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A RECIPE FOR *Contractor Success*

Throughout my career, I've wondered why some contractors continue to make money during downturns while many others fail.

Over the years, I've discovered that contractors must be able to quickly constrict and expand during economic cycles. In order to be flexible, your company must have solid best practices and a dedication to exceptional planning.

When this article was first published, the construction industry was emerging from the post-9/11 recession, which depleted the work available within commercial construction. Although it was well received at its release, the article lost its luster when contractors were busy building subdivisions, high-rises, mega high schools, or major infrastructure projects to support growth fueled by the housing expansion.

However, the backlog of projects masked managerial weaknesses. The availability of work kept cash flowing in, and then right back out for newly acquired corporate debt, expansion, personal real estate developments, more staff, and additional equipment.

Given current economic conditions, it seems fitting to revisit this article. We will explore how to constrict and expand a construction business by exploring best practices, cost control, and proper planning using the following recipe: 1 Cup of Honesty, 1 Cup of Cost Control, and 1-1/3 Cups of Preparation.

1 Cup of Honesty

At first glance, honesty may seem like an unusual ingredient for our recipe. However, many organizational mistakes stem from misunderstanding a company's strengths and weaknesses.

Often, this inability to look into the corporate mirror comes from a lack of knowledge of construction best practices. In addition, denial can prevent management from making the necessary changes to ensure profitability, measure

risk vs. reward, and implement change. Also, very successful construction companies can grow complacent and become unable to adapt to changes in the business climate.

As with any business, it's important for contractors to continually examine their strengths and weaknesses. A comprehensive review of your company's financial performance during the past 5-10 years will provide an accurate scorecard of its strengths and weaknesses.

This data should consist of a detailed analysis of job performance – sliced and diced by superintendent, PM, scope, geography, size, and duration. In addition, calculate and understand your company's average gross margin, particularly how it relates to company overhead.

Other scorecard measures include liquidity, profit fade vs. profit pick-up, leverage position, profitability, receivable/payable aging, interest expense, and cash flow – just to name a few.

As your company's financial manager, you should analyze its financial history at least quarterly. Also, obtain third-party input into this analysis from such business partners as your surety professional, CPA, and Board of Directors. This input often increases accountability when rectifying weaknesses.

In addition, *CFMA's Construction Industry Annual Financial Survey* provides a thorough peer review analysis, including comparative financial data on companies similar in size and niche.

As you examine your company's financial scorecard and its resulting strengths and weaknesses, compartmentalize your company into three distinct business units: 1) Get Work, 2) Do Work, and 3) Keep Score. Each of these business units must have the same weighted management oversight. When a construction company focuses on one of these business units more than the others, poor performance often results.

As you review the following best practices implemented within each business unit, ask yourself if your company maintains these disciplines. If not, then you've located a weakness that could prevent optimal profitability.

Get Work

Stick to Your Niche

While this may seem like a very basic concept, many contractors have not properly identified their expertise. In addition, they change their core business without proper planning and risk analysis.

If a contractor that typically performs private work elects to perform public work, then there will certainly be a learning curve, as both markets require different management practices. In addition, a successful residential contractor that moves into commercial work may compromise profitability. The same holds true for opening branch offices during geographic expansion.

As a general rule, only make one change at a time. While it's possible to effectively manage many changes, this approach often produces unprofitable results. Stick to your core business, perfect your policies and procedures, and maximize profitability. Once your core business is well managed, take on a new challenge.

Sticking to your niche is challenging in this economy. Reinvent your company, but try to stick to what you know. This may take on the form of more "green" construction, moving from schools to universities, or even expanding into infrastructure work. The key is to ensure that changes are absorbed within your company so that it doesn't take on too many changes at once.

Know Your Overhead Burden

Most contractors generally work eight months of their fiscal year in order to break even. The estimating department should know how many dollars per month a project must produce to cover its pro-rata share of the monthly overhead.

Ensure that your company's estimating department has adequate information on the overhead burden as well as margin requirements, and update the information continually throughout the fiscal year. Getting *profitable work* is the goal.

Your company's overhead burden could change on a quarterly basis as it constricts for economic decline. Analyze and communicate this information to estimating and project management frequently.

Build a Team Approach

In many companies, estimating is separate from project management. This is an effective procedure if both departments maintain a high level of communication with each other.

