manufacturing and marketing chain. (*Atlas of Wooden Furniture Industry in Jepara, Indonesia*)

⁸ Roda, Jean-Marc, Philippe Cadene, Philippe Guizol, Levania Santoso & Achmad Uzair Fauzan. (2007). *Atlas of Wooden Furniture Industry in Jepara, Indonesia*. CIRAD & CIFOR, Harapan Prima, Jakarta.

As his travels continued through cities on the islands of Java, Bali, Lombok and Sumbawa, O'Brien noticed old wooden structures being replaced by more secure structures built from concrete and rebar. In many instances no plan existed to re-use the old beams, boards and poles. Old, hand-hewn wood derived from mature, wild-grained, tropical hardwood trees was fueling simple cooking fires. The idea for Tropical Salvage struck – salvaging wood from deconstructed buildings can be a significant source of raw material for hardwood furniture production.

As the wheels for his new business venture turned in his head, O'Brien began to view Indonesia a little differently. Travel in population centers made him acutely aware that the high deforestation rates have devastating effects, not only on the environment, but also on the social and economic climate. Depletion of the forests was not only leaving wildlife homeless, but was also putting millions of Indonesians out of work. O'Brien started Tropical Salvage based on a conviction that “a reasonable and promising market-oriented strategy can contribute to positive change in a part of the world beset by extraordinary challenges.”

The Tropical Salvage Business Model

O'Brien knew that earning and maintaining the respect of Indonesians, especially in Java, would be important to the success of his business model. One day by chance, he was fortunate to meet Agus Rafiqkoh, a likeminded, well-connected and trustworthy businessman. After many lengthy conversations, the two of them set out to actualize Tropical Salvage.

Rafiqkoh, Partner and the Director of Indonesian Operations, had worked in Jepara's wood furniture production industry for eight years prior to meeting O'Brien. He now plays a number of critical roles in Tropical Salvage's Indonesia operations: hiring employees, designing new pieces, directing production, and locating and coordinating wood salvage projects. He is skilled in networking and admits to approaching most new interactions with the business in the forefront of his mind. Brought together by rather random circumstances, O'Brien and Rafiqkoh have developed a strong partnership and friendship, based on shared philosophies, trust and commitment. It is this relationship in particular that serves to anchor Tropical Salvage and has permitted it to overcome the many obstacles faced since its inception.

Both social and environmental mission objectives were implemented at the onset of business in 1999 with eight employees working in a two thousand square foot rented space. O'Brien was excited about the market back then, but was also uninformed of it. After a number of setbacks, he still marvels in the company's utter existence. Today, the company's operations in Indonesia have grown into a salvaging operation and production facility that employs 85 people, including wood salvagers, millers, kiln operators, artisan furniture-makers and carvers, and finishers, some of whom quite likely used to be employed in the illegal logging industry. Tropical Salvage employees are compensated with benefits and wages twenty percent higher than the local industry average and the company has been instrumental in developing the Jepara Forest Conservancy, which protects land for reforestation, economic opportunity and educational purposes.

Sourcing

Tropical Salvage uses only salvaged, or rediscovered, wood to build its line of furniture. So far the company has worked with wood from around 55 different species of trees including teak, acacia, jackfruit, and ingas. O'Brien claims to be a pioneer in using ingas for constructing hardwood furniture and much of what the company finds and uses is this particular specie. Although, and perhaps because, they carry the heaviest weight with consumers, primary forest teak trees have possibly the saddest story of depletion. Today these fast growing hardwoods are grown on plantations and tend to be cut after just ten years. This is half the time it takes for teak to fully mature. Because mature teak has become increasingly rare, much of the teak used by Tropical Salvage comes in the form of old objects used for outdoor purposes, such as boats.

Fortunately for Tropical Salvage, the company's business model has not yet required it to compete for raw materials. Most of the wood the salvaging crews retrieve is without value in Indonesia. The beauty is that, through years of experimentation, Tropical Salvage has determined how to give new life to the wood so that it becomes valuable again, in the form of furniture. One piece of Tropical Salvage furniture might consist of several species of wood aged from thirty to thousands of years. O'Brien and many of Tropical Salvage's customers feel that the effects of nails, seasoning cracks, bore holes, wild-growth grain, and mineral deposits in the finished products are a wonderful testament to the wood's historical richness.

The company estimates that the supply of salvageable wood in Indonesia is inexhaustible for meeting its own demand. Tropical Salvage has already discovered and surveyed multiple wood salvage sites in Sumatra, Kalimantan and Sulawesi. When it discovers salvageable wood, the company pays for short-term 'rent' of the land immediately surrounding the site. If the salvaging process compromises crops or other NTFPs, it will pay the landowner to replace them after the process is completed. Well known as the authority on wood salvaging in Jepara, the company is often contacted by government officials when salvageable wood is discovered. However, as other producers adopt salvaging methods, Tropical Salvage may face competition for rights to salvage in certain areas.

Using hard labor, basic winch systems and limited heavy machinery, the company applies five principle wood salvage strategies on the island of Java. It reclaims wood from demolition sites where old buildings, houses or bridges have been razed or deconstructed. Old fishing boats and truck roofs are also used. It salvages old, wild growth trees from rivers and lakes (Appendix 2), as well as those that have fallen off logging barges or were felled by floods and landslides during the rainy season. The company also uses diseased or unproductive plantation coffee, cacao, and fruit trees. And finally, unique to the company, since 2003 it has mined entombed trees from beneath the ground (Appendix 3).

Manufacturing

After the wood is salvaged it is transported to a storage yard in Jepara and cut into boards. Currently, Tropical Salvage contracts primary milling of the wood it salvages. This makes sense in a very soft market where wood processing facilities are operating at a fraction of capacity. From here it moves to the production facility where it is treated for insects and placed in a kiln for drying. Discovering the optimum adjustments for the kilns in order to dry the numerous species is an ongoing challenge, but has gotten much easier with years of

experience. The unique expertise that Tropical Salvage has developed in drying a vast array of species serves the company well and provides it with a competency that competitors find difficult to imitate. From the kiln, millers, artisan furniture-makers, carvers, and finishers construct the furniture that makes up Tropical Salvage's product offerings, including dining tables, chairs, benches, drawers, armoires, cabinets, buffets, shelves, desks, beds, side tables, media stands, coffee tables, and console tables (Appendix 4).

