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Survival of the Fittest

How Smart Contractors Plan for Survival, and Growth, During a Recession

Only the strong survive. This core tenet of laissez-faire capitalism has rung painfully true during this unprecedented economic recession and slow-pace recovery. Contractors are wondering what steps they must take to better compete.

Freed from the bonds of prosperity, natural selection is weeding out the weak and creating opportunities for properly positioned survivors to lead the recovery. Contractors that take these steps will find that they can remain competitive until margins increase and significant private sector construction returns.

Learn from Others

Through its 90-year history, J.H. Cohn has guided clients through 16 economic recessions and 17 recoveries. Along the way, our Construction Industry Practice has worked with clients across all major construction segments and has uncovered several reasons why otherwise well-managed contractors fail.

Failures Due to Learning Curve Factors

The more one does an activity, the better one gets at it. During a recession, when projects get scarce, contractors are tempted to take on projects for which they might not have sufficient expertise or experience.

- Projects too large or complex—Most contractors can succeed in expanding the scope of a contract, but the real question is whether they can do it while earning a profit.
- Projects in unfamiliar geography—Differences in construction customs, methods, regulations, and labor conditions can be costly without proper planning.
- Projects requiring different expertise—Contractors usually underestimate the entrance cost of moving into new types of construction. The shift from private to public sector jobs is particularly challenging.

It is not unusual for a contractor to experience one or two losing projects before learning how to earn a profit. Ask yourself, can you afford to incur the loss if it is unprofitable work?

Failures Due to a Lack of Management Maturity

As a construction company grows, it needs to develop the management philosophies and infrastructure needed to sustain success.

- Proper delegation of authority—Recessions push management to the breaking point as they attempt to manage all aspects of the business in micro detail. Managers need to be able to delegate less critical tasks to trusted team members who are able to bring a fresh perspective to the project.

- Investment in people—Companies need to develop the bench strength to survive the loss of a key person. For many contractors, losing the wrong person can be costly and have a significant impact on the future operations of the company.

Failures Due to Inadequate Financial Management

Recessions expose flaws in contractors' financial management systems that may be obscured during economic booms.

- Business systems fail to produce actionable intelligence—Contractors need to synchronize the estimating and job cost systems to identify potential problems as they arise. Otherwise, it may be too late or too costly to take corrective action.

- Ineffective billing procedures—Many underbillings are the result of poor billing practices. Being underbilled in one month and billing the project in the following month equates to being cash out-of-pocket for potentially 30 days at the time you actually bill it. When credit is tight, don't willingly extend it free of charge. Contractors need to maximize cash management at the project level.

- Lack of targeted cost controls—In tough times, companies need to apply more specific cost controls. This includes making decisions related to the owning and leasing of equipment and methodologies for capturing equipment and equipment overhead to be billed to the projects.

Step back and critically evaluate your business based on these factors and make necessary adjustments. Keep these elements of failure in mind before you make decisions regarding how to streamline costs.

During a down economy, ownership and management must determine priorities, be diligent—but realistic—about finding new sources of revenue, and align the organization to meet the new economic conditions.

Focus on the Core Business

During a recession, a contractor's tendency is often to apply a quick fix by slashing overhead costs. Doing so without forethought can prove counter-productive and limit opportunities for growth during the recovery. Before implementing cost reductions, contractors should first conduct a department-by-department review to align business processes with the changed business environment. Focus on the three departments critical to contractors.

Administration

During a down economy, ownership and management must determine priorities, be diligent—but realistic—about finding new sources of revenue, and align the organization to meet the new economic conditions. As suggested above, identify the key people you need in your business when the economy recovers and continue investing in them. Look to new markets, but do not overestimate your capabilities. Develop realistic estimates and consider joint venture partners with more experience in the geographical area or type of construction you are expanding into. Review your bonding and banking relationships and insurance programs. Your working capital requirements will increase as A/R collections slow. Re-evaluate your insurance coverage and deductibles and assess how effectively they align with your changing business requirements.

Estimating

The economic downturn brings harsh realities, including more competition, an increase in bidding activity, lower mark-ups, and surety bond capacity restrictions. Make the increase in competition work for you by identifying opportunities to improve the estimating and sales functions. During these times, the quality of subcontractors becomes especially important as tighter margins magnify problems and errors. Review subcontractor qualification policies and procedures and consider requesting financial statements and surety bonds. Also, review contract terms and provisions as some may now be more negotiable. Explore creative ways to increase a project's cash flow. Consider if you can front load the billing on a project.

Operations

Streamlining operations requires management to have a strong handle on active jobs. Get back to weekly job meetings, regular status reports, and job-monitoring activities. Management should focus on budget-to-actual variances, productivity levels, change order status, costs to complete, cash-flow analysis, and job close-out procedures. Remember that if laborers and inspectors do not have another job to move on to, they may try to delay closing-out jobs.

Examine several factors related to the design of your job cost system. Budgets need to be identified in a format consistent with how the actual costs will be tracked through the job cost system and they should be maintained and revised for items such as buy-outs, change orders, and changes in estimated quantities. Actual-to-budget variances should be analyzed monthly, or preferably weekly, throughout the job.

Finally, establish an internal billing system that improves cash management. Create a checklist for all paperwork, including certified payroll reports, insurance certificates, and surety bond requirements. Closely monitor and analyze change orders and secure approval before you commence work. Coordinate material deliveries and project walk-throughs with the owner's representative so that you are of like mind with regard to quantities and percentage of completion. These little details can have a big impact on cash flow.

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Take Control

To be a survivor, contractors need to take control of efforts to drive inefficiencies out of the business. Be sure to involve all employees in this process, including project managers, superintendents, and administrative personnel. Consider offering incentive bonuses to employees that produce the best ideas.

On the construction site, waste comes in many forms, including idle equipment, poorly timed delivery of materials, less than optimal vendor contracts, and unnecessary employee perks. Eliminating waste should be a top priority for management and supervisors. Review major expenses and capital investment plans to evaluate how they fit into the revised plan for the company. Renegotiate vendor contracts to look for better terms or higher discounts for early payment. Reduce employee perks including vehicle usage and meals and entertainment and consider methods of reducing retirement plan benefits. And, unfortunate as it is, when times get tough, theft and insurance fraud increase. Examine your security measures and align them with the increased risk.

Sound internal controls are a deterrent to fraudulent activity and provide a basis for sound accounting practices. In maintaining internal controls, there needs to be a strong emphasis on communication. From the field office to the home office, effective communication should flow down, across, and up the organization.

Integrity and ethical values, commitment to competence, management philosophy and operating style, assignment of authority and responsibility, and human resource policies and practices are all components of an organization's control environment. The control environment sets the tone for the organization, and during a recession, management should not underestimate integrity and ethical values. If management is committed to strong internal controls and ethics, it will trickle down throughout the company.

Policies and procedures, which are the responsibility of the controller, should include approvals, verifications, and reviews of operating performance as well as the security of assets, and segregation of duties. Remember to regularly monitor the internal control system to make certain that it is working for the organization.

Anticipate the Future

The business environment over the next decade will be significantly different than the environment of the previous decade. Contractors are experiencing increased regulation of construction activity. Federal Acquisition Regulations have been modified to include ethics compliance programs. Construction projects are increasingly utilizing construction monitors. To position your company for success, develop an approach based on the new realities. Involve your business advisors in the decision-making process.

Contractors can survive—and succeed over the long term—by creating a plan, building a strong organization centered around core business processes, controlling costs, and avoiding the missteps that have doomed contractors to failure during economic downturns. ■

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