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# HOW TO SURVIVE & THRIVE *Amid Economic Uncertainty*

The recession is “very likely over,” according to Federal Reserve Chairman Ben Bernanke. Growth and job creation will be slow, he added, but based on the numbers, the U.S. economy is poised to recover.

However, it certainly doesn’t feel like the recession is over – at least not for the construction industry, where the economic downturn has caused both immense upheaval and low numbers that will linger well into 2010.

In October 2009, the national unemployment rate reached double digits for the first time since 1983 and has remained around 10% ever since. But that looks pretty good compared to the construction industry’s unemployment rate of 22.7% – the highest among major industries.

So, that’s the bad news. Here’s the good news: Many contractors are finding ways to survive – often through strategies that help retrofit their companies and better position them for the eventual recovery.

In this article, we’ll review what’s on the economic horizon for the construction industry and then cover strategies to help your company survive the next 6-12 months (and make your business more profitable in the long run).



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## ECONOMIC & CONSTRUCTION INDUSTRY TRENDS

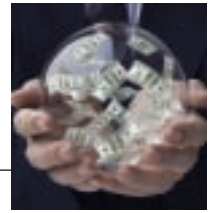
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The past decade propelled the construction industry to very high “highs” before closing with some very low “lows.” It’s difficult to say what the next few months will look like – let alone the next decade – but it might be useful to begin with some facts and figures.

In addition to unemployment rates, other statistics that significantly impact how quickly the construction industry will rebound are worth examining.

### Interest Rates

Over the past few quarters, the Federal Reserve’s rate-making



panel, the Federal Open Market Committee (FOMC), opted to keep interest rates at record-low levels, maintaining the federal funds rate (the rate at which the Federal Reserve lends money to banks) within 0-0.25%.

Some predict that the Federal Reserve will begin to nudge rates higher – up to 1% in early 2011 and 2.75% later that year. But, the FOMC has stated that interest rates should “remain low for an extended period.” In addition, the prime loan interest rate is forecasted to remain at 3.25% in 2010, a steep drop compared to 8% in January 2007.

## Inflation

Inflation is nowhere to be found – at least not yet. Many had predicted that the American Recovery and Reinvestment Act of 2009 (ARRA or federal stimulus package) and other government policies would trigger inflation, but so far that hasn't come to pass. Continued weakness in the labor market has limited consumer spending, which has slowed recovery, but it has also kept inflation at bay. However, this may prove to be only temporary. In November 2009, inflation was 1.8%. Then in December 2009, inflation increased to 2.7%.

Does this rise in the rate of inflation mean that significant growth is around the corner? Perhaps. But, more signs seem to point to only moderate growth in the first half of 2010, as popular stimulus programs (such as Cash for Clunkers) come to an end. In a welcome piece of news for the construction industry, President Obama extended the First-Time Homebuyer Credit, which will remain in effect until June 30, 2010 (originally scheduled to end in November 2009).

Now, let's take a closer look at trends that affect different construction sectors, beginning with housing and commercial construction.

## Residential & Nonresidential Construction

History has shown that when residential housing declines, nonresidential construction lags by about 1.5-2 years (and vice versa). Unfortunately, residential housing isn't predicted to bounce back until at least the second half of 2010. And if the historical trend repeats itself, we probably can't expect nonresidential construction to rebound until the latter part of 2012.

However, the circumstances vary in each contractor's marketplace. The old adage “location, location, location” is still valid in this economy. For example, if your construction market is in Southern California, Southern Florida, Arizona, Nevada, or Michigan, then your recovery period will likely be significantly longer.

The Architecture Billings Index (ABI) has long been considered a leading indicator of nonresidential construction activity. Derived from a survey conducted by the American Institute of Architects (AIA), the ABI measures the average time it takes to get an architect's plans from the drawing board to the jobsite.

According to *Building Design & Construction* (December 16, 2009), “...the November ABI rating was 42.8, down from 46.1 in October. This score indicates a continued decline in demand for design services (any score above 50 indicates an increase in billings).”

Thanks largely to continued job losses, housing delinquencies and foreclosures continue to rise. It's unlikely the employment rate will improve until later this year, and even then, jobs will increase at a very slow pace. In addition, defaults on maturing balloon loans have continued to push up delinquencies for collateralized debt obligations for commercial real estate loans.

Occupancy and rental rates have fallen, and owners are unable to generate sufficient cash flow to make debt payments. Owners have also run into refinancing difficulties. The delinquency rate climbed to 12.1% in November 2009, compared with 10.8% a month earlier.