Warehouse employees receive specification guidelines from Rafiqkoh in order to assemble and finish the furniture; each piece passes through many hands to complete the process. The greatest challenge during the manufacturing process is determining how to put together the different species and grain patterns to create attractive finished products. Rafiqkoh also handles quality assurance, making sure each piece is built to Western standards. The product catalog includes roughly 150 different models, but the company also builds one-of-a-kind custom pieces and furnishings built to commercial specifications. O'Brien and Rafiqkoh keep the catalog fresh by introducing at least one new design with each container shipment, about four times a year.

By offering steady employment, Tropical Salvage positively affects an area distressed by high rates of poverty, underemployment and unemployment⁹. In addition, the company offers benefits such as paid vacations and health care. Tropical Salvage is committed to its employees and respects their rights to fair wages, health, and safe work environments. The company became a member of the Fair Trade Federation in 2003; all of its products are Fair Trade certified, a result of which being that wages are 20 percent above the local standard.

Distribution

Containers are loaded with finished Tropical Salvage products (Appendix 5) in Jepara and shipped to North America. These containers take anywhere from 25 to 40 days to arrive and come directly to the main warehouse in Portland, Oregon or to Ten Thousand Villages Canada's receiving warehouse and distribution center. From these receiving locations, the products are dispersed to each Ten Thousand Villages store location in Canada and wholesale retailers in the United States.

Tropical Salvage has only a few employees in its Portland, Oregon headquarters, which is home to a receiving warehouse and small showroom that manages wholesale sales and distribution and some retail transactions. Independent contractors are occasionally brought in to assist with unloading containers or to make local deliveries.

Customers in Portland have the option to come to Tropical Salvage's warehouse location to buy products directly at standard retail prices. As a furniture manufacturer, Tropical Salvage is able to offer products at wholesale prices to its retail partners, but can also gain higher margins by selling at regular retail prices in its own warehouse location.

ECOpdx, also located in Portland, Oregon, is the company's largest local wholesale customer. Tropical Salvage has a number of other wholesale customers including: Small Planet Trading in Hood River, Oregon and Kizuri in Spokane, Washington. The Banyan Tree in Portland sells Tropical Salvage furniture to customers on consignment.

⁹ According to a local source, Jepara is experiencing 25-30% unemployment.

Beyond the local market, Ten Thousand Villages Canada is a key retail partner for Tropical Salvage. Ten Thousand Villages Canada has truly embraced the Tropical Salvage business model and its products. In fact, the Fair Trade retailer took the initiative to create a hard-copy 'Tropical Salvage' catalog for its customers. This strong retail partner regularly stocks a number of furniture pieces and has arranged to receive direct container shipments of specifically selected pieces. In addition to the local partners and Ten Thousand Villages Canada, Tropical Salvage caters to other retailers across the United States for occasional wholesale orders.

Partnerships

Tropical Salvage initiated its business model without deliberate attention to partnerships outside of its supply chain and manufacturing operations. In the refinement and actualization of its sustainability-inspired mission, Tropical Salvage found NGO partnerships to be a critical resource. NGO partnerships bring expertise and credibility that have, according to O'Brien, permitted Tropical Salvage "...to hasten development and expansion of the model."

Since 2007, Tropical Salvage has been a leader in the creation of a conservation, education and reforestation project in Kunir, a village community in Jepara experiencing the widespread effects of overdependence on unsustainably harvested teak forests. The Jepara Forest Conservancy (JFC) shows how ecological restoration integrates with and positively influences cultural, social and economic conditions. For instance, with the help of Tropical Salvage, Kunir has recently adopted a number of Etawah goats, which are highly valued and produce exceptionally nutritious milk. Not only will this provide nutrients directly to the community, it will eventually result in improved economic conditions. JFC's restoration efforts have also had a positive effect on the area's native wildlife; its work is crucial in saving the Lutung monkey species.

Tropical Salvage collaborates with The Institute for Culture and Ecology (IFCAE) to maintain the JFC. IFCAE, a 501(c)(3) nonprofit organization, seeks to improve human and environmental conditions through applied research, education, and community improvement projects. Through its cross-sector partnership with IFCAE and the creation of the JFC, Tropical Salvage is able to fully realize its social mission objectives. The JFC provides a recreational botanical park for the community, educational facilities for school children and community members, and a model for alternative, economically sustainable land uses for local landholders. O'Brien firmly states that, "such collaborations are very important to Tropical Salvage's current and future business model," partially because Tropical Salvage does not have in-house expertise to overcome many of the challenges that arise in developing its mission. And, both O'Brien and Rafiqkoh do not consider the partnership with IFCAE and the creation of the JFC as optional; rather these efforts are at the core of the market-based strategy that seeks to reverse the destruction of Indonesian forests and the communities that depend on them.

The Hardwood Furniture Industry

Hardwood furniture is a sizable global industry, requiring intense labor and natural resources (Appendix 6). Between 1995 and 2000, trade in furniture grew by 36.5 percent, faster than world trade as a whole (26.5 percent), and, also in that time, became the largest low-tech sector¹⁰. Indonesia ranks fifth among the world's fifteen major furniture exporters (Appendix 7). Sixty-two percent of all furniture exports are wooden, which includes both solid wood and flat-pack, or ready-to-assemble, furniture made by both craft-based firms and large-volume producers.

