CFMA Building Profits

THE MAGAZINE FOR CONSTRUCTION FINANCIAL PROFESSIONALS

R E P R I N T

JANUARY-FEBRUARY 2006

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

The Source & Resource for Construction Financial Professionals

A Contractor's Diet: HOW TO GET LEAN

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During the past two decades, the construction industry has experienced repetitive economic cycles characterized by an abundance of work, followed by a reduction of work.

These cycles significantly affect earnings performance.

Few construction companies have maintained profitability through every economic valley.

But, there is a way …

Looking back, the abundance of construction work in the 1990s created a bumper crop of new contractors. In addition, the amount of available work often offset managerial weaknesses and minimized their impact on company performance.

As we approached the millennium, the availability of work diminished – and the oversupply of contractors created fierce competition and reduced margins.

2002 and 2003 were certainly challenging years for the construction and surety industries. In 2002 alone, the surety industry produced $3.5 billion in earned premiums and reported $2.5 billion in losses, a loss ratio of almost 70%.[1]

Contractor income statements commonly showed a decrease in revenue compared to previous periods. Unfortunately, many contractors did not make the necessary adjustments to restore profitability, and ongoing managerial weaknesses translated into poor performance.

As a result, many construction companies failed, which prompted tighter credit from the surety industry and other credit facilities serving commercial construction.

Tightening the Company Belt

Those construction companies that produced positive earnings at the turn of the millennium – despite economic volatility – were well managed, and were able to constrict and expand based on current and forecasted economic conditions. This article will explore the best practices of those well-managed construction companies.

Using the "Contractor's Diet," we will also explore how to contract and expand a business with proper planning and cost control measures.

Three ingredients comprise the Contractor's Diet – a well-developed recipe for profitability, regardless of market conditions:

1 Cup of Honesty, 1 Cup of Cost Control & 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 the company's strengths and weaknesses.

Often, this inability to look into the corporate mirror comes from a lack of knowledge of best practices within construction. 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, unable to adapt their company concurrent with changes in the business climate.

As with any business, it's important to continually examine the company's 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 the overhead of the company.

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 a CFM, you should analyze the financial history of the company 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 third-party input often increases accountability when rectifying weaknesses.

In addition, *CFMA's 2005 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.

When a construction company focuses on one of these business units more than the others, poor performance often results. Each of these business units must have the same weighted management oversight.

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

Get Work

Stick to Your Niche

While this may seem to be a very basic concept, many construction companies 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, there will certainly be a learning curve, as both markets require different management practices. In addition, a successful residential contractor that moves into non-residential work may compromise profitability. The same holds true for opening branch offices during geographic expansion.

For example, let's suppose a contractor has been successful in a particular niche market. In a different city, an economic upswing creates an abundance of work outside the contractor's niche. To take advantage of the market conditions, the contractor opens a branch office, increases backlog, hires personnel to run the project – and commits to a capital outlay that is difficult to undo if the venture fails.

A general rule of thumb: Only make one change at a time. While it is 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.

Know Your Overhead Burden

Generally speaking, most construction companies work eight months of their fiscal year simply to breakeven. 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 the 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.

Build a Team Approach

In many companies, estimating is separate from project management. This is an effective procedure, if estimating and project management 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

The next phase after project turnover? Documenting part of that communication when preparing and maintaining the schedule.

Often, the schedule is simply prepared for contractual reasons rather than *updated weekly as a tool to manage profit*. Although most companies make modifications to 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 between trades. You can anticipate and prepare for problems, while monitoring project expectations and benchmarks identified during the project turnover meeting.

Not only can the schedule provide a forecast of the project lifecycle, 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 updating.

Manage the Budget & Then . . . Manage the Budget

Presently, establishing a budget on each project is standard practice. This wasn't the case as little as 5-10 years ago.

The project budget is crucial; however, management must adjust the original budget throughout the project lifecycle. In an industry that already has limited return for the risk, a company cannot afford profit fade. If the budget is not re-developed throughout the project, cost overruns will likely occur.

When you continually work the budget, you 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 human behavior is difficult to change, so you must simplify your field documentation requirements instead.

And, don't expect field personnel to document and track too many cost codes. Because many field personnel are "documentation-adverse," simplify your data requirements by tracking those cost codes that are most vulnerable (no more than five).

Another effective method? Use compensation incentives to obtain documentation from the field. This can be as simple as a bonus. For example, to obtain the reports the head office requires, pay bonuses for completion of the documentation.

Pre-Qualify & Manage Subcontractors

Since subcontractor failure can make or break the profitability of a project, many construction companies have implemented their own internal subcontractor pre-qualification process, in addition to transferring the risk to a surety bond.

Incorporate the following information into your company's pre-qualification process and update the information annually:

- Check references.
- Have first-hand 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?

