Construction Practice Group

BOOSTING PROFITABILITY with Flexible Overhead

A White Paper for Construction Contractors

OVERVIEW

The Great Recession of 2007 shed a painful light on the inadequacies of the construction industry's typical business model. Because of the highly cyclical nature of the business, contractors can no longer measure success on how much revenue growth they experience, how much equipment they own or how big their jobs are.

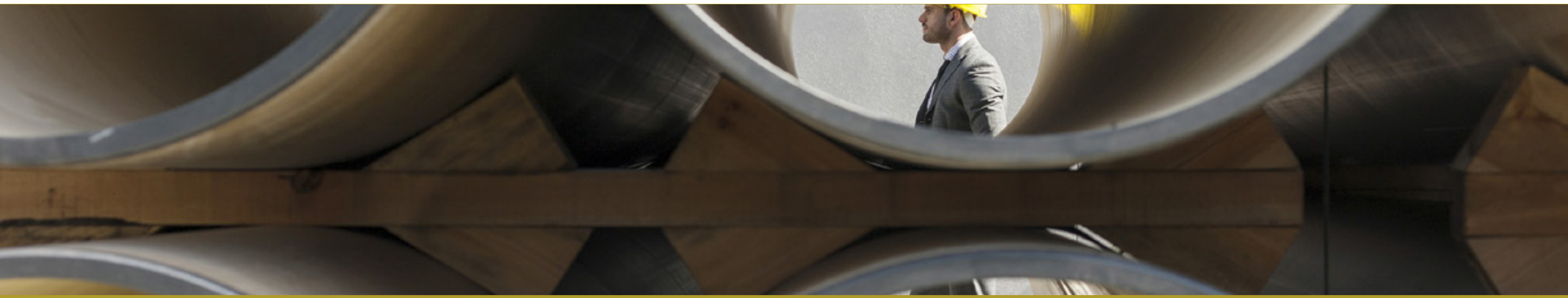
While the recession officially ended in 2009 according to the National Bureau of Economic Research and other gurus, the downturn for construction contractors lasted well into 2013. Now that we are coming out of this lengthy slowdown, it is the ideal time for contractors to question long relied upon business practices and rebuild their organizations using new, sustainable business models. One such model is the "Flexible Overhead" paradigm posited by Dr. Thomas C. Schleifer.

This white paper encompasses Schleifer's views on flexible overhead—the ability to turn off 15 to 25 percent of all overhead costs in a week or less. To weather the cyclical nature of the construction business and economic downturns, the successful contractor of the future must be able to quickly reduce excessive and unnecessary overhead. Construction businesses can't simply measure the difference between total sales and operating profit: They also need to measure operating profit to overhead.

FLEXIBLE OVERHEAD

The ability to turn off 15 to 25 percent of all overhead costs in a week or less.

WHEN COMPANIES GAIN CONTROL of overhead through the flexible overhead model, sales no longer drive the entire organization. Without a desperate need to take on any and every project just to cover fixed overhead expenses, companies are free to pursue only profitable jobs and stop chasing high-risk work. This white paper is divided into five sections to help contractors move toward flexible overhead and financial stability.



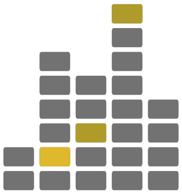
Who Is Dr. Thomas C. Schleifer?

Working for more than 45 years in the construction contracting and consulting industries, Dr. Thomas C. Schleifer has a unique blend of hands-on experience and research-backed insight. He began working in construction at age 16. Through the years, he has served as foreman, field superintendent, project manager and vice president of a construction company he co-owned with his brother.

HIGHLIGHTS OF TOM SCHLEIFER'S CAREER INCLUDE THE FOLLOWING:

- Holds bachelor's, master's and doctorate degrees in construction management.
- Is past president of the largest international consultancy firm serving the contract surety industry.
- Authored the book Construction Contractors' Survival Guide and Managing the Profitable Construction Business.
- Serves as research professor at Arizona State University's Del E. Webb School of Construction.
- Frequently lectures on construction and business management at universities, professional organizations and trade associations.

Why should you listen to Tom Schleifer's theories on flexible overhead? He is often dubbed the "turnaround expert" because he has rescued countless companies from financial distress. Over a 13-year period he collected extensive data on nearly 1,250 failed construction companies: The lessons learned from those collective failures can help your company not only survive, but thrive.