The United States is not a major exporter of hardwood furniture. In fact, in the last 10 years the U.S. has become a major importer. In 2000, U.S. hardwood furniture manufacturing was a \$13 billion industry employing over 135,000 individuals¹¹. In 2006 the industry had shrunk to US\$8.6 billion in revenue and 63,066 employees¹². These numbers reveal the significant decline in the U.S. industry over a relatively short period of time. Between 1997 and 2005 U.S. demand for furniture grew by 27 percent¹³, but the market share was captured by imports whose outsourced labor and production costs are much lower than those in the U.S. For example, China's household furniture imports to the United States increased 78 percent between 2003 and 2007¹⁴, and rose a total of 525 percent between 1998 and 2005¹⁵. Currently, nearly 70 percent of hardwood furniture purchases in the U.S. are imported products; about half of those are manufactured in China. Amidst this global competition, hardwood furniture has remained the largest sector of the U.S.-manufactured furniture industry.

The growth in demand for furniture occurred while the U.S. real estate market flourished from 2001 to 2006, due to favorable mortgage interest rates. Furniture sales are closely related to the state of the real estate market, which includes new and resale housing sales as well as home remodeling. The real estate market's sharp downturn in 2008, correlating with the U.S. financial crisis, resulted in a decrease in sales for numerous industries, including hardwood furniture. The effects of this downturn are noticeable throughout Jepara; a city that, before the recession, had been teeming with foreign business people buying furniture. Many warehouses and showrooms in Jepara now stand empty as a result of this decreased demand.

Another important trend in the furniture industry is consumers' shift from considering furniture a lifetime or even generation-to-generation investment to deeming it disposable and easily interchangeable. Often sold by big-box retailers and warehouse stores because it requires less inventory space, ready-to-assemble (RTA) composite wood furniture has proven to be the answer to consumer demand. A report by Mintel/Simmons NCS revealed that

¹⁰ United Nations Industrial Development Organization. *The Global Wood Furniture Value Chain: What Prospects for Upgrading by Developing Countries?*

¹¹ The Gale Group, Inc. 2010. Industry Report: Wood Household Furniture, Except Upholstered, NAICS 337122.

¹² U.S. Census Bureau, 2007. http://factfinder.census.gov/servlet/IBQTable?_bm=y&-ds_name=EC0700A1&-NAICS2007=337122&-ib_type=NAICS2007&-_industry=337122&-_lang=en.

¹³ Wood Digest. Datamonitor Industry Market Research. 2000. *US Wooden Household Furniture*.

¹⁴ Reuters. <http://www.reuters.com/article/idUSN2537252220080725>

¹⁵ Industry Report: Nonupholstered Wood Household Furniture Manufacturing. Business & Company Resource Center.

people in older age groups bought less RTA furniture. But older people buy less furniture and younger, more mobile, people buy more furniture in general and embrace RTA furniture, stand-alone furniture stores selling high quality, fully-assembled furniture have faced increased competitive pressures. This shift was likely brought on by increased frequency in relocation and less immediate disposable income. Because RTA furniture sells on average for less than half the price of comparable assembled furniture, price is a major driving factor in the increased demand for RTA items.

Although RTA furniture has increased in popularity, some providers of solid hardwood furniture continue to successfully compete in the furniture industry. The wood furniture industry is structured as a buyer-driven value chain with few scale- or technology-entry barriers in production. The consequence of this structure is that lead or governing firms that set prices, delivery schedules and quality standards are located at the apex of the chain; that is, among the buyers. The top two furniture retailers in the United States¹⁶, WalMart, Inc. and Ashley Furniture, both carry solid wood pieces. In addition to distributing its products to a range of specialty and department stores, Ashley Furniture sells its products in over two hundred branded retail stores called Ashley Furniture HomeStores. Williams-Sonoma is third in total sales and focuses exclusively on high quality, premium furniture. It owns Pottery Barn and Ethan Allen. Both Williams-Sonoma subsidiaries have built their reputations on consistent high quality, distinctive product and store designs and standalone branded retail stores. The next tier of competitors includes Cost Plus World Market and Pier 1 Imports, both of which sell mid- to low-end furniture.

There are only a few, smaller competitors that offer hardwood furniture with explicit social and environmental missions. The Wooden Duck in San Francisco uses reclaimed timber from pre-1920 structures to manufacture and sell household and office furnishing. The Wooden Duck's sales are primarily in San Francisco and the surrounding area. Environment Furniture is headquartered in Los Angeles and has showrooms in New York, Atlanta and Orange County. It salvages wood from Brazil as well as from forests certified by the Forest Stewardship Council and the Sustainable Forest Initiative. It offers uniquely designed, premium products for the home.

These two companies, as well as Tropical Salvage, are well-positioned to take advantage of a more recent trend impacting the tropical wood and hardwood furniture industry. The trend entails regulatory and non-regulatory initiatives to limit imports from non-sustainably managed tropical forests and promote sales from sustainably managed tropical forests. The Lacey Act¹⁷, The Rainforest Alliance's SmartWood program (Appendix 8), The Sustainable Furnishings Council, and The Prince's Rainforest Project were all launched between 2007 and 2009. By restricting importation of illegally harvested tropical timber – whether raw logs or in finished product – and by encouraging consumers to buy sustainability-based certified furniture, these developments seem to provide ample opportunity for socially-minded businesses in this industry to expand. In fact, with growing consumer awareness of environmental issues, eco-friendly furniture is no longer a niche market. It is increasingly common for wood products to be manufactured with Forest Stewardship Council-certified

¹⁶ Mintel Reports. Home Furniture – US. 2008. (Data from 2006)

¹⁷ The Lacey Act, part of the Farm Bill of 2008, combats trafficking of 'illegally acquired or off-limits wildlife, fish and plants, including tropical hardwoods.

wood and environmentally friendly finishes. Recycled materials are also gaining popularity. Although less common in the industry and not well recognized as an issue by the marketplace, there is significant opportunity for furniture companies to focus on social issues, such as labor conditions and wages. All facets of sustainability will gain importance over the coming years as both governments and consumers demand greater transparency of environmental and social impacts.

O'Brien knows that his craft-based company must produce affordable, high-quality furniture products to effectively compete. His unique business model – combining low raw material and production costs with a clear and compelling social mission – helps mitigate some of the current industry trends and competitive risks faced by other companies. Tropical Salvage's profit margins remain high because the company controls the majority of its value chain. Furthermore, Tropical Salvage has a clear sustainability-oriented brand, which provides an authentically differentiated position in the marketplace.

