HOW TO BUILD A HEALTHY CONSTRUCTION BUSINESS IN ANY ECONOMIC CLIMATE

BY LAURA SPARKS

LEARNING The Hard Way

Sam, a Seattle home framing contractor, could hardly keep up with the business coming his way in late 2007. His biggest problem (or so he thought) was finding and keeping quality workers.

He saw news reports about the housing collapse in other parts of the country, and his CPA cautioned him it was time to get "lean and mean" to prepare for the downturn. But Sam didn't have time to consider what-if scenarios when he was making a good living working 80-plus hours a week.

Flash forward 15 months: Sam's backlog is nonexistent. Funding for his last job dried up about halfway through the project, so he's still waiting to get paid. Meanwhile, the bills are piling up.

Sam's options now are severely limited, but his fate was by no means inevitable. Plenty of contractors and builders are healthy right now and positioned to grow when the turnaround comes. What did the winners in this current down cycle do differently? And what can be learned from those who are struggling now?

For one thing, successful business owners took the early warning signs to heart and made changes in their personal and business lifestyles.

"There was a lot of press about the economy, and particularly the construction industry, slowing down," says Rob Trammell, a CPA and partner with Abbott, Stringham & Lynch, Inc., San Jose, Calif. "Some moves that should have been taken 12 months ago, or more, were deferred because things 'weren't that bad.' Well, as it turns out, things are worse."

Some of those moves include selling nonessential assets, such as equipment that wasn't used regularly, real estate investments, and personal items like boats and cars. Those with foresight also paid off any personal and business short-term debt so they could remain in good standing with lenders and potentially qualify for a higher working capital line of credit to carry them through the rough patch.

But the true winners didn't need to take any of these actions because they already had strong cash flow, manageable debt, a realistic growth plan and solid relationships with sureties and lenders.

"Being a healthy contractor is not just something you do overnight like flipping a switch," says Jay Rammes, a CPA and partner with Cincinnati-based Barnes Dennig. "Truly healthy companies don't let expenses get out of hand during the good times. They build up strong balance sheets and retain some of those earnings, knowing that tough times are ahead. They continue to hone their processes, even when they're making money."

Successful construction business owners make decisions that are in the best interest of the health of the company, not necessarily their own interests.

"They make tough decisions to cut personnel and overhead that cannot be supported by the current volume of business and backlog," says Jonathan Mangels, a CPA and partner with Greer & Walker, LLP, Charlotte, N.C. "And when times are tough for pass-through entities, they limit owner distributions to the amount needed to cover taxes related to the company."

Construction businesses in the best position now kept a close eye on financial management, echoes Mickie Huneycutt, a CPA and manager with Atlanta-based Porter Keadle Moore, LLP.

"Their growth was financed mostly with a combination of retained earnings and investments, and only a prudent amount of debt. They borrowed appropriately, using long-term debt to finance a percentage of their purchases, and they used lines of credit only for seasonal or short-term credit cycle needs, never as permanent sources of capital," Huneycutt says.

Questions to Consider

Contractors should answer the following questions to be sure they are on the path to strong business management.

- What is the company's average gross profit?
- How many months of backlog does the company have?
- What is the company's percentage of over-billings and under-billings?
- Do company executives review, analyze and determine action plans based on current and past job reports?
- What is the company's sweet spot (i.e., what are the characteristics of its most profitable type of contract)?

Source: Best Practices Guide: Key Financial Performance Indicators, published by ProfitCrew, Inc.

FOLLOW THE FLOW OF CASH

"The dangers that a contractor has today are lack of liquidity and cash flow," says Dale Ruther, a CPA and partner with Bober Markey Fedorovich, Akron, Ohio.

Smart business owners know they can't make good decisions without proper information, just like drivers can't make good decisions without knowing their speed, gas level and engine performance.

Financial management reports are a company's dashboard. They provide information on how fast the company is growing (profit and loss report), how much cash is coming in and going out (cash flow report), and if any problems are looming (receivables aging report and financial forecast).

"If business owners can't get accurate, timely financial information from their accounting department that can be used to manage jobs and the overall financial health of the company, they will be in trouble in good times and bad times," says Laurie Johnson, a CPA and partner with Las Vegas-based Johnson Jacobson Wilcox.

Adds Huneycutt: "Too many construction companies do a poor job of cash flow analysis—both short- and long-term. They often rely only on profit and loss statements, which do not warn adequately of cash flow issues."