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6 Misguided Construction Industry Beliefs

Schleifer calls the construction industry “the foundation of the world.” It’s a proud industry with a proud heritage. There are nearly 1.3 million construction enterprises in the U.S. employing approximately 7.3 million people.

HOWEVER, THE PICTURE ISN’T ALL ROSY: The construction industry is the second most risky business venture. It falls just behind restaurants. A study released by market researcher Statistic Brain reveals that less than half of all construction companies are still operating after four years in business. That’s not surprising when you consider that many contractors operate on outdated beliefs.

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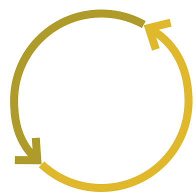
These long-held misconceptions are carried down from industry veterans to newcomers. The problem is that while these overarching beliefs may have once held a kernel of truth, construction is changing. In the 1960s, contractors could make 10 to 15 percent profit margins. Since the 1980s, that margin has dropped considerably. But contractors—and their beliefs—haven't adapted. **CONSIDER THESE SIX FLAWED BELIEFS:**

1 GROWTH IS ALWAYS GOOD.

The business model for construction has always been based on growth. You’ve probably heard the mantra if you’re not growing, you’re going backward. The idea is to start an enterprise, put a lot of work into it, build it to critical mass and then grow it. Because the rebounds from prior economic downturns were so robust, it validated the thought that growth is always good: Companies lost money, but they got it back. Not this time. The industry put in place 30 percent less in 2013 than in 2007. And as a whole, it’s giving away work and not profiting.

2 THE CONSTRUCTION INDUSTRY ISN’T NECESSARILY CYCLICAL.

This notion came into place because of the exceptional growth and prosperity from World War II through the 1980s. Times were so good—and recoveries from recessions so robust—that people failed to acknowledge the cyclical nature of the economy. However, the construction industry follows the U.S. economy, which has always been cyclical. Construction lags behind the general economy, either turning downward or picking up momentum approximately 12 to 18 months later. But it’s most certainly locked into the U.S. economy. Cycles are the norm in construction, and the time to prepare for the next downturn is now.



Construction lags behind the general economy, either turning downward or picking up momentum by approximately 12 to 18 months.

SIX FLAWED BELIEFS, CONTINUED:

3 DOWN TIMES ARE BAD NEWS, BUT A NATURAL PART OF THE INDUSTRY.

Construction companies can't accept downturns as minor blips in business and continue to function as normal. In bad years, many companies give back in losses what they gained during good years.

4 OVERHEAD IS A SYMBOL OF SUCCESS.

One of the problems with overhead is that it increases the capacity of a company by adding more employees, office space, equipment and so on. Increased capacity correlates to growth, which takes us back to the first industry misconception. Contractors are reluctant to downsize because it means giving up much sought after growth.

5 CUTTING OVERHEAD IS AN ADMISSION OF FAILURE.

Companies are unwilling to surrender overhead unless there are no other options. They cling to the notion that "things will get better eventually."

6 UNPROFITABLE WORK IS JUST PART OF THE BUSINESS.

It's an accepted belief that there are losing jobs in every company's book of business. Some construction contractors hope to make money on nine jobs and lose money on one, but not so much that it hurts the company.

SCHLEIFER URGES CONTRACTORS TO RETHINK THESE BELIEFS. Companies are in a position during this economic recovery to reconsider the business side of their operations. It's time to examine firmly held beliefs and make tough decisions about how much overhead to take on—and how to take it on—as companies grow back. That way, they can break the cycle of making money in good times and giving back in bad times.

"Everyone, without exception, holds to beliefs that are largely unexamined but are often our deepest convictions. Because we are familiar with our beliefs, they make us feel safe. We constantly collect evidence to support them, and it is almost impossible to dislodge beliefs even if they are patently false."

Barry Kaufman, author and philosopher

Recovering from the Recession

Schleifer has spent years measuring and tracking the rise and fall of sales and profit margins in the construction industry in relation to economic recessions and booms. His analysis suggests that the effects of the 2007 recession will last longer and go deeper than any previous downturn since World War II.

We're simply not seeing the same rebound as other recessions, and that has taken a toll on construction contractors.

THERE ARE SEVERAL ROADBLOCKS THAT HELP EXPLAIN WHY the recovery of this most recent recession hasn't gained traction. Schleifer's research reveals eight serious issues related to economic recoveries:

1 AGGRESSIVE PRICING CONTINUES.

During the early stages of recovery, companies strive to undercut the competition because they desperately want every job they can get.