Challenges to the Business Model

“The road to the vision has been a lot more fun and a lot more difficult than I expected it to be. Both the risks and rewards have been a thrill and have brought true happiness.” – Tim O'Brien

Although O'Brien is confident in his expansion plans for Tropical Salvage, the company has had, and continues to have, its share of challenges. In the beginning, O'Brien needed to learn the Indonesian culture and language. It was important for him to be able to communicate his philosophies and vision first-hand. Furthermore, because the company's wood salvaging techniques were groundbreaking in the region Tropical Salvage had to work to determine proper and effective kiln times for the 55 different woods to be utilized. Today O'Brien's knowledge of the language and culture, his partnership with Rafiqkoh, and the company's salvaging and dry-kilning techniques are considered to be the company's key competitive advantages.

Operations

Distance contributes greatly to the challenge of quality control. North American consumers expect unique designs and exceptional quality in high-end hardwood furniture and O'Brien is not able to oversee warehouse operations year-round. Rafiqkoh has developed good insight into North American consumers and is charged with managing the furniture designs and quality standards. One of the most recent issues the company has encountered involves the presence of boring insects in certain pieces of recently fallen wood. Tropical Salvage lost some sales as a consequence and had to add a permethrin treatment for the wood at the production facility.

Expanding salvage operations presents another challenge for Tropical Salvage. The expense of setting up operations at a new site on the island of Kalimantan has been much higher than originally anticipated; mechanized systems are necessary to recover the wood and it is more difficult to move the wood across the Java Sea to the Jepara warehouse. There is an abundance of quality salvageable wood in Kalimantan's rivers and O'Brien is confident that the volume of wood recoverable from this new site will more than compensate for the

additional expense. However, as Tropical Salvage continues to seek out additional sources of salvageable wood around the Indonesian archipelago, it will need to ensure efficient salvage and transport processes to maintain the margins that are key to its expansion efforts.

Inventory

Tropical Salvage also must deal with unreliable shipping schedules. Due to traffic in Indonesian and U.S. ports or extreme weather, a container can be delayed by several weeks. Such delays have been costly, particularly when working with commercial clients facing deadlines of their own.

Tropical Salvage also lacks a formal computer-based system to track and control its incoming and outgoing inventory. While the current informal approach has been sufficient for the small warehouse in Portland and its retail partnerships, this is a challenge that will become more evident with the introduction of one or more branded retail locations. O'Brien understands that he will need to be able to accurately evaluate a store's sales turnover and support the retail staff's forecasting and inventory management processes. Further, tracking inventory will help O'Brien understand the customers in a given location and place appropriate orders for the future.

Marketing

Increased demand for its furniture is necessary in order for Tropical Salvage to expand its operations and social and environmental missions. While untapped prospects and channels of distribution remain, determining the most effective ways to market the product line and mission is essential. O'Brien considers this his greatest challenge.

Tropical Salvage serves three core audiences: B2C retailers, commercial businesses, and consumers. Each audience requires a unique message. Creating the appropriate marketing approach for each group will involve learning about their needs and values. For example, commercial business prospects include both restaurants and offices. Determining the messages that resonate and which materials will get noticed for these two segments of the commercial business market is critical.

While the demand for sustainably sourced furniture increases, the majority of Americans remain unaware of the effects of illegal logging and deforestation. Because Tropical Salvage produces high-quality furniture while at the same time promoting social and environmental sustainability, the marketing must blend and balance two notions that perhaps consumers have yet to associate. Images are exceptional tools for telling a story and are an asset to Tropical Salvage, whose business model allows direct access to sourcing and restoration sites. By emotionally connecting consumers to its products through images of Tropical Salvage's work in Indonesia, the company may be able to offer a persuasive marketing message. But to what extent should Tropical Salvage take responsibility for educating its audiences on the effects of illegal logging and deforestation? And could too much emphasis on the mission deter certain prospective customers?

Although the hardwood furniture market is fairly saturated, O'Brien believes there is an opportunity to continue to supply the Lifestyles of Health and Sustainability (LOHAS) market segment (Appendix 9). LOHAS consumers are passionate, environmentally and

socially responsible and tend to be early adopters who can be used as predictors of upcoming trends. They are also influential over friends and family, are more brand loyal than other consumers especially to companies whose values match their own, and most importantly, are willing to put their money behind their beliefs and values¹⁸. It is roughly estimated that a third of Portland's population practices a LOHAS perspective; O'Brien knows that most of his customers in the Portland warehouse are LOHAS consumers. These consumers share many of Tropical Salvage's values, focusing on health and fitness, the environment, personal development, sustainable living, and social justice¹⁹. These consumers are educated and informed, and many have traveled abroad to less developed destinations which increased their awareness of social, environmental, and health-related issues on a global scale. About one in every four adults in the United States, roughly 41 million, falls into this market segment; this US\$209 billion market is shaping future consumer trends. O'Brien can incorporate his existing knowledge of the target customer into the marketing message; however, he still needs to determine how to reach this target market with his value proposition.

The Business Expansion Plan of 2010

It is obvious to O'Brien that expansion is necessary in order to sustain Tropical Salvage's growing business. In response, he has devised an extensive expansion plan to move toward branded retail stores, and has numerous other ideas and new products in mind.

O'Brien sees forward vertical integration of the company into branded retail stores as the first step toward growth. In remaining loyal to his retail partner, EcoPDX, O'Brien will seek retail space outside of Portland. Seattle is an obvious choice for the first market that Tropical Salvage will enter with a branded store. Because of its proximity to Portland, O'Brien can be as involved as is necessary to find a location, hire a team to maintain the store, and create a strong storefront. Further, he will be able to supply a Seattle location through his existing Portland warehouse and a third-party trucking company. Appendix 10 provides the estimated annual operating expenses for the Seattle-based store, including on-going and one-time expenditures. Although the new store represents a significant financial commitment for Tropical Salvage, the financial projections (shown in Appendix 11) suggest that this expansion plan could be quite successful.

