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Faced with stalled business opportunities and continued uncertainties of the future, many contractors are still unable to move forward; they are essentially stuck in Neutral.

Contractors aren't alone. Congress is stuck in Neutral, stock market bulls and bears are stuck in Neutral, and banks and the federal and state governments are all stalled and stuck in Neutral.

It's been nearly five years since the beginning of the Great Recession. Although it was declared over in June 2009, the pain remains for most contractors.

2012: Engines Ready?

History shows that the economy moves in cycles. After weathering this storm for so long, could we now have time on our side? Are we months, or even weeks, away from being able to rev the engines?

Unfortunately, probably not.

Common sense tells us that a recession this broad and deep doesn't go out like a lamb. Economist Carmen Reinhart suggests that the economy will need a complete reset – that debt deleveraging will take at least seven years due to the scope and magnitude of the financial crisis.[1]

If this prediction is accurate, then the good news is that we are more than halfway to normalcy. Now is the time to begin a realistic assessment of where your company is currently positioned. You must ensure that your business strategy protects your company over the next couple years and be prepared to capitalize on growth opportunities when they do eventually arise.

Which Gear Is Your Company in?

Begin by asking yourself: Is your company stuck in Neutral, trying to rev the engine and going nowhere? Is it still in Park, or even worse, Reverse?

This may come as a surprise, but I believe that it's okay to be stuck in Neutral. In this gear, your company should strive to exit this recession the same as it entered – sound and solvent, poised and ready. Then, as future opportunities arise, you will be prepared to shift your company into Drive.

There is a slang term for being stuck in Neutral within the construction industry: Trading dollars. In the past, trading dollars was seen as temporary because there was always another market to enter.

Such is not the case with the Great Recession. Alternative markets are few and far between. The average 2012 budget shortfall for state governments is 15.9%,[2] hardly an incentive to move from private to public work. AIA's Architecture Billings Index (ABI) just barely rose over the expansion mark at 50.9 in January 2012.[3] And, the *American Recovery and Reinvestment Act of 2009* (ARRA) only affected a few players within our industry, leaving the majority with a significant reduction in backlog comparable to pre-2008 levels.

What seems to be worse this time around is an oversupply of contractors and a decreased demand for work, which has caused serious downward margin pressure on bid day. There is simply no room for mistakes in today's environment.

Park

There are some contractors that have put their companies in Park; in other words, they have tossed in the towel. Most of the reasons I observed were related to aging owners, inability to change markets, inflexible management, inadequate capital, or inability to reinvent the company. Also, many in this category took the earnings from the expansion period of 2004-2008 and retired.

Ironically, those that shifted into Park strengthened the overall construction industry. After all, the industry needs to reset from the expansion peak.

Reverse

Many contractors have been in Reverse since the credit crisis. Some of them have already shifted down to Park, and I expect more to close their doors or file bankruptcy through 2012.

Denial

One of the predominant issues that leads to Reverse is denial. Owners are typically optimistic in nature and continue to keep an organization's overhead and cost structure at unsustainable levels with the belief that the economy will soon pick up.

Rainy Day Cash

Another prevalent theme surrounding Reverse is the lack of "rainy day cash." Contractors that flourished during 2004-2008, but didn't save, were left without a cushion of cash.

Diminished backlogs over the past three years prompted reorganization, which stretched resources and required balance; contractors had to perfect the when, how, and why to make cuts in order to protect their cash.

If the timing was off just a little, and without rainy day cash, the potential to lose money was almost guaranteed. The earnings squeeze caused a domino effect with contractors' debt service, creditor relationships, and cash flow.

Buying Work at Cost

In addition, the unsustainable theory of "buying work at cost" has given rise to contractors in Reverse. On bid day, we have all seen the low bidder with a spread of 20% or more. When this happens, you probably ask yourself: How is their cost structure so much lower than my company's? The answer: Their cost structure is *not* that much lower.

