

Are You Risking Your Company By Growing Too Fast? (Back to [Table of Contents](#))

The Good News

In a growing market the good news is there is plenty of work, however, the bad news is there's plenty of work. Growth is a two-edge issue. Early stages of a recovering market offer more work, but little improvement in margins because everyone wants the newly available work. Profits eventually improve, but slowly as the industry approaches the size it was before the slowdown.

The Power of Negative Thinking

The construction industry is its own worst enemy, continually undermined by misinformation that leads to negative thinking. We move between there is not enough work to there is not enough labor. I have not experienced a time when anyone said there is just the right amount of everything. All indicators suggest as work increases it should be a seller's market, but it does not happen. The industry is fragmented with over a million construction businesses in the country to the extent that contractors cannot easily get an overview of how the industry as a whole is doing. As a result we tend to make pessimistic, short-sighted guesses.

In past cycles, during good years contractor opinion polls continually predicted a slowing construction market and during bad time the same polls predicted a slowing market. The consensus opinions appear to be more guesswork than research because the market indicators at the times of the surveys were quite different. Inaccurate forecasts create a problem because the sense that there may be less work in the near future causes contractors to price more aggressively, defeating any probability of market-driven margin increases. The industry suffers from a margins problem more than a market problem.

Margin Realities

While reduced profits may be expected in a down market an unfortunate number of construction companies experience adverse effects from good markets as well. In a growing market some organizations take on more work than they can efficiently handle and finance, suffering financial distress or worse. The difficulties in down markets is significant, but does not change as much as should be expected in a good market. During recoveries some contractors enjoying the rebound capture more than their share of the market and then falter from the overload. The casualties of a robust construction market suggests financial distress increases in direct proportion to market growth and well a market reduction.

It is extremely difficult for a closely held construction enterprise to project how much it can effectively perform and finance, every organization has a limit. The problem is that the surest way to discover that limit is to exceed it and even then because industry record-keeping can obscure problems for a long time the limit may not be obvious. Even profitable work puts a strain on cash flow, and few construction organizations can gear up quickly enough or solidly enough to hold profit margins during rapid growth periods, particularly given today's labor market.

Growth and Risk

The construction industry, historically volume-driven, thrives on growth. The words “growth” and “growing” recur in my research into the management of risk in the construction industry because the business risks in construction are magnified during growth phases. In the best of times there is risk, and a rapidly expanding construction company sustains increased risk even if closely and intensely managed. Contractors should not underestimate the magnitude of increased risk from growth in the closely held construction enterprise.

Overhead

Overhead costs are difficult enough for contractors to control when their companies are not growing, but in a growing organization managing overhead is a very real and hazardous problem. Because organizations cannot add a half-person or a half-piece of equipment, they are forced to incur overhead costs during growth in larger amounts than they would like. This creates losses until the company grows into the overhead. The problem is magnified when lagging profits create an absolute necessity to increase volume to cover the increased overhead, putting the company in double jeopardy.

Pricing Dynamic

As an organization attempts to increase market share, price suffers because it is always necessary to make at least temporary price concessions in order to take market share away from competitors. Although construction organizations may not make conscious decisions to lower their prices to capture added volume that is what occurs. And when selling price suffers, it is usually for all the new work, not just part of it. Therefore, the company ends up needing even more volume than originally planned. This leads to a downward profit spiral because when an organization gets stretched there is little time for anyone to see the problem coming. Additional growth requires more overhead, creating the immediate need for even more volume. This chain of events has caused numerous construction business failures.

Measuring Performance

Rapid growth also puts a strain on a company’s key people and systems, and sustained growth doesn’t allow for a reasonable training period. Of even greater concern, continued growth doesn’t give an organization a chance to test new people or systems before the next new people and systems are added. If performance deteriorates as a result of growth it will only be discovered after the additional volume and people are taken on. Corrective measures are more difficult with people and systems stretched out and overworked managers are coping with the largest volume the enterprise has ever handled. Some companies can’t recover from this scenario. Too many organizations pursue growth without measuring performance until it is too late.

Rate of Growth

Years of research indicate that growth for a construction enterprise of more than 15 percent annually should be considered substantial and adversely affects business risk. Sustained growth over more than a couple of years compounds quickly. At 15 percent a company doubles its size in five years and triples in seven; at 25 percent it doubles in three years and triples in five. And at 50 percent a company doubles in 20 months and will grow by 500 percent in just four years.