Fortunately, Tropical Salvage has not acquired any debt during the recession, but O'Brien needs to decide how to proceed with the financial outlay required of opening a retail store. Venture capital financing or a small business loan seems to be the most appropriate options, but O'Brien has not yet settled on one over the other.

It may make sense to incorporate some of O'Brien's other expansion ideas into his branded retail store strategy. Some new products that he would like to introduce include: sustainably sourced bamboo and rattan, coffee, tea, spices, and textiles (including pillows and cushions). Offering a more diverse product line may, in fact, be necessary for a successful retail location. The diversity of sustainability-oriented products will draw more people into Tropical Salvage

¹⁸ French, S. and Rogers, G. *Understanding the LOHAS Consumer: The Rise of Ethical Consumerism: A Strategic Market Research Update from The Natural Marketing Institute (NMI)*. Available from www.lohas.com/journal/consumertrends.htm.

¹⁹ <http://www.lohas.com/>

storefronts to increase opportunities to sell higher-end – and often higher margin – furniture. Tropical Salvage could acquire these products through its relationship with JFC, further benefiting the residents of Kunir and fulfilling the company’s mission.

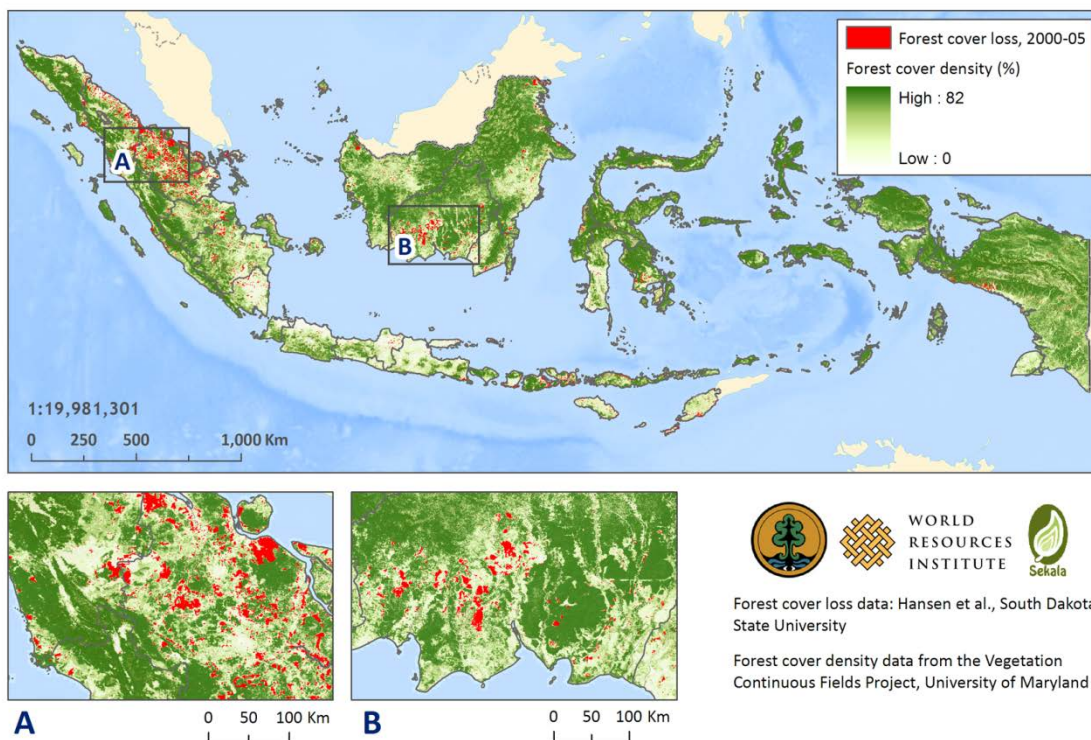
The Future of Tropical Salvage

As O’Brien prepared signs for the warehouse clearance sale, he thought about different ways to arrange his furniture in a retail store. He believed that strong displays would draw more customers and increase demand so that he could expand his sourcing operations and employ more people. He was also confident that he could introduce new merchandise to complement Tropical Salvage’s furniture, which would greatly benefit the small communities in Indonesia working with the company.

O’Brien still questioned the best financing option for his expansion plan however. Does it make sense to appeal to investors or continue down his financially independent path? Further, is he in a secure enough position to take on expansion while the economy’s future is so unclear? He worried that if his expansion efforts failed, Tropical Salvage’s social mission could be compromised. He also wondered whether he should consider The Rainforest Alliance’s SmartWood Certification in order to increase visibility to consumers in the LOHAS market. This question was part of the larger challenge of how to effectively communicate the value of Tropical Salvage to its target customers. What marketing efforts would best serve his plans? O’Brien had a lot of thinking and work to do before he would be able to jump into branded retail stores successfully.

Appendix 1

Forest Cover Loss in Indonesia, 2000-05



Indonesia Forest Area										
Classification	Area			Annual change rate				Total change		
	1990	2000	2005	1990-2000	2000-2005	2000-2005	2005	1990-2005	2005	1990s vs 2000s
Period	ha	ha	ha	ha	%	ha	%	ha	%	%
Total forest area	116,567,000	97,852,000	88,495,000	-1,872,000	-1.7	-1,871,000	-2	-28,072,000	-24.1	17.65
Other wooded land				0			0	0		
Primary forests	70,419,000	55,941,000	48,702,000	-1,447,800	-2.06	-1,447,800	-2.59	-21717000	-30.8	0
Plantations	2,209,000	3,002,000	3,399,000	79,300	3.59	79,400	2.64	1190000	53.9	-26.3

All data derived from the Forest Resources Assessment and the State of the World's Forests
published by the U.N. Food and Agriculture Organization (F.A.O)

Appendix 2 – Wood Salvaging



River salvage site in Bundu (Java, Indonesia)