However, many contractors perform poorly in the area of project turnover, which includes communication, strategy, and planning at the beginning of a project between estimating, project management, and field supervisors. Contractors that hold project turnover meetings have fewer surprises, increase productivity, and generate a team approach to project performance.

Do Work

Plan & Schedule

Scheduling is a natural risk management tool to ensure solid footing during claims and disputes. With subcontractor failures on the rise and owners tightening their financing, you cannot afford scheduling setbacks. Schedule delays equate to lost profit.

Often, the schedule is prepared for contractual reasons rather than updated weekly as a tool to manage profit. Although most companies modify the schedule on a monthly basis, weekly modifications turn the process into a planning and documentation tool.

Maintaining a weekly schedule increases communication and coordination among trades. You can anticipate and prepare for problems while monitoring project expectations and benchmarks that were identified in project turnover meetings.

Not only can the schedule provide a forecast of the project life cycle, it can also diminish future disputes or communication breakdowns associated with scope changes or project disruptions. The superintendent is the most effective participant in the schedule's preparation and weekly update.

Manage the Budget & Then ...Manage the Budget

Many contractors do not maintain margin discipline (known as "buying work"). As a result of this downward margin pressure on bid day, there is little room for mistakes. Manage to the budget (costs), not to the contract (billings). This is your most vulnerable area during the current economic decline.

Management must adjust the original budget throughout the project life cycle. In an industry that already has limited return for the risk, contractors cannot afford profit fade. If the budget is not redeveloped throughout the project, then cost overruns will likely occur.

When you continually "work" the budget, you'll discover disruptions that could reduce the project's profitability while there is still time to minimize the effects. You can also implement creative cost methods to compensate for profit deterioration later in the project.

To effectively develop the budget, you must be able to quickly retrieve field production rates (quantities) and costs. And, to maximize profitability, you must maintain a unit price job cost system.

However, onsite field personnel and supervisors often prefer not to record data. As a result, it's difficult to capture the necessary data and update your cost records. In my experience, this behavior is difficult to change, so you must simplify your field documentation requirements by tracking those cost codes that are most vulnerable (no more than five).

For more information on this topic, see "Using Job Cost Reporting to Mitigate Risk & Improve Profitability" by William M. Kerns in the November/December 2011 issue.

Prequalify & Manage Subcontractors

In stable economic times, subcontractor failure can quickly compromise a project's profitability. However, the current rate of subcontractor failure is on the rise and as such, an internal prequalification process is mandatory to mitigate this risk. The ideal option is to transfer the risk to a surety bond. Unfortunately, surety credit tightening and downward margin pressure on bid day can prevent this risk transfer.

Although your staff is probably working harder (and maybe with fewer people), streamlining subcontractor prequalification may be necessary. For example, provide field superintendents with vendor monitoring education to document lower-tier suppliers and subcontractors on a project to prevent paying twice.

Be sure to incorporate the following information into your company's prequalification process and update the information annually:

- Check references.
- Have firsthand knowledge of the subcontractor. Don't automatically hire the new, low bidder.
- Look at the subcontractor's backlog.
- Have a description of the subcontractor's largest project to date.
- Determine if the largest project is within the subcontractor's normal scope of work.
- Verify the subcontractor's payment record with creditors.
- Confirm that the subcontractor is bondable and identify the surety.
- Decide if the subcontractor maintains adequate cash flow management practices. How will retainage impact its ability to fund the job?

However, it works both ways. Subcontractors should prequalify their GCs and encourage annual prequalification.

For more on these topics, see "Prequalification from the Subcontractor's Point of View" by David A. Walls in the November/December 2011 issue and "Lien Laws & Out-of-State Projects:

A Little Research Goes a Long Way" by Lee A. Weintraub in the May/June 2011 issue.

In addition to prequalification, require subcontractors to provide a field manpower utilization schedule with their estimate, clearly define the scope of work, and highlight any potential areas that require close attention.

Also, break down the subcontract scope into line-item level detail for cost control and progress. This should be in the subcontractor's schedule of values.

In addition, implement controls to minimize the exposure of paying twice to lower-tier subcontractors and suppliers. To reduce this exposure, record the suppliers and subcontractors that visit the site on a daily job report. Then, compare the daily report to the original vendor list supplied by the subcontractor to see if there are any changes or alterations to their creditors.

GCs should also pay subcontractors promptly and process change orders in a timely manner. Engage in clear and concise subcontract agreements and reference the subcontractor's proposal in the subcontract agreement. GCs should also notify subcontractors of their binding contractual conditions to the owner.