Your company can certainly buy a job; however, that practice will quickly send it into Reverse. When a project is taken at cost, there is no room for mistakes. Since we are in an environment where most everyone in the supply chain (including the owner) has economic stresses, it's likely that unforeseen issues will occur. These issues promote scheduling delays, changed conditions, trade failures, unpaid suppliers, and litigation.

So, the project taken at cost has now caused a loss and probably used up any available rainy day cash. It only takes one of these types of jobs to send a contractor into Reverse.

Leveraged Investments

Personal leveraged investments have also caused contractors to downshift into Reverse. During 2004-2008, stockholders' personal statements received a boost and equity requirements for development activity were historically low. So, when underwriting guidelines tightened after the credit crisis, many personal investments required additional capital, which was withdrawn from the core business. Sometimes, this used up the last of the company's rainy day cash and sent the company into Reverse.

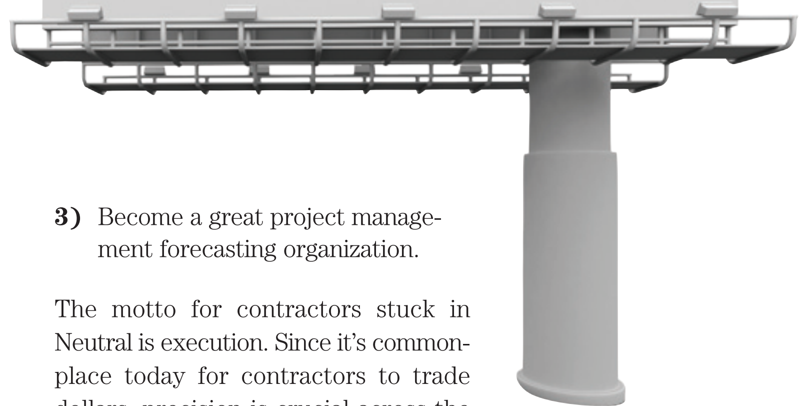
If a contractor experienced any of these issues, it's possible that its surety underwriter limited or withdrew the program, its bank called the operating line, or its suppliers tightened their credit extension, which further constricted the company's cash.

Stuck in Neutral

As I mentioned, Neutral is not a bad place to be. Given the diminished availability of work and significant downward margin pressure, here are three important steps to take if your company is stuck in Neutral:

1) Have at least three contingency plans of varying revenue and margin scenarios.

2) Exit the recession with the same cash position as you entered.



3) Become a great project management forecasting organization.

The motto for contractors stuck in Neutral is execution. Since it's commonplace today for contractors to trade dollars, precision is crucial across the organizational, financial, and project management areas of your company. These segments have one common goal: Protect your company's cash.

Organizational Management

Organizational management is assessment in action. It is imperative to develop at least three contingency plans to encompass various levels of revenue, gross margin, and the subsequent overhead structure at these levels. If many of the contractors in Reverse or Park had these types of contingency plans, I dare to say they would be in Neutral right now.

These three plans should include a best case, worst case, and an in-between drop in revenue with a corresponding decrease in margin. Let's consider a hypothetical contingency option (shown below) for a commercial GC with $50 million in revenue that shows a 30% revenue decrease and 2% margin decrease. In this basic example, $1 million in G&A must be cut just to break even.

	ACTUAL FYE 12-31-2008	CONTINGENCY OPTION (30%)Revenue/(2%)Margin
Revenue	$50,000,000	$35,000,000
Gross Profit	$2,500,000	$1,050,000
Gross Profit %	5%	3%
G&A	$2,000,000	$2,000,000
Interest/Other (Income) Expense	$100,000	$100,000
Total Expenses	$2,100,000	$2,100,000
Income Before Taxes	$400,000	$(1,050,000)

Various contingency plans, including cash flow from operations, can be forecast to minimize the effects of cash depletion. In addition, gross profit analyses on existing backlog and future work can be included to generate likely margin scenarios. Then, make corresponding plans on the achievement of an overhead structure that promotes a break-even position.

Within a company's historical data, there are organizational charts corresponding with various levels. Look through your company's old files when it was 50% smaller and pull out the organization chart.