House deconstruction site

Appendix 3 - Tropical Salvage Wood Salvaging Methods

Deconstruction wood	Indonesia is replacing a number of its buildings and structures with concrete and rebar; deconstruction wood is very common. Teak was used in many of the deconstruction projects Tropical Salvage comes across. Old doors and shutters from deconstruction are often used in Tropical Salvage's armoires and wine cabinets.
River and lake salvage	Years of severe weather and volcanic activity in Indonesia have knocked down a number of trees that have been swept into rivers. Low water levels in the dry season make it easy to find these trees; the wood is pulled out of rivers and lakes, cut into two-meter lengths and brought to the sawmill.
Flood and landslide salvage	Trees and houses fallen victim to landslides are a result of illegal logging. Deforestation eliminates the soil's protective canopy, increasing the likelihood of landslides during Indonesia's rainy season.
Plantation "waste"	Coffee and cacao trees are not typically used in furniture, but Tropical Salvage has learned to use them in their furniture designs. These woods are traditionally burned when they are culled from a plantation.
Entombed wood	Entombed wood exists as a result of volcanic eruptions hundreds of years ago. These trees became entombed in bogs and aged below ground, deep enough so that oxygen has not decomposed them. The rainy season erodes the soil around the bogs and brings the entombed wood closer to the surface. While the logs are entombed, they absorb minerals from the soil to add density to the wood; the woods are very hard and very heavy. Tropical Salvage can sometimes make tabletops with a single plank of wood that still holds the shape of the tree's trunk.

Appendix 4 – Jebara Production Warehouse



Appendix 5 – Tropical Salvage Finished Products



Outdoor chairs from a deconstructed boat

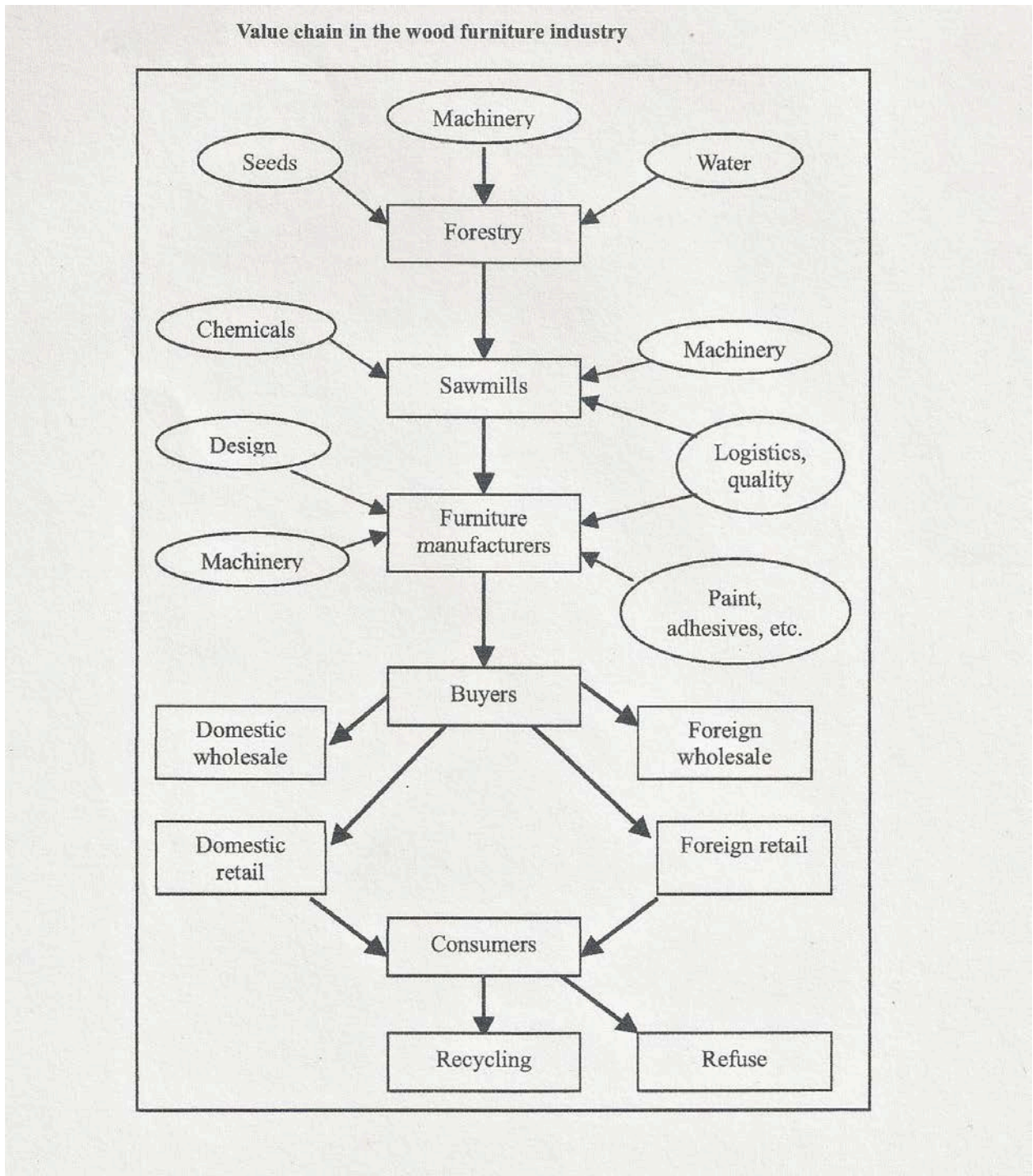


Mimpi Manis Day Bed



Higher Cause Storage

Appendix 6 – Wood Furniture Industry Value Chain



Source: Global Wood Furniture Value Chain: What Prospects for Upgrading by Developing Countries

Appendix 7 – Top 15 Furniture Exporters (2000)

Table 1 Global furniture trade—top 15 net exporting countries (US\$ million)^a

<i>Country</i>	<i>Gross exports 2000</i>	<i>Net exports 1995</i>	<i>Net exports 2000</i>	<i>Net exports percentage change 1995-2000</i>
Italy	8,359	7,595	7,395	-3
China	4,582	1,671	4,412	164
Canada	5,179	685	2,044	198
Poland	2,191	1,180	1,815	54
Indonesia	1,518	819	1,498	83
Malaysia	1,596	826	1,491	80
Denmark	1,900	1,687	1,209	-28
Mexico	3,315	468	1,173	151
Thailand	949	712	909	28
Spain	1,453	523	531	2
Slovenia	586	409	461	13
Czech Rep	780	148	445	201
Romania	445	472	377	-20
Sweden	1,298	510	338	-34
Brazil	496	212	333	57
Total of rest	22,742			
Total^b	57,388			

Source: Global Wood Furniture Value Chain: What Prospects for Upgrading by Developing Countries

Appendix 8 – Rainforest Alliance SmartWood Certification Program

Rediscovered Wood and Underwater Salvage: approves wood that is reclaimed in such a way to preserve the “integrity of the environment as well as the health welfare of workers and the community”.