Evaluate Project Performance

As one of the most effective methods to improve future teamwork, conduct project performance evaluations after all costs (including change orders and punch list items) are recorded. At that time, the budget variance report should be the focus of discussion.

Implementing a "lessons learned" program at the close of each project is vital. ***After all, much of the data necessary to ensure future success is in your project folders.***

At the close of every project, hold a meeting to discuss all aspects of the process. Don't limit the meeting to just the project's team members; the whole company stands to benefit from information about mistakes, as well as creative field solutions.

Focus on budget overruns and underruns, and solicit feedback from all personnel on communication, change order management, scheduling deficiencies, creative cost measures, material procurement, and strengths and weaknesses associated with the execution of the work. Also, discuss relationships with subcontractors, suppliers, architects, engineers, and the project owner.

This process protects future profits by fostering open communication while improving employee performance. This will also encourage a team approach among each business unit within your company.

Keep Score

Manage Profit, Not Revenue

If you are fortunate enough to obtain a project with margin discipline, then the emphasis should be ***protect the profit – no fade allowed***. CFMs will have to work more closely with PMs and field superintendents to ensure adequate evaluation of costs to complete, as well as become more focused on forecasting and less focused on transactional activity.

All budgetary forecasting should work the income statement from the bottom up. Set a profitability goal and then make corresponding income statement entries. Remember, a contractor can only control two areas on the income statement – overhead and profit in the field.

Revenue can simply be defined as the economic availability of work. Unfortunately, contractors have no impact on the availability of work or on the economic conditions in their particular markets. As a result, managing revenue without an equal focus on profitability could lead to negative cash flow and ultimately failure.

Gross profit is dictated by economics as well. The number of contractors and the respective availability of work will dictate the project's price on bid day. Well-managed contractors maintain a margin discipline irrespective of competition. As a result, the area of concentration should be protecting – and ultimately increasing – the profit anticipated during the original estimate.

Maintain 12-Month Cash Flow Projections

Some contractors are currently bidding work at or below costs just to survive, which is not a sustainable practice. Cash flow management is imperative; without a cushion, cash can dwindle quickly. ***Contractors should strive to emerge from this recession in the same cash position with which they entered.***

Most CFMs agree on the importance of cash flow and its role as a better scorecard of financial condition than an income analysis. A cash flow analysis on a project level reveals problems more quickly than other methods.

While this responsibility is generally delegated to the CFM, buy-in from PMs is imperative to cash analysis and forecasting. Your company should maintain its cash flow projections at both a company and project level. When PMs learn to look

at a project from a cash flow vs. billings standpoint, their business maturity increases.

Collect All Receivables on Time

Always analyze an owner's ability to pay. This is a prudent business practice and should never be overlooked. Assuming your company verified the owner's sources of funding, it's a good business practice to establish your collection expectations up front.

Generally, the accounting department contacts the owner about late payments a couple of months into the billing process. At this point, the behavior has already been established and will likely get worse before it gets better.

The "squeaky wheel" saying works in collections, but only if you set expectations early on. In other words, set the precedent for timely collection before the first progress bill is due.

For example, one contractor dedicated an accounting employee to call owners to advise that the first progress billing was in the mail and mention the payment due date. The accounting employee called again three days before the bill was due to remind the owner of the due date. A third call was placed on the due date.

This procedure sets precedence for your collection tolerance and establishes the behavior for payment up front, before a problem occurs.

1 Cup of Cost Control

Here's one of my favorite quotes: "…being frugal is not just a matter of cutting costs in a downturn. It is a question of being sparing with resources at all times, of continually looking for new ways to cut costs, and of creating an atmosphere in which waste and excess are unacceptable, no matter what the market conditions."[1]

Maintaining a frugal environment is imperative to cost control. However, it's important that employees who buy into this concept are rewarded for their efforts. The construction industry already operates on extremely lean returns; therefore, maintaining a "no waste" philosophy throughout the company is imperative.

One cost control option is flexible overhead. Although the short-term costs of flexible overhead may be more expensive, they are easier to dissolve over the long term. Flexible overhead includes:

- Equipment leases and rentals
- Month-to-month rentals
- Outsourcing
- Temporary employees
- Contract employees
- Reward-based compensation plans, rather than fixed salaries and a company truck
- Deferred employee benefits
- Joint ventures

If your company rents equipment or utilizes outsourcing, will it price itself out of the market? Depending on the continued severity of this economic decline, it's certainly possible. Fixed costs and fixed debt require fixed revenue and margin; you cannot control revenue and margin as previously explained. Efficiency and innovation are requirements when you utilize flexible overhead.

