Financial Distress - Turnaround Management

Warning -- Financial Distress in Good Times (Back to **Table of Contents**)

The Good News

The good news is there's plenty of work. The bad news is there's plenty of work creating growth problems for some contractors.

Introduction
The construction industry has always been cyclical and always will be. Construction is a lag industry that it follows the US economy up and down, but lags behind the economic cycle by 12 to 18 months. Most people understand that the industry suffers in down cycles for obvious reason that have been address else were in this manual. Less understood is why many construction enterprise suffer is up cycles. Part of the explanation is that when the economy turs up the construction industry continues to go down for 12 to 18 months causing some to suggest that the industry is suffering during an up market.

It may be semantics, but the economy begins to recover or goes up, the construction market is lagging and remains down for 12 to 18 months. Therefore the industry may be thought to be suffering in an up economy when in fact the construction market is still down. However when the construction market finally turns up (begins to recover) after the lag period of 12 to 18 months the margins or profits do not recover for at least another 12 to 24 months and following a long downturn it may be much longer. Margins do not recover until well after construction put in place measured in dollars returns to at least 50% of the amount it was prior to the downturn.

There are other issues to consider in recovery which are mainly growth related. During recovery by definition construction businesses are growing back to the size they were and beyond. There are serious risks associated with growth and rate of growth. This paper discusses industry difficulties and risks during the early and mid-recovery periods following a downturn.

The 2017 Recovery
The construction economy is finally keeping pace with the general economy and in some areas exceeding it. Industry margins have improved in most areas of the country, but not nearly as much as they should be. Current increases in construction industry margins should actually be in proportion to the favorable market we are enjoying and are not because some contractors continue to price work as if there were no other jobs coming along. Others are trying to grow at a rate that they need to capture so much work it forces them to remain aggressive.

All indicators suggest it should be a seller's market, however, in this regard, the construction industry is its own worst enemy. Because the industry is so fragmented, with so many separate construction enterprises, a seller's market has not developed. Contractors, generally considered optimists, appear pessimistic and short sighted when it comes to forecasting their market. When contractor opinions were sought by various groups over the past several years to develop consensus forecasts of the construction market, contractors predicted a slowing construction market prior to each of the past several very good years. The consensus opinions appear to be more guess work than research as the market indicators were quite positive. Inaccurate negative forecasts create a problem because suggestion that there may be less work in the future has the effect of causing contractors to bid more aggressively, defeating the probability of market driven margin increases.

THE BAD NEWS

An unfortunate a number of construction companies are experiencing adverse effects during a good market. There are a considerable number of small and mid-size organizations taking on more work than they can efficiently handle and finance, suffering financial distress or worse. Difficulties in several of the largest, oldest and most sophisticated construction companies in the world have made the press with one article stating “If they can get into trouble anyone can.” The number of contractors in claim situations with their sureties has increased out of all proportion to the good construction market we are enjoying. In almost every case the contractors had been growing rapidly over recent years. Those not enjoying the rebound in margins are typically trying to capture more than their share of the market. The casualties of the robust construction market are contractors growing beyond their organization’s capability”. It is extremely difficult for a closely held construction enterprise to project how much they can effectively perform and finance, but for certain, every organization has a limit. Unfortunately industry record-keeping can shield problems for a long time. Even profitable work puts a strain on cash flow and few closely held construction companies can gear up quickly enough or solidly enough to hold profit margins during growth periods, particularly in today’s labor market. If our industry sustains these disasters in good times what will happen when the next slowdown occurs?

Growth and Risk

The construction industry, historically volume-driven, thrives on growth. The words "growth" and "growing" appear often 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.

Growth Dynamics

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 the market share away from competitors. While construction organizations may not make a conscious decision to lower their prices to capture added volume, it 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 because margins are suffering. This leads to a downhill 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.

Rapid Growth

Rapid growth 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, by definition, only be discovered after the additional volume and people are taken on. Corrective measures are more difficult with people and systems stretched out and when 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

In a reasonable market companies will be growing at some rate. Years of research indicate that growth for a construction enterprise of more than 15% annually should be considered substantial and adversely impacts 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 triple in five. And at 50 percent a company doubles in 20 months and will grow by 500% 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 in advance of expansion, and finance the increase. Rate of growth obviously impacts the likelihood and timeliness that an organization will be able to bring qualified and adequate resources to bear on the new work. The alternative is to expect existing resources to do more, 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 they can roll back to their 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, there are some highly respected management specialists who don't believe there is a limit. However, there are enough companies that no longer exist, that were household words in the industry during their meteoric growth stage, to suggest there are restrictive factors. While critics may point to other reasons for failures during growth, the reality is, that rapid growth itself is dangerous--not always fatal, but always risky.

Financial Constraints
There are fundamental financial constraints to 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, available 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 an organization is to grow, its management must grow and growth must be qualitative, not just quantitative. Qualitative organizational growth takes time and needs to occur prior to sales growth. It takes more time to grow management 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 the sake of growth is risky in any business, but growing in the construction business is far more complicated than it is given credit for.

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%. With a series of: growth, then test, growth and test again; an organization is able to reevaluate and recover after a bad test in lieu of constant growth until a bad year is encountered--from which the company may or may not be able to recover. It is prudent risk control. In sustained growth a company grows beyond its people and systems so often that they never really have the same organization long enough to truly test it, and are at constant risk with an ever changing team. In some cases it's just a matter

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, they will eventually run out of cash and credit. With so much work available, it is critical (and difficult) for contractors to accurately project how much they can effectively perform and finance. The appropriate measure is: Growth in excess of 15% annually increases

Construction professionals should understand that it is extremely complex to project how much their organization 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 impact 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 can be found in the February, 1996, issue of Constructor.)

The construction industry should not be looking at another round of business failures during one of the best construction markets in years.

Sidebar
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: 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. And separate short climbs are much easier than sustaining continuous up-hill progress. We have all seen trucks attempting a very steep and long hill slow to a crawl. Laboring to gain forward progress. Some actually stop.

When a construction organization embarks on a steep climb at a growth rate in excess of 15%, there will always be 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. Analogous to a construction organization: Managing strain on company resources increases efficiency, profitability, and risk control. Subjecting resources to severe or continuous stress encourages inefficiency, deterioration, and potential decline.