Rainforest Alliance Rediscovered Wood Standards

Part 1. Rediscovered Wood Eligibility and Recovery

1.1 Rediscovered Wood Classification

1.1.1 RWO systems shall ensure materials it reclaims for use as Rediscovered Wood qualify as coming from one of the RW categories defined in section D above.

1.1.2 RWO systems shall ensure materials obtained from suppliers and used as Rediscovered Wood qualify as coming from one of the RW categories defined in section D above.

1.2 Wood Recovery Source Information *(for each source)*

1.2.1 Each source of Rediscovered Wood shall be sufficiently documented to provide credible evidence that materials qualify as coming from one of the RW categories defined in section D above.

1.2.2. Source information including origin/recovery and classification under one of the RW categories defined in section D shall be demonstrated through the completion of the RW Source Information Form (Annex 3) or through equivalent documentation.

1.2.3 If Rediscovered Wood materials are purchased or obtained from a supplier, the RWO shall provide documented evidence that the source meets Rediscovered Wood requirements as defined in this standard.

1.2.4 A summary of the methods used for recovery of the Rediscovered Wood materials and potential impacts shall be developed and maintained.

1.3 Wood Recovery Impacts

1.3.1 Environmental impacts associated with recovery and on and off-site processing shall be identified and mitigated.

1.3.2 Worker safety conditions associated with the recovery operation shall meet legal requirements.

1.3.3 Any cultural, historic, or social impacts of the Rediscovered Wood recovery shall be identified/researched and reconciled.

1.4 Resource Rights and Use

1.4.1 All necessary documentation that accompanied the Rediscovered Wood source shall be in place, e.g., permits, deeds, demolition contracts.

1.4.2 Clear evidence of rights to the Rediscovered Wood source shall be demonstrated, e.g. permits, deeds, demolition contracts.

Part 2. Chain-of-Custody

2.1 Quality System

2.1.1 RWO shall define CoC system responsibilities and appoint staff positions, including the following:

- a) One overall responsible person shall be designated for the CoC control system;
- b) Individual responsible persons shall be designated for each part of the CoC control system (purchasing, processing, final storage, marking, sales documents, recordkeeping, etc.).

2.1.2 RWO shall develop and maintain up-to-date documented procedures and/or work instructions to ensure implementation of all applicable CoC standard requirements.

2.1.3 RWO shall develop and implement procedures for addressing non-conformances (corrective action requests, observations) identified by auditors.

2.1.4 RWO shall develop and implement procedures for internal auditing of its systems as related to CoC requirements in this standard and include the following:

- a) Documentation to show when audits take place and audit results;
- b) Provision for review of internal audit results by senior management staff; and
- c) Provision for internal audits to occur at least annually.

2.1.5 RWO shall develop training requirements and implement training as follows:

- a) All applicable staff and workers shall be trained according to the CoC procedures;
- b) Record shall be kept to demonstrate training has taken place.

2.1.6 RWO shall define and document the product that will be tracked as Rediscovered Wood.

2.1.7 RWO shall develop and maintain records to document quantities of Rediscovered Wood product for the following:

- a) Purchased as inputs/raw material;
- b) Used in production;
- c) Conversion factors;
- d) Inputs and final products in stock; and
- e) Final products sold with and without a Rediscovered Wood claim.

2.2 Purchasing and Receiving

2.2.1 If supplier is a Rediscovered Wood certificate holder, RWO shall verify the validity of the supplier's RW certificate.³

2.2.2 RWO shall verify that material purchased and received is consistent with Rediscovered Wood categories.

2.2.3 RWO shall store Rediscovered Wood material as separate, secure units.

2.2.4 RWO shall use a distinguishing mark to identify Rediscovered Wood material.

³ When supplier is not RW-certified, 1.2.2 and 1.2.3 requirements apply.

2.3 Processing

2.3.1 RWO shall keep Rediscovered Wood material physically separate during all stages of processing.

2.3.2 RWO shall use a tracking system or production records to document production of Rediscovered Wood material.

2.3.3 RWO shall ensure that any off-site processing that takes place at a subcontracted facility follows CoC procedures and is covered by a signed outsourcing agreement.

2.3.4 All material that cannot be identified as qualifying for Rediscovered Wood shall be kept physically separate from all other material until documented evidence of the Rediscovered Wood status is obtained.

2.4 Shipping and Sales

2.4.1 RWO shall store final Rediscovered Wood products as separate, secure units.

2.4.2 RWO shall use a distinguishing mark to identify final Rediscovered Wood products.

2.4.3 RWO shall include Rediscovered Wood claim information on sales invoices and shipping documents, including the following:

- a) A description of the product as “Rediscovered Wood”;
- b) The quantity/volume for each product; and
- c) The SmartWood Rediscovered Wood certificate code.

Part 3. Rediscovered Wood Claims and Public Information

3.1.1 All on-product and off-product/promotional claims made by the RWO shall be in compliance with Rainforest Alliance Rediscovered Wood trademark requirements.

3.1.2 RWO shall have procedures in place and demonstrates submission of all on-product and off-product/promotional claims to SmartWood for review and approval prior to use.