Here are other practical ways to control costs:

- Invest in construction software for efficiency and long-term cost savings.
- Improve the company's safety plan.
- Prevent small tool losses.
- Manage purchase orders and implement centralized controls.
- Avoid accumulating non-performing assets.
- Plan and document any external borrowings.
- Maintain a philosophy of creative, innovative solutions to construction challenges.
- Track costs within a unit-priced job cost system.
- Overbill, or internally finance the operation with the owner's money.
- Understand the components of your overhead. (How much does it truly cost to turn the lights on?)
- Reward employees for being frugal.

1-1/3 Cups of Preparation

Planning for future production is vital to any contractor's financial success. Although preparation sometimes takes a back seat during times of stress and adversity, that is actually when it is most needed.

Preparation and planning should be a part of each key manager's job responsibilities. In fact, the CEO, CFO, and VP of Operations should maintain a management journal that records business plans, forecasts, and strength/weakness analyses.

Unlike a formal business plan, this management journal, by its private nature, will be more reflective of issues and weaknesses. As you review the following planning guidelines, think of this exercise as an informal process – not the formal business plan contractors typically submit to creditors.

Short-Range Planning

As you plan for the short and long term, concentrate on "what-if" planning to move the company to proactive management.

Get Work

- *Market Analysis* – Monitor building trends and economic indicators regularly, both locally and on a larger scale.
- *12-Month Budget* – Update this budget frequently using the work-in-progress (WIP) report.
- *Overhead Burden Analysis* – Review this information often to maintain your company's focus on margins. Forecast your breakeven point and review its status regularly. Communicate this information to your estimating department.
- *Potential Opportunities/Threats* – Revise your list quarterly, or when a new opportunity or threat arises. For example, material shortages due to hurricane damage would influence prices across the country.

Do Work

- *Lessons Learned Analysis* – Maintain information about each project's mistakes, successes, and creative solutions.
- *Cost Savings in the Field* – Keep a separate history of cost reductions identified in the field and provide the information to your PMs annually.
- *Communication Goals* – List the company's goals for internal and external communication, and check the progress at least quarterly.
- *Company Goals and Objectives* – Compare your company's policies and procedures to its strategic goals and objectives on a regular basis.
- *Get Everyone Doing the Same Thing* – Have an action plan to move all staff in the same direction. This plan obviously includes your accounting staff and should contain ideas to motivate others in your company.

Keep Score

- *SG&A Budget* – Remember, this is a dynamic document. When reviewed often, this is a valuable management tool.
- *Capital Expenditure Budget* – Evaluate capital expenditures at least annually and look for opportunities such as leasing savings and tax benefits.
- *Cash Flow Projection* – Analyze your company's cash flow often and develop a method to forecast EBITA, A/R, Inventory, Net WIP, Fixed Assets, A/P, Accruals, and Debt.
- *Cost to Complete Projections* – During budget variance meetings with PMs, change the project data to a cash basis instead of a billings basis in order to educate PMs on the cash requirements of their respective projects.

Long-Range Planning

Prepare documented contingency plans in the event the company experiences a significant drop in revenue. *There should be three contingency plans in place that fully document various levels of revenue, gross profit, overhead, and organizational structure at those levels.*

This will limit confusion and emotion if you are faced with the decision to constrict your overhead as a result of revenue and margin decline. When planning, consider margin discipline, acceptable revenue per employee, and a rework of the income statement.

Many contractors that do not have contingency plans have been caught off guard with reactive management, which has caused poor performance or forced them out of business.

Be sure to design a plan to deal with ownership changes. Formalize all stock transfer agreements and develop an exit strategy for key stockholders.

Historical Trends, Predictions & Comparisons

History shows us that economic cycles move in waves of 7-10 years. In addition, most economic upswings abruptly end. Fast-forward to our present day credit crisis and housing bubble.

In my opinion, this housing bubble created an illusion of growth equal to 30% excess. Capitalism runs on supply and demand; if the demand for work remains stagnant (which is unlikely given the current global macro problems), then the supply of contractors must be adjusted to meet current demand. This is necessary in order to achieve equilibrium in the supply/demand curve that governs our industry.