2 GROWTH CREATES CASH FLOW NEEDS.

Because the construction industry has been hurt economically, companies seek any and all projects so that they can return to pre-recession sales levels. That eats cash. Most companies are spending more money than they are collecting, and the lag in getting paid creates a cash flow crisis.

3 CASH FLOW ISSUES LEAD TO A NEED FOR FINANCING.

When companies can't pay their bills, they turn to banks or bonding companies. If those contractors don't have the appropriate resources, they go under. The nearly 1,250 failed companies that Schleifer studied did not run out of money. They ran out of credit, couldn't pay their bills and went into default.

4 THE REACTION OF BANKS AND SURETY COMPANIES IS UNCERTAIN.

Banks are nervous about lending money to contractors. Surety credit for bonded work also dries up during economic recoveries.

To survive the recovery, contractors must avoid losses, keep their capital bases intact and avoid diminishing the equity in their companies. That means they must manage cash flow judiciously to remain financially viable and credit-worthy.

ROADBLOCKS THAT HELP EXPLAIN WHY, CONTINUED

5 THERE ARE LABOR SHORTAGES.

All downturns and recoveries have labor shortages. During this long recession, many people left the construction industry because there was no work. While contractors hope these people come back, some have moved into other industries.

6 THE LEVEL OF LABOR SKILLS IS SUB-PAR.

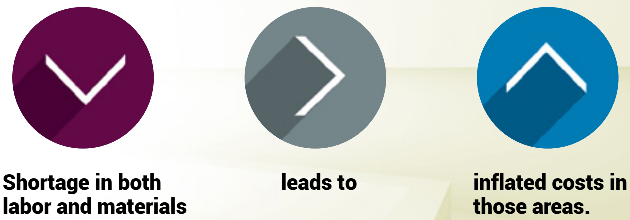
Because experienced laborers have left the industry and others are aging, the skill level of the new workforce is questionable.

7 THERE ARE MATERIAL SHORTAGES.

They always occur following a slowdown. For instance, several drywall suppliers have closed down. They will not resume production until there is sufficient work to keep the plants busy. Meanwhile, there is a material shortage.

8 LABOR AND MATERIAL COSTS ARE INFLATED.

A shortage in both labor and materials leads to inflated costs in those areas.



A Vision of the Successful Contractor of the Future

The length and depth of this recession and construction slowdown finally brings into question the industry's long-held growth model: It simply does not work. To thrive, construction companies need to undergo a paradigm shift. The goal of that shift is to create the successful contractor of the future.

SO WHAT WILL SUCCESSFUL CONTRACTORS LOOK LIKE? SCHLEIFER OFFERS A SIMPLE THREE-PART DEFINITION:

They will be profitable in good markets and bad.

The drive for size will be substituted with a drive for prosperity.

Prosperity will be measured in profitability.

In his role as a business consultant, Schleifer has worked with companies focused on size and others focused on prosperity. Those concerned with the latter ask, "Where is the profit in this?" The owners are not fixated on building a business as a monument to themselves: The drive is toward prosperity.

At first glance, it may be hard for some contractors to get on board with this message because they believe that prosperity is inextricably linked to size: Bigger is better. Schleifer poses a question to those contractors: Is there one construction project last year that you wish you did not take? For most companies, the answer is yes. There is a weak job, a bad job, a losing job. The company would've been better off without it. If contractors answer yes to Schleifer's question, they're admitting they wish they had smaller sales last year—they would give up that job—and higher gross profits.

A successful contractor profits during good times and bad. And the primary way that's accomplished is by staying away from losing jobs. That's common sense. Most contractors know the sources of their losing jobs. It usually happens when there's not enough work that the company normally does. Rather than reduce overhead, contractors take a different type of work. This may include:

- A larger job than the company has ever handled before.
- A project in another geographic area.
- A job where the company is forced to make changes in personnel, putting different work teams together.

The successful contractor of the future will be able to go up and down in sales, easily cope with market cycles and not be forced to take inappropriate work to maintain sales.

WHEN COMPANIES WORK WITHIN THEIR COMFORT ZONE, repetition sets in. By doing the same thing over and over again, they get better at it—and more profitable. But if contractors are in growth mode and won't reduce overhead, then they are forced to take inappropriate work.

