MCAA Management Methods Manual

Bulletin No. AF 4
File: Accounting and Finance

Bulletin

Tips to Help Contractors Manage Through an Economic Downturn

INTRODUCTION

And you thought death and taxes were the only sure things in life. You can add economic business cycles to the list. A common definition of an economic business cycle is a recurring and fluctuating level of economic activity that an economy experiences over a long period of time. There are generally five stages that make up a business cycle:

1. Growth (expansion)
2. Peak
3. Recession (contraction)
4. Trough (bottom) and
5. Recovery

A cycle tends to indicate a normal pattern. At times in the past, business cycles may have been considered regular and predictable. But today, they are quite variable and unpredictable. According to the National Bureau of Economic Research, between 1945 and 2009, there have been 11 confirmed business cycles, with the latest one lasting from December 2007 (peak) through June 2009 (trough). The average duration of the 11 business cycles from peak to trough during that time frame was 11.1 months and 68.5 months from peak to peak.

For the contractor, early recognition of an economic downturn can make the difference between survival and demise. Managing through an economic downturn and coming out whole on the other side requires planning, savvy business decision making, execution of a plan and, frankly, a little luck.

EARLY WARNING SIGNS

There are many recognized early warning signs for the economy that indicate some sort of business downturn is on the horizon. The contractor must always be aware of the current business climate. What is happening to economies around the world? How are housing starts, unemployment, GDP and inflation trending, just to name a few?

It is generally true that the construction industry lags behind economic cycles. During robust and expanding economic times, contractors generally have plenty of work. Owners and developers are flush with cash and capital budgets are healthy. Businesses build new facilities, expand existing facilities, modify and improve processing equipment, and install new technologies. Construction work is plentiful. Backlogs expand and the outlook is bright.

When an economic downturn begins to set in, the brightness begins to dim. Owners stop spending uncommitted cash fairly quickly, preferring to sit on the cash to see how the economic cycle develops, while projects that had funds already committed may still move forward, but possibly at a slower or reduced rate.

For developers, the effects of this beginning downturn are different. Their project funding is often based on pre-sales and venture capital. Those sources of funds dry up quickly in the face of a downturn, and those projects can stop overnight.

So while an economic business cycle may be showing signs of trending down, often contractors are still busy with work under contract. That committed work may allow a contractor to work deep into an economic recession. But without replacing that booked work with new work, the backlog quickly runs out and the contractor is faced with making some difficult business decisions, even when the economy may already be picking back up.

What are some early warning signs particular to the contractor that indicate an economic slowdown or even an economic recession is looming?

- **The architect and engineering community begins to slow down**. In the contracting world, the harbingers of market trends are the architects and engineers. For the construction market to be healthy and busy, projects must be in design and development. They will naturally flow down to the construction community. However, when the volume of new projects flowing in to architects and engineers begins to slow down, designers will be laid off and small shops shut their doors; the signs are there that a slowdown in the construction market is near. Conversely, you will have a good feeling that the market is coming out of a full-fledged economic recession when the architecture and engineering community gets busy again.

- **The numbers of participants on bid lists are growing.** When the number of available projects begins to shrink, that leaves fewer and fewer projects to feed the construction community. Therefore, an early warning sign is an increase in the number of competitors for new business.

- **The bid margins shrink**. With less work available and more participants competing for what work is out there, the natural economic forces of supply and demand will begin to drive bid margins down quickly.

- **The bank and bonding companies start tightening lending products and seeking more and more detailed information about your current work.** Financial institutions have to manage a lot of financial risk with contractors, and when they see an economic downturn coming, they jump to attention and want to make certain that their clients are in healthy financial shape for the coming storm.

- **Accounts receivables start to lengthen out**. When an economic recession is looming, owners and general contractors quickly go into cash conservation mode. That does not bode well for the contractor as it starts to stretch out the spend-to-collection time cycle. Your average day's sales outstanding may go from 30 - 45 to 90 - 180 days. Owners and general contractors can find lots of reasons to hold on to the money that the contractor has earned. Consequently, you have to manage the relationship with your customer along with managing your cash.

- **When receivables start stretching out, so does your available cash reserves or line of credit.** During good economic times when cash flow is regular and timely, funds are plentiful to finance your current work. But when your customers start hanging on to your money longer and longer, you are forced to dig deep into your cash reserves to finance your work or to borrow more and more funds from your bank. Your cash drops significantly and your bank line maxes out. You may have work that you booked during the peak of the cycle and you are working it off, but you are getting strained to meet payroll and other financial obligations because the flow of cash begins to slow significantly.

- **The number of disputes and claims with your customers for extra work increases**. When cash starts to tighten up in an economic downturn, you will experience more challenges from your customers about your claims for extra work. They will find reasons to claim "that was implied in your contract" or "you should have known you had to do that" or some other similar excuse to pay for the extra work performed.

- **Your suppliers and subcontractors start calling earlier for payment.** In an economic downturn, your suppliers and subcontractors are facing the same economic challenges as you. Cash is the lifeblood of the construction industry.

All of the above are among several red flags that signal an economic downturn is starting. When it does, no one really knows how deep it will go or how long it will last. But the contractor needs to be prepared for the worst. You will need to navigate through the downturn and be poised to take every advantage of the upturn when it comes (and it will). To do so requires planning and execution along with some good business sense.

SURVIVAL STEPS

When the economic downturn begins—even though you may be flush with work—you you need to act early to prepare for the difficult times ahead and position yourself and your company to be successful when the economy recovers.