3.1.3 RWO shall have procedures in place and demonstrates that all trademark review and approval correspondence with SmartWood is kept on file for a minimum of 5 years.

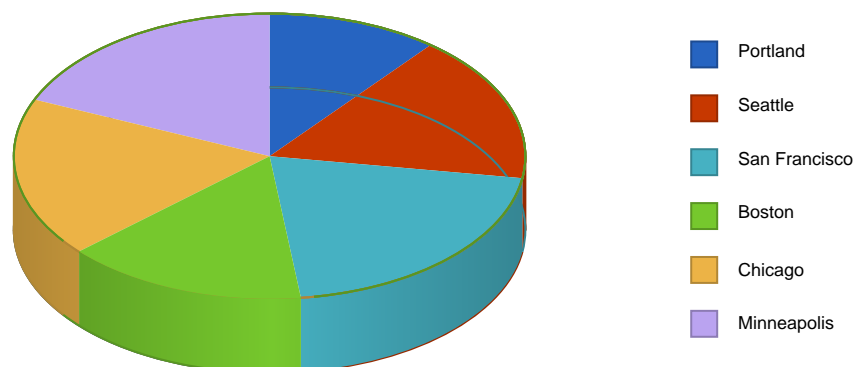
Source: http://www.rainforest-alliance.org/forestry.cfm?id=smartwood_program

Appendix 9 – LOHAS Market

LOHAS (Lifestyles of Health and Sustainability) populations are the ideal target customers for Tropical Salvage. A market analysis of the top six potential markets is below:

<i>Market Analysis</i>		2009	2010	2011	2012	2013	
Potential Customers	Growth						CAGR
Portland	3%	247,405	254,827	262,472	270,346	278,456	3.00%
Seattle	3%	384,741	396,283	408,171	420,416	433,028	3.00%
San Francisco	3%	473,369	487,570	502,197	517,263	532,781	3.00%
Boston	2%	351,000	358,020	365,180	372,484	379,934	2.00%
Chicago	2%	419,000	427,380	435,928	444,647	453,540	2.00%
Minneapolis	3%	424,807	437,551	450,678	464,198	478,124	3.00%
Total	2.67%	2,300,322	2,361,631	2,424,626	2,489,354	2,555,863	2.67%

Market Analysis (LOHAS Households)



Source: Tropical Salvage Growth Plan: August 2010

Appendix 10 – Estimated Annual Operating Expenses for Seattle Store

Category	Expense (US\$)
On-Going Expenses	
Wages and salaries	\$110,000
Lease	\$80,000
Utilities (phone, broadband)	\$12,000
Marketing	\$50,000
State/local license and permits	\$3,000
Container furniture shipments (5 shipments, 40' containers)	\$100,000
Computer and organizational/inventory software	\$6,000
Information kiosk in storefront	\$5,000
Miscellaneous supplies	\$2,000
Travel	\$5,000
Furniture maintenance tools	\$3,000
Subtotal	\$376,000
One-Time Expenses	
Delivery truck (used)	\$8,000
Signage	\$10,000
Expansion of production capacity in Indonesia	\$20,000
Lighting system in storefront	\$10,000
Subtotal	\$48,000
Total	\$425,000

Appendix 11 – Tropical Salvage Condensed Financial Data

<i>Consolidated Income Statement Data</i>	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Sales	\$470,000	\$478,813	\$863,480	\$1,674,450	\$2,881,364	\$4,529,157
Gross Margin	\$204,000	\$282,682	\$583,266	\$1,212,062	\$2,113,682	\$3,435,952
Gross Margin %	43.40%	59.04%	67.55%	72.39%	73.36%	75.86%
Total Operating Expenses	\$250,000	\$288,420	\$520,000	\$903,000	\$1,304,450	\$1,719,900
Profit Before Interest and Taxes	(\$46,000)	(\$5,378)	\$43,266	\$289,062	\$774,232	\$1,716,052
Other Income	\$77,212	\$0	\$0	\$0	\$0	\$0
Retail Door Build Out & Remodel	\$0	\$0	\$20,000	\$20,000	\$35,000	\$0
Net Profit (Loss)	\$31,212	(\$10,258)	\$27,123	\$200,762	\$541,962	\$1,201,237
Consolidated Balance Sheet Data	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Current Assets						
Cash	\$28,593	(\$10,598)	(\$16,933)	\$52,207	\$473,381	\$1,652,700

<i>Consolidated Income Statement Data</i>	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Accounts Receivable	\$5,000	\$5,608	\$10,113	\$19,610	\$33,745	\$53,043
Inventory	\$14,400	\$48,859	\$133,639	\$257,027	\$429,349	\$524,416
Total Current Assets	\$47,993	\$43,868	\$126,819	\$328,844	\$936,476	\$2,230,159
Total Long-term Assets	\$4,837	\$3,517	\$8,517	\$6,517	\$4,517	(16,483)
Total Assets	\$52,830	\$47,835	\$135,336	\$335,361	\$940,993	\$2,213,676
Accounts Payable	\$5,000	\$9,813	\$50,641	\$95,102	\$158,772	\$230,218
Total Current Liabilities	\$5,000	\$9,813	\$50,641	\$95,102	\$158,772	\$230,218
Long-term Liabilities	\$45,197	\$45,197	\$45,197	(\$1)	(\$1)	(\$1)
Total Liabilities	\$50,197	\$55,010	\$95,838	\$95,101	\$158,771	\$230,217
Paid-in Capital	\$0	\$0	\$20,000	\$20,000	\$20,000	\$20,000

<i>Consolidated Income Statement Data</i>	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Retained Earnings	(\$28,579)	\$2,633	(\$7,625)	\$19,498	\$220,259	\$762,222
Earnings	\$31,212	(\$10,258)	\$27,123	\$200,762	\$541,962	\$1,201,237
Total Capital	\$2,633	(\$7,625)	\$39,498	\$240,259	\$782,222	\$1,983,458
Total Liabilities and Capital	\$52,830	\$47,385	\$135,336	\$335,361	\$940,993	\$2,213,676

Source: Tropical Salvage Growth Plan: August 2010