The irony is that most contractors have no desire to reduce overhead: It's a badge of courage. Decreasing overhead is viewed as an admission of failure. They want overhead, they want to be a large company, and they defend themselves by taking work they never would have done in good times. This pattern led to the demise of nearly all of the 1,250 failed companies Schleifer studied.

The quandary most businesses have is what to do as an alternative. They are in a risky circumstance, down on work and overloaded with overhead. To fix the situation, they create more risk by taking on larger jobs in new areas using different personnel. That's why the failure rate of businesses skyrockets during economic rebounds.

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The Overhead Paradigm and Risks of Growth

It's important to understand the dynamics and patterns of overhead in order to manage it.

SCHLEIFER HAS COLLECTED FINANCIAL STATEMENTS FROM 10,000 construction companies. When he began formulating the concept of flexible overhead, he examined two key pieces of information from those financial statements:

- What percentage of sales were used to cover overhead expenses?
- How did companies treat overhead when sales moved either up or down?

Schleifer discovered that companies add and purge overhead based on the current market. They may speculate that the market will go up or down, but they don't act on those suppositions: Companies typically leave overhead alone until market conditions change. When a downturn occurs, companies reduce overhead, but only to the known market—that which they can measure.

During economic booms, this model leads to a guaranteed profit because companies never have too much overhead. The problem, however, occurs when the market drops. Waiting until the market has fallen to remove overhead is a guaranteed loss: During a downturn you will always have too much overhead.

As the construction industry enters a period of growth following this most recent recession, it needs to heed some warnings from history. The failure rate of businesses rises during economic rebounds, and construction is starting to see such failures.

Controlled growth in-and-of itself is not a cause of business failure. However, continuous growth of more than 15 percent annually increases risk. Schleifer graphed the profitability of the 10,000 companies in his database and noticed the top companies were growing less than 15 percent a year. Those growing at higher percentages had less profit: They were doing the things mentioned in section 3—bigger jobs in new areas with different teams—and it affected profitability. Every time companies get away from what they normally do, they add risk.

If you have the opportunity to take less risky work or more risky work, why not design a firm that lives on less risky work? You will sleep more nights and make more money.

AS THE CONSTRUCTION INDUSTRY ENTERS A GROWTH MARKETPLACE, companies need to keep in mind that there's a cost to growth. Schleifer cites three potential risks of growth:

1 CONSIDERING INCREMENTAL SALES GROWTH TO BE PERMANENT.

Many companies are doing just fine and making money, then a big project comes along with a trusted architect or owner. They take the big job, and it works out. Now the company is at a new plateau. It doesn't want to go back to its previous size. So it spends the next several years demanding enough business from the marketplace to fill that bucket and reach that new sales number. But in all likelihood, that was a one-time boost in sales.

2 BELIEVING THAT OVERHEAD IS NECESSARY FOR A NEW, LARGER ORGANIZATION.

That assumption is correct only if a company's growth is permanent. Putting on overhead, then finding out the growth was temporary, is a real threat.

3 ACCEPTING AND EMBRACING UNPLANNED GROWTH.

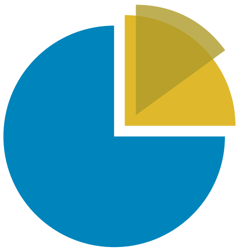
Planned growth is fine; unplanned growth can cause problems. Companies often describe unplanned growth as an opportunity, but many of the 1,250 failed companies in Schleifer's database were exploiting "opportunities" when they ran into trouble. That's not to say companies should never take advantage of unexpected potential business. They do, however, need to carefully consider what taking on that project means to the rest of the company and its two- to five-year business plan.

The construction industry's traditional growth model works fairly well in a growing economy, but margins drop in a declining market. The successful contractor of the future doesn't face reduced profits in a down market: Its percentage of profits decline, but the company remains profitable. One way to ensure profitability is through flexible overhead.

Flexible Overhead and Financial Security

As the construction industry rebounds, it's critical to examine how companies will treat overhead. During growth periods overhead must increase, but how should companies add it back?

SCHLEIFER RECOMMENDS FLEXIBLE OVERHEAD, a new concept that views overhead items as fluid rather than permanent. Companies should allocate 15 to 25 percent of total overhead as flexible, meaning it can be added or subtracted in a week or less.



Allocate 15 to 25 percent of total overhead.

