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# RISKS AND OPPORTUNITIES FOR HVAC AND SHEET METAL CONTRACTORS DURING THE CONSTRUCTION MARKET RECOVERY

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# INTRODUCTION

The construction industry is rebounding after the worst market in decades. The pace of the initial recovery may be agonizingly slow, but there has been an increase in work put in place in the last 12 months and, providing the US economy continues to strengthen, this marks the beginning of a construction market rebound. Forecasters are cautious, but there is data that indicates the pace in 2014 will improve considerably and continue to improve in subsequent years. Recovery will present HVAC and Sheet Metal Contractors with both opportunities and risks. Risks are addressed here first because a misstep during the initial recovery could jeopardize a contractor's ability to enjoy the opportunities. Having made it through the most threatening market most can remember, it is critical that HVAC and Sheet Metal Contractors understand what to expect now.

# RECOVERY RISKS

## Economic Impact

A study of the economic dynamics of prior construction market rebounds indicates the developing recovery is going to be a financial struggle for some contractors. The primary reason is that growth eats cash and many firms have been straining financially during this unprecedented downturn to the extent that they will have difficulty financing the growth recovery will offer. This study is conclusive that during the initial part of the recovery margins will remain low because aggressive bidding continues until the appetite of construction organizations is satisfied. The research also confirms that the failure rate of construction enterprises is much worse during recovery than during the downturn. HVAC and Sheet Metal Contractors will have an advantage if they more clearly understand how to approach this recovery. There are too many economic uncertainties at this time to project a rapid, slow or modest recovery. This information, critical for any longer range business planning, will be made available to HVAC and Sheet Metal Contractors as it develops.

There is little doubt that the length and depth of the market slowdown have produced extremely aggressive pricing, changes in owner attitudes, and declining margins. Construction organizations will need to manage cash flow judiciously during the recovery to remain financially viable and credit worthy. HVAC and Sheet Metal Contractors are encouraged to develop cash flow strategies to deal with the significant cash demands of growth and to have the discipline to resist engaging in any "feeding frenzy" for work that may develop during early recovery which could deplete capital and diminish equity. Bonding capacity could also be affected, creating barriers to fully participating in the recovery.

Contractors will need to finance the recovery growth differently than the growth market of 2005 through 2008 where the industry was able to finance the growth with profits. With the reduced margin potential, the recovery growth will require outside financing from a banking industry that may be hesitant to fully re-engage in construction lending.

## Historical Perspective

Prospering in cyclical markets and surviving both a recession and recovery in the construction industry starts with recognizing what is happening in the marketplace. The results are totally predictable and have occurred without fail in every industry cycle for the last 40 years. When there are fewer projects in any market, competition intensifies and prices and profit potential diminish. In a shrinking market the ideal would be for each contractor to accept proportionately less work so that market share of each business is maintained. However, there is a tendency in the construction industry to resist any reduction in sales, often strenuously, and to fight vigorously for the fewer available projects, driving down prices for everyone. The tendency continues through the initial and intermediate stages of recovery when every project looks like the last project on the horizon. Trying to maintain volume in a declining market is, in effect, an attempt to increase market share and any increase in market share is universally "bought" at a cost. Trying to be the first business to return to prior size creates the same effect, limiting profit potential and magnifying risk in an already risky business.

This exposure is compounded by the fact that in each stage of recovery, particularly after a sustained downturn, inflation is common; caused by labor and material shortages. Some laid-off construction tradespeople and managers have vacated the industry and do not return, or return only after they have confidence in a sustained recovery. Material manufactures and suppliers have suffered the same financial difficulties as contractors, forced to cut back capacity and unable to raise prices. Regaining the capacity requires investment and takes time causing material shortages that lead to rapid price increases.

If history repeats itself, contractors attempting to make up for lost ground will load up on cheap work increasing their risk in already difficult circumstances. We cannot control the market, but we can control our response to it. This study indicates that contractors will encounter nine threatening recovery issues:

### Threatening Recovery Issues

1. Aggressive Pricing Continues
2. Growth Creates Cash Flow Needs
3. Financing Will Be Essential
4. Banks' Reaction Undefined
5. Sureties' Reaction Unclear
6. Labor Shortages
7. Labor Skill Level Declines
8. Material Shortages
9. Labor And Material Inflation

These recovery issues are addressed in more detail in the order listed:

1. Aggressive Pricing Continues– In the past three major construction market downturns, aggressive pricing has continued through the initial and intermediate stages of the recoveries and it is almost a certainty it will happen in this one. There is limited advantage to an increase of available work if aggressive competition continues. Unfortunately, margin rebound has not occurred in prior recovering markets until well into the rebound cycle.