- **CASH IS KING.** Cash is the lifeblood of the contractor. You can have all the work you can stand at margins that make you smile, but if you do not have access to the cash to finance the work, those projects can disappear virtually overnight. Here's how to manage your cash flow:

  a. **Make sure your bank is knowledgeable about the construction industry and your business**. Your financial institution should understand the construction industry and contractor business cycles. It is sort of like insurance. In the good times, you do not need them much, but when times are tough, you need your bank more than ever. Manage that relationship. Keep your bank appraised of your work in progress (WIP) and possible awards. Let them know that you have a plan to manage through an economic downturn. Make sure your line of credit is large enough to carry your business deep into a recession.

     Banks that are unfriendly to contractors or unknowledgeable about their business will tend to tighten up credit and be reluctant to lend or put covenants in place that will be difficult to meet. This is especially true when you are looking for an increase in the middle of the storm.

  b. **Manage your accounts receivable as though it is your own personal money (and often it is)**. Don't get lazy with your receivables. Work hard to claim the money that you have earned. Make sure your billings are 100% correct and in accordance with the requirements of your contract before you submit them. Don't give your customer a reason to send them back for a "correction," which only lengthens the payment cycle.

Manage your customer relationship. Your customers should see you more often than when you want payment. Let them know that for you to continue doing the fine job you were contracted for, the cash needs to flow in a timely fashion. Don't let your receivables get 30, or 60, or 90 days past due before you take action. BEFORE the due date, give your customer a friendly reminder that payment is due soon and ask if there is anything you need to do on your end to make sure payment is timely. Be proactive, not reactive.

c. **Manage your accounts payable like you are giving away your most prized possession, which it is, your cash**. Work with your vendors to achieve the most advantageous payment terms. This is best done BEFORE an economic downturn hits. Negotiate extended payment terms. Remember, your vendors are in competition for your business. In addition to negotiating on the price of commodities, you can negotiate payment terms too as a part of the deal. Don't always settle for their standard 30-day payment terms, especially if your terms with your customer are longer. Negotiate for 60 or 90 day terms, all the while giving the same effort with your customers to shorten your receivable days. Try to work toward the biggest gap between shorter receivable days and longer payable days that you can. You should prefer to use someone else's money rather than your own to finance your work. In the end, whatever you commit to, stand by your commitment. Be a contractor of integrity.

d. **Maximize your overbillings and minimize your underbillings.** Always, but especially in the early stages of an economic downturn, it is crucial to manage your billings. This starts with a thoughtful schedule of values which allow for creative billing. Bottom line, you need to bill for as much as possible as early in the job as possible. Create a schedule of values that allows for invoicing early and often. The goal is to get way ahead of billings versus costs. Lump sum projects are ripe for effective cash management, but you need to strategize early on in the process to maximize this effort.

Conversely, large time and material projects are difficult to manage during a downturn unless you are substantially capitalized. Those projects require large outlays of cash before you can invoice and well ahead of getting paid for your services. Minimize those projects where you can only bill based on some sort of completed project milestone or achievement. Bill ahead, early and often.

e. **Drive down the cost of commodities.** Just as more bidders compete for less work during a downturn, more vendors will compete for your business. Take advantage of getting price concessions you normally would not enjoy in a robust economy. Bid and rebid your commodity materials. Drive those prices down. Ask for services you normally would not see, like free bundling, kitting, special deliveries and pre fabrication. Use your vendors to your advantage.

f. **Manage the efficiency of work on jobsites.** While efficient productivity is normal practice for all successful contractors, it is crucial during an economic downturn. You must squeeze every fractional percent of efficiency out of a dollar spent. Take a look at your crew ratios, and then get that crew mix down with a higher number of apprentices. Foremen need to work with their tools when available. Maximize your pre-fabrication efforts in a more efficient work area such as your shop. Solicit your vendors to deliver your commodities to the work area, not just to the front gate. Get them to package and prefab the equipment as much as possible so that you do not spend your field labor dollars on those tasks. Maximize safety efforts to minimize the amount of money, time and effort spent on workers' compensation claims. Identify your absolute best employees—field and administrative personnel—and maximize their contribution to your projects.

g. **Manage your overhead, but do not unnecessarily go too deep.** In an economic downturn, everyone goes into cost-cutting mode, and well they should. When times are good and work is plentiful, we can all enjoy the benefits of higher overhead. But as soon as an economic downturn hits, we tend to start slashing cost and personnel like there is no tomorrow.

Downward trends in a business cycle are certainly good times to get rid of unproductive and wasteful costs, whether those are processes or personnel. But be sure to give due consideration before making those cuts, especially on the people part of the overhead. Often times, contractors will send employees packing citing that they cannot afford to have them stay. Sometimes we go too deep and send some really good and productive personnel out the door. And as sure as death and taxes, economic recessions will turn into economic expansions. When that happens and work becomes available, you want to be positioned to take advantage of every opportunity. If you have cut too much of your overhead personnel, you will be faced with the quandary of, "Do I take on work and then go hire the people to run it, or do I go hire the people to run work and then try to get it?" You also run the risk that when you let too many of your good employees go, they will not be available for rehire or, even worse, your competitors will have hired them and now they are working against you.

Bottom line: don't make a knee-jerk reaction and unload the boat at the first sign of a leak. Be mindful of your best folks. While you may need to spend a few unproductive dollars during a downturn, when the economy recovers, you will want to have the resources available to jump on the available work and be ahead of your competition while they try to figure out how to get the work without having the people to run it.

SUMMARY

The Boy Scouts' motto is *Be Prepared* and the same motto should apply to contractors. Have a plan for an economic slowdown. Watch for the early warning signs. Don't get caught in the middle of one and only then start thinking about survival. Contracting is a risky business. Manage that risk each and every day during good times and difficult ones.