Each company should carefully examine its operations to discern which overhead items do not need to be permanent. Let's consider three areas that may be transitioned to flexible overhead, including industry examples in which the business model worked:

Equipment—Any piece of equipment that isn't utilized 65 percent of the time can be rented rather than owned. There is a cost to owning equipment: When it's not working, it's overhead. If companies rent a portion of their fleet, they can send it back when they aren't busy. As an added benefit, they don't incur maintenance costs.

Industry Example—A company specializes in clearing land and preparing pad sites for residential construction. It typically uses track loaders two to three days each week. Schleifer convinced management to try renting track loaders on one job. During the first few weeks, the equipment rental company dropped off the track loaders when needed and picked them up when called. After that, they left the equipment on site and charged the contractor per metered usage. The trial was a success, and the company now rents track loaders for all its jobs.

Personnel—A minimum of one to two office employees can be hired from temporary agencies, particularly for jobs in the accounting department. By cross-training all full-time employees on jobs within the department, companies can easily outsource a couple positions to temporary employees. The goal is to have a core group of full-time employees, plus a certain number of temporary employees to perform routine work.

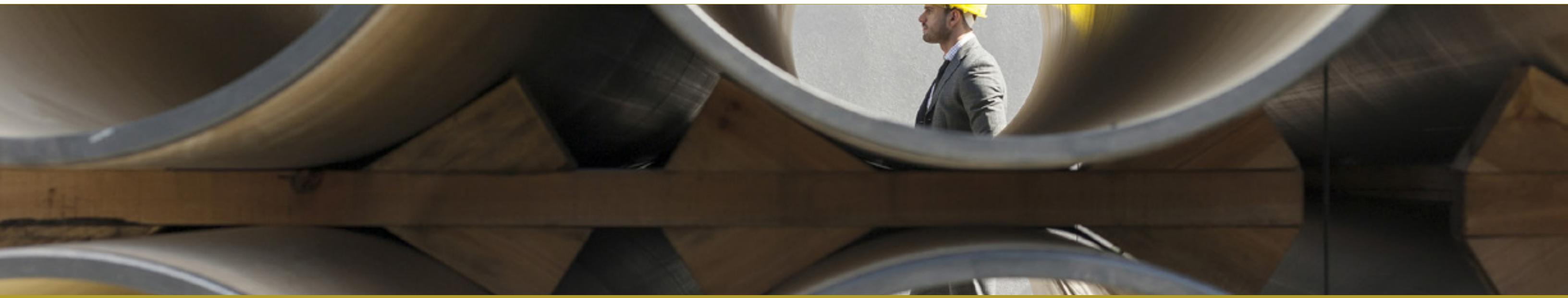
Industry Example—A large general contractor in an area with harsh winters utilizes temporary accounting personnel from the spring through Thanksgiving. Through cross-training and the judicious use of overtime, the remaining full-time employees handle all the accounting functions during the winter when business is slow. The model works so well that the company has since adopted it for yard employees, too. It only employs full time the number of drivers and yard employees required during the winter; the remainder are temporary employees hired during the busy season.

Interim Office and Shop Space—Companies can't wait to be large enough to build their own offices and construction yards. But buying and owning a building or property is an investment decision, not a construction decision. Instead, companies should exploit the cost of their office space by using it more efficiently, such as through selective overtime and shift work.

Industry Example—A contractor with a handful of leased offices across the city can shift employees as needed to different locations, sub-lease the space during slow times or close an office quickly.

In construction companies, some of the biggest overhead expenses are equipment, personnel and office space. But there are other areas to consider when implementing flexible overhead. Here are five contenders:

1. Company-owned delivery vehicles
2. Information technology services
3. Company functions, such as holiday parties
4. Corporate gifts and bonuses
5. Job training or education



SUMMARY

THE SUCCESS OF A CONSTRUCTION BUSINESS IS NOT ITS GROSS PROFIT, but its net profit. When companies gain control of overhead, then sales no longer drive the organization. Absent the desperate need for sales, companies can pursue solid, risk-balanced work—jobs in the geographic area and of the size and type from which they normally profit. They stop chasing non-typical, high-risk work so they can cover fixed overhead with ease.

The successful contractor of the future will be able to:

- Reduce overhead practically overnight.
- Take on the kind of projects that are normally profitable.
- Avoid all jobs that are out of the ordinary.

If there is work in your past you wish you hadn't taken, then consider flexible overhead.

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