2. Growth Creates Cash Flow Needs– Construction organizations will expand to

meet increasing demands and that growth will immediately impact cash flow needs at a time when numerous organizations are suffering cash flow difficulties.

3. Financing will be Essential– For even a financially healthy company, bank financing needs will increase to pay for the work in progress and bond credit demands will rise immediately. In this economy many construction enterprises' credit lines are already stretched and assets already pledged.

4. Banks Reaction Undefined– At this time most banks are not particularly enamored with the construction industry and it may take some time for them to become interested in returning to contractor lending. Banks' response to requests for more lending is uncertain at best and should be tested early by prudent contractors.

5. Sureties Reaction Unclear– Sureties, similar to banks, rely on the financial strength of an enterprise to extend or increase bond credit. Sureties are confronted with a construction industry that has been weakened by almost five years of slumping sales at a time when owners are increasingly looking to protect their investments by expanding bonding requirements.

6. Labor Shortages– The construction workforce, from field labor to management, reduced proportionately as the market diminished. Some will return as they are needed, but some have moved on to other occupations, retired or otherwise departed for lack of work. Attracting new entrants into construction has been a problem for decades and the industry is less attractive to young people than ever. To some the industry appears unstable at best and unsuitable at worse.

7. Labor Skill Level Declines– The skill level of the construction workforce has been a common complaint among industry observers for decades. If a large percentage of the workforce will be new entrants, this problem is unlikely to improve. Even skilled workers who return to the industry after years of doing something else will have a lot of catching up to do as technology, which they have not been exposed to, continues to march on. Diminishing skills at all levels make it that much harder to profit from work captured at extremely low margins—and, in some cases, unrealistic pricing. As the market gains momentum HVAC and Sheet Metal contractors will also be in need of professional staff. The conventional talent pool has diminished and universities will be hard pressed to increase their output of young engineers and managers in the short term. Strategies for retaining key staff will be important. Those companies who found that they were compelled to reduce salaries or cut bonuses may find some key people discontent in what some describe as the "new normal", particularly if it involves a long path to earning back previous raises or bonus.

8. Material Shortages– The ready supply of construction materials has reduced as the market decreased and capacity is diminished as some production of these materials is idled. In a market rebound, capacity does not immediately reappear. It takes time to bring production back on line and there is a cost to doing so. Manufacturers and suppliers are not likely to respond to shortages until there is a sure and certain recovery creating a sustainable demand for their products.

9. Labor And Material Inflation– The availability of labor and materials alters rapidly to the realities of "supply and

demand." If there is a shortage of an item, even for a limited time, the price of that item goes up almost instantly. In the current circumstance, the beginning of material shortages is already pushing prices up and the sure-to-follow labor shortages will do the same. Manufactures have little incentive to resist price increases and the common reaction to a labor shortage is to overpay for it in order to attract people or keep them. When work increases during recovery it is difficult to expand the labor force at the same pace causing overtime and schedule difficulties as well as resource constraints such as tooling, equipment, shop space, detailing, CAD, BIM) which often causes additional overtime. At the same time there is little ability to introduce apprentices and lower classifications of labor in sync with schedule or manpower needs causing expanded crew sizes to become top heavy increasing labor costs, impacting margins and the bottom line. Companies that could not invest in emerging technology such as BIM, prefabrication, etc. during the downturn may now find themselves behind the curve, and at risk of being excluded from some opportunities, or of going through a learning curve during a busy period being forced into a costly alternative of rushing the implementation of new technology in order to keep up with their competition.

It would be best if only some of these nine issues were likely to impact only "some" projects. However, the reality is that all of these issues have either occurred or will occur and will, without question, impact all projects. With these factors affecting work, captured with already thin margins, profits will suffer and the escalating potential for loss could be severe, particularly in an industry where inflation clauses are difficult to get. The impact of these issues on an industry attempting to come out of a terribly challenging market is unfortunate, but is definitely predictable.

# RECOVERY OPPORTUNITIES

## Introduction

The construction industry (both design and construction) has very little influence over its market and almost no ability to cause construction projects to happen. The buyers, usually the end-users, decide if and when the construction, renovation or retrofit of a project is required and if they can fund it. They then go to the design and construction industry to produce the work. The point being, the construction industry does not cause the work to happen, but rather is available when other industries, public bodies or individuals require design and construction services. While HVAC and Sheet Metal contractors are prime contractors on some projects, the primary source of their work is as a subcontractor to general contractors or construction managers. As subcontractors and prime contractors the opportunity for increased sales during recovery is, for all practical purposes, limited to a proportional share of the overall construction industry's growth.