The difference between the 2008 credit crisis and the economy at the time this article was originally published in 2006 is the length and severity of the current recession. The reason is due to the financial infrastructure meltdown that did not occur in the non-financial related recession of 9/11.

In fact, in the *Washington Post* (August 8, 2011), Carmen Reinhart (an economist for the Peterson Institute for

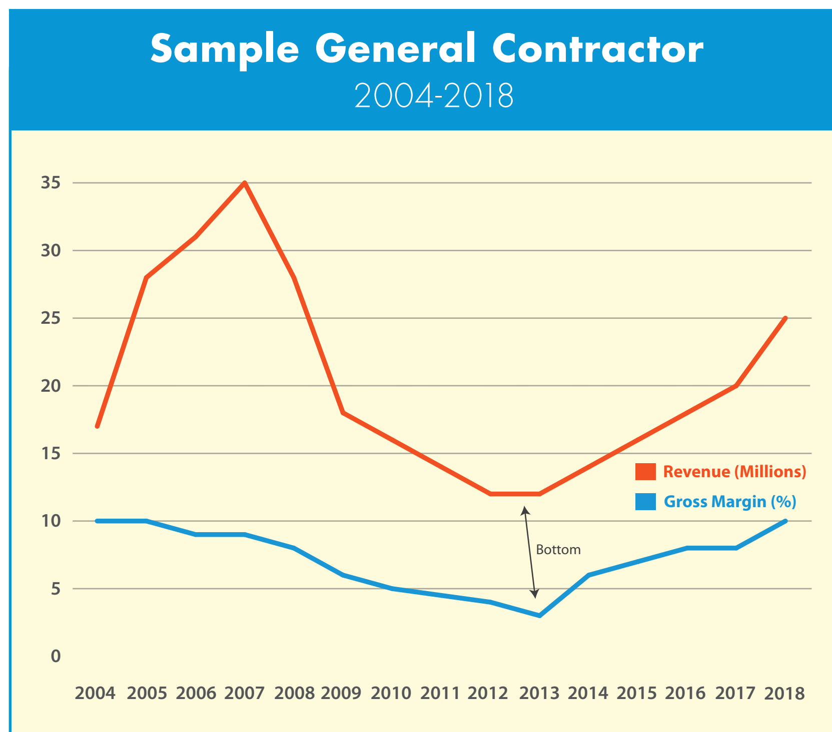
International Economics) suggests that debt deleveraging takes about seven years to accomplish after a financial crisis. If this opinion is accurate, then we are looking at possible volatility through 2016. I believe we are looking at long-term stagnation with a possible bottom in the third quarter of 2013.

Another difference between this recession and the one noted in the original article is the effect on public work. Many private contractors saturated the public work arena during the 9/11 recession. The predominant issue with the current availability of public work is the lack of funding.

While the *American Recovery and Reinvestment Act of 2009* provided some relief, many contractors did not benefit from the stimulus. As a result, there has been a significant reduction in the availability of public work, which has furthered the severity of this recession for our industry.

Since the 2008 credit crisis, I have noted that 2011 financial statements resemble pre-2004 statements with respect to revenue. However, the gross margins are unfortunately much worse. As I analyzed historical data more closely, it became apparent that many companies are "giving back" everything they made from 2005-2009.

The graph at right is an example of what a typical GC's revenue and gross margin might resemble from 2004-2018. Note that in 2007, the $35 million in revenue corresponded with a 9% gross margin. In 2011, the revenue dropped to $14 million with a corresponding 4% gross margin – all a result of the credit crisis. The 2004 organization charts and G&A analyses could assist in planning and execution in order to constrict this contractor's business.



Compare your own company's historical financial statements to see if there is any correlation with this timeline. It would be interesting to pull out your coordinating organizational chart and G&A expenditures for 2004 as well. This comparative data could be instrumental in helping your company plan for 2012 and beyond.

Conclusion

With a reduced demand for work, today's contractors compete on thin margins at best. In order to succeed, your company must be flexible.

As a CFM, you must understand your management strengths and weaknesses and concentrate on promoting a change-friendly business environment. And, by perfecting your three business units (Get Work, Do Work, and Keep Score), you should be able to constrict your company within a short period of time.

Since the economy always rebounds, will your company be ready when the demand for work increases?

A version of this article appeared in the January/February 2006 issue.

Endnote:

1. "Back to Basics," *The Economist*, March 7, 2002.

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