A construction-focused accountant can help business owners determine which financial reports they need to review, set up systems to capture the vital information, analyze that information and challenge them on their management decisions, Johnson says. An accountant also can help establish and review budgets, compare budgeted targets to industry benchmarks, and identify cost containment actions and timelines if budgets are not met.

Without access to accurate cash flow and forecasting data, companies run into one or more of the following problems, says David McLellan, a partner with Catalyst LLP Chartered Accountants, Calgary, Alberta:

- They over-bill in the first part of the job, but don't manage cash flow appropriately and end up running out of cash toward the end of the job.
- They don't know their cash flow requirements to fund items not related to the job (such as loans), so they don't build enough margin into the bid to cover these costs.
- They don't maintain a healthy backlog, leaving them flat-footed when current jobs are complete.

"My largest and best-run client has invested in new accounting systems that will provide better job-costing data so they can manage their projects more efficiently and maintain higher margins," McLellan says. "It also will allow them to see where their costs are getting out of line so they can deal with cost overruns much earlier in the job."

ASSESS GROWTH OPPORTUNITIES

A business plan is essential in any economy. Without establishing goals, business owners have no litmus test to determine whether growth opportunities are in their best interest.

In tough times, it is tempting to take any work regardless of whether it conforms to the strategic plan. Contractors with enough cash to outlast the downturn are better able to resist that temptation, so they can bid on profitable work when it does come along.

For example, Mangels' best clients require credit checks on new customers and subcontractors. They also keep a close eye on subcontractors to make sure they're paying suppliers and second-tier subcontractors.

Hungry contractors also might be tempted to squander valuable capital by expanding into new territories or trades in which they have little experience. But, successful business owners never stray from their "sweet spot," Johnson says.

Of course, careful diversification can be a winning strategy. Smart, growth-oriented contractors started diversifying during the boom times, armed with strong working capital and a balance sheet that

could convince a surety and bank that funding such expansion was a safe bet.

STRENGTHEN RELATIONSHIPS WITH SURETIES AND LENDERS

To lenders and sureties, the most obvious sign of trouble is a sudden lack of communication. Contractors are often afraid to let their surety or bank know about problems, but underwriters know contractors that quickly identify problems and seek solutions to get projects back on track are more likely to avoid default. Consistent and open communication is key.

"Meet with your bankers and bonding agents often and be honest," Trammell says. "It is important to keep them in the loop about your company performance and the steps you are taking to be a survivor. They will not be happy if they are caught off guard by financials that show a loss, and now is not a good time to be looking for a new lender or surety company."

During such meetings, the most successful construction companies share their budgets and any cost containment strategies to "demonstrate that they are on top of current projects even more than they have been in the past," Rammes says.

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After ensuring their credit lines and bonding are secure, healthy construction company owners discuss with banks and bonding companies what they need to do to ensure they can take on higher volumes of work in the future.

THE SILVER LINING

For companies that outlast the recession, opportunity awaits. "Those who have been proactive and made the appropriate adjustments to their business as the down economy has evolved will be in the best position to ride out the storm and reap the benefits of the next upswing," says Pete Weir, a CPA and partner with Hutchinson and Bloodgood LLP, Glendale, Calif.

Growth in the construction sector is inevitable, Ruther adds. "Construction jobs can't be moved overseas and are good-paying jobs that will support the middle class," he says. "Infrastructure contractors appear most likely to benefit from the current administration's plan."

Construction company owners should start positioning themselves now to benefit from the government and private funding that should start flowing again into the construction industry.

"Keep tabs on the projects being considered for the stimulus funding and start networking with the owners of such projects," Mangels says. "Do whatever it takes to keep the lights on, because there will be a lot of pent-up demand for construction once the financial markets get back online, and there also likely will be fewer contractors to compete with."

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Do you know where you stand?

Take Control With Best Practices

It is always challenging to run your business, but never more so than in a down economy, when competition is tougher and margins are tighter than ever. Smart construction company owners know they can't make sound business decisions — or get access to vital credit lines and bonds — without solid financial performance information.

ProfitCrew™ and Clemson University's Department of Construction Science and Management developed the *Key Financial Performance Indicators Best Practices Guide* to identify and help you measure financial benchmarks that drive construction companies, including yours, toward success.

ProfitCrew™ is an association of independently owned accounting and consulting firms that specialize in serving construction businesses. For more information, contact the ProfitCrew™ member firm nearest you.

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