In addition to pre-qualification, 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 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 to a construction company's education. *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 profit by fostering open communication while improving employee performance. This will also encourage a team approach between each business unit within your company.

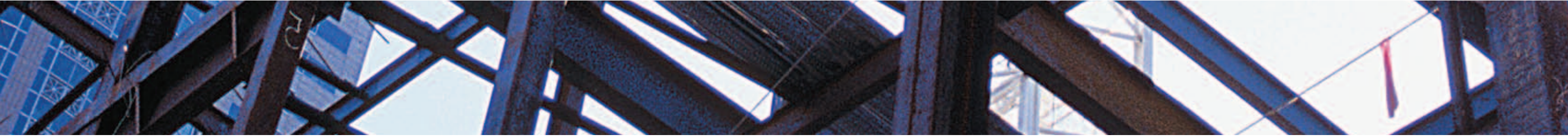
Keep Score

Manage Profit, Not Revenue

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 to the extent that you become a volume-driven contractor can result in poor performance.

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.



Remember, a contractor can only control two areas on the income statement – **OVERHEAD & PROFIT in the field.**

Contractors have the most influence on their overhead expense and field management systems. So, elevate your management strengths to concentrate on SG&A analyses, as well as strong field management communication. Concentrate less on growth and revenue in order to have more time to improve your company's systems.

Control the Rate of Growth

The key to controlled growth? Ensure that your margin grows at a faster rate than SG&A, without overextending management. This requires the company to maintain margin discipline at all times.

Uncontrolled growth is a result of poor management. Contractors that control their growth implement proper policies, procedures, delegation, and oversight prior to and during expansion. In addition, they stabilize their revenue every two to three years to ensure the company has absorbed the necessary management changes. They plan and document their controlled growth – and have a "Plan B" to reverse their strategy if the company doesn't achieve its forecasted benchmarks.

Maintain 12-Month Cash Flow Projections

Few CFMs disagree about 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 project managers is imperative to cash analysis and forecasting. Your company should maintain its cash flow projections at a company level ***and*** a project level. When you train PMs to look at a project from a cash flow standpoint (rather than a billings standpoint), you raise their business maturity.

For more information on cash flow, see "Cash Flow Formula, Part 1: How to Measure Cash" by Steven D. Lords in this issue.

Collect All Receivables on Time

First and foremost, always analyze the 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 upfront.

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 precedence 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 to mention the payment due date. The accounting employee called a second time 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 a precedence for your collection tolerance and establishes the behavior for payment upfront, 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."[2]

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 lean returns; therefore, maintaining a "no waste" philosophy throughout the company is imperative to maximize profitability.

And, in order to maintain profitability, you must be able to quickly undo any change that does not produce expected results. For example, if a contractor carefully expands operations by adding *flexible* (rather than *permanent*) overhead, it could mean the difference in maintaining profitability if the market opportunity is short-lived.

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 lease and rental
- Month-to-month rentals
- Outsourcing
- Temporary employees
- Contract employees
- Reward-based compensation plans, rather than fixed salaries and a company truck
- Deferred employee benefits
- Minimal expenses during a geographical expansion
- Joint ventures

In addition, there are many, 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.
- Implement a meaningful reward compensation plan.
- 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.

1⅓ Cups of Preparation

Planning for future production is vital to any contractor's financial success. (Please note that "preparation" has more ingredients than the rest of the "Contractor's Diet.")

Preparation and planning should be a part of each key manager's job responsibilities. In fact, each 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 – rather than 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* – Check out 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 instead of revenue. 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 because of this year's hurricanes will influence prices throughout 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 communications, and check 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.

Long-Range Planning

Prepare documented contingency plans in the event the company experiences a significant drop in revenue. When planning, consider margin discipline, acceptable revenue per employee, and a rework of the income statement.

Also, maintain a detailed business plan with one-, three-, and five-year objectives, and review them semi-annually. The one-year plan should be the most comprehensive with detailed cash flow projections.

In addition, design a plan to deal with ownership changes. Formalize all stock transfer agreements, and develop an exit strategy for key stockholders. The principals of the company should complete this plan, while they are still relatively young (in their 40s).

Conclusion

Compared to the heyday of the 1990s, today's contractors compete on thin margins with a reduced demand for work. Those who stay lean will earn the biggest share of the pie.

Improve your managerial skills to foster a team approach within your company, improve communication, and power-up performance. Examine your company's strengths and weaknesses to promote a change-friendly business environment.

Remember, you only control overhead and profit in the field, so concentrate on perfecting those two areas to sustain profitability, regardless of market conditions. BP

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Endnotes

1. Aon's Surety Report, Vol. 1, Issue 1, March 2004.
2. "Back to Basics," *The Economist,* March 7, 2002.

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