Growth requires more resources in the way of people, systems, and money. Success is measured in an organization's ability to find the necessary qualified people, put appropriate systems in place before expansion, and finance the increase. Rate of growth obviously affects an organization's ability to bring adequate resources to bear on the new work. The alternative is to demand more from existing resources. However, few construction organizations are known for having underutilized resources or bench strength.

As volume increases, an expanded company is untested as an organizational unit. The only reasonable test is for the new organization to operate profitably and smoothly for a minimum of a year. Sustained growth creates a situation in which, if the test proves unsatisfactory, new growth has already been added during the test year. The organization is then facing a second bad year before it can roll back to its proven size and proven team. For many it is too late to retreat and recover.

Limits of Expansion

Determining the limits of expansion is complicated. In fact, some highly respected management specialists don't believe there is a limit. A good number of construction companies that were well-known names in the industry have failed during meteoric growth suggesting that restrictive factors exist. Although critics may point to other reasons for failures during growth, the reality is that in and of itself rapid growth is dangerous—not always fatal, but always risky.

Fundamental financial constraints limit healthy and sustainable growth. The management of growth requires careful balancing of sales objectives with the firm's operating efficiency and financial resources. The trick is to determine what sales growth rate is consistent with the realities of the company and the marketplace. Companies have limits in abilities, resources, and capital. Each organization is capable of doing just so much. During periods of rapid growth, closely held construction companies are so changed that they really become new, untested organizations—right at a time when they have a lot more work to produce. The prior organization that was so successful is gone forever.

If growth is to be successful quality must be preserved, but growth usually dilutes quality unless expertly managed. It takes more time to grow management and supervision than it takes to capture more work, and most companies decide to grow management only after additional work is on hand—not before. Growth just for growth's sake is risky in any business, but growing in the construction business is far more complicated than is commonly believed.

Controlling the Risk

Incremental growth instead of sustained growth may seem unnecessary—even unnatural—but it is the best way to control the inherent risk in growth beyond 15 percent. With cycles of growth and testing, then growth and testing again, an organization can reevaluate goals and recover after a bad test instead of pursuing constant growth until hitting a bad year (from which the company may not recover). This is prudent risk control. In sustained growth, a company grows beyond its people and systems so often that it never has the same organization long enough to truly test it and ends up functioning at constant risk with an ever-changing team. In some cases, failure is just a matter of time. Prudent business management requires that contractors grow with care, test as they go, and be prepared to withdraw from bad decisions.

Summary

Growth eats cash primarily because construction enterprises put the work in place and wait for their money. If a company is continually putting more work in place in each subsequent accounting period, it will eventually run out of cash and credit. If more work is available, it is critical (and difficult) for contractors to accurately project how much they can effectively perform and finance. The appropriate measure is: Annual growth exceeding 15 percent increases risk to the extent that a contractor needs to think twice and plan well about how it will undertake the additional work and where the internal or external financing will come from to support it.

Construction professionals should understand that it is extremely complex to project how much their organizations can effectively perform and finance. Every organization has a limit. If the company is growing rapidly, it is at risk. Consider carefully how additional work will affect the organization and approach cautiously. If you are concerned now, measure the extent of your present risk. Calculate your RScore (measure of financial risk) for the past three to five years and determine if it is trending up or down. If it's up, scrupulously examine your exposure. (The RScore formula has been around for a long time and can be found elsewhere in this manual.

Caution: Steep Grade

Managing a closely held construction company is like driving a truck up a hill. The steeper the grade, the more strain on the truck—on the engine, suspension, and drive-train—(or in the case of a company—on the employees, systems, and finances). A truck starting up a hill from a level roadway finds it easier than starting on the grade and increasing the slope. Separate short climbs are much easier than sustaining continuous uphill progress. We have all seen trucks attempting a very steep and long hill, slow to a crawl, labor to gain forward progress and some actually stop.

When a construction organization embarks on a steep climb at a growth rate of more than 15 percent, it will always experience a strain on its resources. During periods of continuous growth, the strain is sustained and magnified, sometimes to the breaking point. A truck advances much more efficiently up a series of modest grades than up a very steep hill or sustained climb. Managing strain on company resources increases efficiency, profitability, and risk control. Subjecting resources to severe or continuous stress encourages inefficiency, deterioration, and potential decline.