There are some drivers of HVAC and Sheet Metal work such as: employee safety, energy savings, new codes and regulations, IAQ (indoor air quality), Green building/LEED, New technology, etc., however, even these have to be originally decided upon by the end user or buyer of construction services. As such, they are driven by needs of those outside of the construction industry and their ability to fund their needs. While some will contend that HVA and Sheet Metal Contractors companies can market their specialized services increasing their share of the work, this does not increase the market, it just redistributes it. There are minor exceptions. New products, usually developed by manufacturers not contractors, can increase market size, usually slowly and marginally and HVAC and Sheet Metal Contractors that do architectural metal, for example, can market designers who may change to a metal product from a non-metal design element which has a net increase in the Sheet Metal market. However, this is again marginal and does not necessarily increase the overall construction market, but moves some revenue from one type of construction to the Sheet Metal market.

## Market Share

Increasing market share by whatever means—usually effective marketing, new skill sets, etc.—is clearly an opportunity for individual HVAC or Sheet Metal companies; however it is not a result of the recovery growth because it simply alters the distribution of the work and does not cause an increase in the market. Individual company growth can be achieved by competing for larger projects than usually attempted, increasing the geographic area the products or services are provided in, or expanding the type of products and/or services provided. However, these types of "opportunities" also have risks associated with them. The associated risks are primarily caused by an organization going outside of its known area of expertise which can have a learning curve that may cause profitability difficulties. For a detailed review of these risks refer to the book *Construction Contractors' Survival Guide*, or the book *Managing the Profitable Construction Business: The Contractor's Guide to Success and Survival Strategies* (March 2014) both by the author of this report.

The current consolidation of the construction industry presents a somewhat obscure growth opportunity for a limited number of companies in the form of mergers or acquisitions. As mentioned earlier, change in size of project, geographic area or type of work creates risks and one of the methods of compensating for these risks is in partnering with or acquiring a company that already preforms the size, location or type of projects being considered thereby acquiring the necessary skills or financial backing. There are risks associated with consolidation the primary of which are: difficulty and cost in merging corporate "cultures", no guarantee that all customers or employees will stay with the merged entity and changes in managing the new, expanded business. These factors will generally be considered by larger contractors, however, there may be opportunities for smaller or mid-size contractors, particularly if the construction market recovery gains traction and expands at a better than anticipated pace. In an industry that is consolidating, every size construction enterprise should be prepared to measure and consider all options. This is particularly significant because the pattern of consolidation for any industry is for larger enterprises to grow putting competitive pressure on mid-size companies. Smaller companies, particularly in niche markets, generally feel less of the impact.

## Ongoing Opportunities

While increasing sales is a common corporate goal, the real opportunity in this and any market cycle is in enhancing efficiency and productivity to increase profits. This is a primary premise in any business because of the reality that the low cost producer will always survive. It is great to sell quality and to have relationships where a customer will pay well for exceptional product, service and often trustworthiness, but true value to a customer includes efficiency and productivity, providing the opportunity for increased profits in good times and staying power in bad times.

According to several published research projects, there is the potential for increasing productivity in the construction industry from 30% to 50% and some claim higher. If the projections are wrong by half, there is still plenty of room for improvement. While these studies are not necessarily HVAC or Sheet Metal specific, there is no reason to assume they do not apply; particularly to self-performing organizations where opportunities to increase productivity are reported to be greatest. In my experience, employee training offers the most immediate and cost effective results. Leadership training for supervisory positions can be very effective. Safety, lean construction methods, and packaging, handling and logistics of material handling all provide opportunities for productivity and profit enhancement.

With the pending labor shortage, programs that consider the "care and treatment" of the workforce can be very effective. Aggressive and selective recruiting, and the introduction and maintenance of accommodating and suitable field conditions promote employee loyalty which fosters improved productivity. Some construction organizations use unique practices such as requiring their people to read specific books on leadership, productivity, etc., and have team discussions to gather ideas on how to improve their processes, productivity, customer service and other subjects of interest to the company. Productivity improvement and related subjects are widely published, easily accessible and may present HVAC and Sheet Metal Contractors with the best opportunity for business improvement during the market recovery process.