How was it structured? How does that compare to your company's structure today? The answer is there, but may require some hard decisions.

The nice thing about preparing this work in advance is that if one of these plans needs to be executed, the emotion has been removed from the equation to make room for effective leadership.

Financial Management

The predominant goal when stuck in Neutral is to protect cash. At a minimum, your company should be prepared to break even. Forecasting accuracy and practicing flexible leadership are two key things you must be on top of constantly. This includes a tight cash management system, which means *managing cash flow daily.*

It is the CFM's job to verify project funding and draw a hard line on late payments. In order to convert underbillings and stay on top of the PM's cost-to-complete analyses, change from transactional to a forecasting approach to your duties.

Also, anticipate increases in claims and litigation, and have a policy in place to mitigate these risks to protect cash. It's important to know your contractual rights and understand the owner's ability to pay. With limited rainy day cash, there is little room for errors in financial management. Remember, your company's goal should be to exit this recession with the same cash as it entered.

Project Management

Project management means *precise* implementation. Never has this area been as important as when your company is stuck in Neutral; accuracy is critical. Since the downward margin pressure is so great, your company cannot afford profit fade, unmitigated contractual risk, scheduling delays, or lackluster change order management.

The project turnover from estimating to field management must take an interactive leadership style, as the tone of the project success begins here. Most importantly, however, is forecasting.

Some CFMs are more transactional in nature and some are more project management focused. While the transactional is ever so important, the cost-to-complete analyses must take a front seat. Since you are working with such tight margins, inaccurate forecasting can do the fastest damage.

There is an excellent article in the January/February 2012 issue: "The Art and Science of Forecasting the Estimated Cost at Completion" by Richard L. Werner. Of particular interest are the PM personality types: Procrastinator, Pessimist, Optimist, and Realist. The Realist should be your area of concentration when educating PMs. The importance of accurate forecasting during economic turbulence should be the emphasis. This will give you the ability to protect cash and maneuver the company quickly and decisively.

I have noticed throughout my career that profit fade is primarily a result of inaccurate forecasting. Your company must become excellent at project management forecasting. Keep in mind that PMs must *manage the budget* – not the contract. They must communicate issues associated with the budget variance quickly and work in an environment where stumbling blocks are communicated early to protect project profits.

Drive

Believe it or not, there are some contractors that are currently in Drive, despite the recent economic downturn. For some, it is a function of their industry segment being scarcely affected by the downturn. However, I have seen many companies continue to make money even with revenue and margin decreases. What do they all have in common? Exceptional planning and flexibility.

Companies in Drive maintain detailed contingency plans and compare them to historical organization charts. They concentrate on elevating the business maturity of their staff though education, whether through external sources or internal "lunch and learns."

They quickly eliminate marginal employees and nonperforming assets at the first signs of economic weakness. They maintain a rainy day cash fund during peak earnings performance. They consistently implement this organizational discipline, although it seems counterintuitive to the trends of corporate expansion during boom times.

Companies in Drive maintain margin discipline and do not buy work. They anticipate the need for innovation and carefully test opportunities in alternative markets. These companies spend considerable time training while their backlog is constricted. They also manage cash flow for strict protection. They prequalify all sources of funds and watch for risk shifting contractually. And lastly, as a good friend of mine in the steel business says, "they hug their customers."

Conclusion

If it takes another two years to return to normalcy, remind yourself that your company has already made it more than four and a half years. Think about what gear your company is in today and act accordingly. Concentrate on cash maintenance, forecasting, and flexibility to emerge with your foot on the gas revving the engine of a well-oiled machine. ■

Endnotes:

1. Klein, Ezra. "Don't Call It a Recession," *The Washington Post*, August 8, 2011.
2. McNichol, Elizabeth; Phil Oliff; and Nicolas Johnson. "States Continue to Feel Recession's Impact." *www.cbpp.org/index.cfm?fa=view&id=711*.
3. *www.aia.org/practicing/aiab093198*.

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