As a result, nonresidential construction is expected to be slightly down in 2010 from last year's levels and then begin to increase in 2011. Similarly, contractor profit (which was relatively similar in both 2008 and 2009 because of backlog carry-over) is expected to be much lower in 2010. According to analysts at McGraw-Hill Construction, overall U.S. construction starts are predicted to experience an 11% jump in 2010, with gains in housing and public works projects offsetting declines in commercial and manufacturing construction.

## Credit

Unfortunately, credit in 2010 may be even worse for the construction industry than in 2009. Banks remain either unable or unwilling to lend money for new commercial projects because so many toxic loans are still left on their balance sheets.

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## MOVING FORWARD

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It's a new world where, frankly, old strategies won't work. And without a doubt, following the crowd is a surefire recipe for disaster.

So, what's the best way to ride out the downturn and remain competitive? Let's look at a few ways your company can make the best of a difficult situation.

### Put the "You" in "Stimulus"

Of ARRA's approximately \$787 billion, only \$143 billion (18%) was earmarked for construction-related projects, with the largest piece (\$49 billion) set aside for transportation and infrastructure plans. This leaves a relatively small dollar amount for most other contractors to bid on. However, if your company is prequalified to perform government work, ARRA funds can be a means to acquire new jobs and stay busy during the downturn.

If government work isn't a pool your company normally swims in, it pays to increase your knowledge before attempting to jump off the diving board. There are two critical issues to be aware of:

- **Federal Acquisition Regulations (FARs) and Cost Accounting Standards.** You'll need to understand and comply with these guidelines in order to bid on government work.
- **Intensive scrutiny.** If you're not accustomed to the amount and complexity of paperwork involved in government contracting, you soon will be. There's also a greater level of financial transparency required for any company involved in government contracts.

On top of these challenges, finding stimulus funding is not as easy as many think. As funding trickles down from the federal government through state and local governments, it becomes difficult to identify and track when and where funds are available, and which agencies have projects ready for bidding.

And, don't forget that sometimes the easiest way to gain access to government contracts is to avoid the costly trial-and-error approach and adopt one or more direct methods of entering this market. For example, your company might:

- Hire individuals with government work experience;
- Hire consultants with government contracting expertise;
- Acquire a construction company with government contracting in its portfolio; or
- Start a joint venture with a government contractor.

Contractors should also be proactive. Such Websites as [www.grants.gov](http://www.grants.gov) and [www.recovery.gov](http://www.recovery.gov) are credible sources of information, and most states have a Website that directs

contractors to information about state stimulus projects. Because many stimulus projects are directly awarded by government agencies, winning those projects will require contractors to be either an approved and/or preferred vendor. (Visit [www.sba.gov](http://www.sba.gov) to learn how to become an approved vendor.)

*Editor's note:* For more on government contracts, see "How ARRA Affects Contractors – Opportunities & Risks" by Dorri C. McWhorter & Bert G. Nuehring in the September/October 2009 issue and "The Potential Impact of ARRA on Construction Business Owners" by Adam Bonsky in the November/December 2009 issue.

### Necessity Is the Mother of Reinvention

As crazy as it may seem, this economic downturn could be an opportunity for contractors to reinvent themselves. Prior to the recession, contractors enjoyed an unprecedented period of prosperity, and most didn't have time to evaluate their companies' operations and procedures. Everyone was so busy that the biggest concern was a shortage of PMs and field staff.

Obviously that's changed. Now, contractors have the time to evaluate their employees and processes and get back to the basics of good business – strategic planning, budgeting, and cash management. This rededicated focus will enable them to emerge much stronger when the construction economy finally rebounds.

Hard times can be revealing because they expose your company's strengths and weaknesses. That's why now is the time for you to: build on what makes your company indispensable, improve what's underperforming, act decisively, be proactive, and put a plan in place to stay ahead of your competitors.

### Stop Being Tactical, Start Being Strategic

One of the most important steps that your company can take is to develop a strategic plan. This includes determining: your company's purpose and goals, its target market, what it does well, what areas need improvement, if you have the right people in place, and what your people need. A well-developed and clearly communicated strategic plan keeps management and staff on track and helps the company stay focused on financial success.

For example, in times of economic distress, it's very easy to venture into markets you've never worked in before (as in, moving from private work into public contracting). Before doing so, consider the following: Do you have the personnel to handle different reporting requirements? Are your operational personnel prepared for the differences in performing



negotiated work vs. hard-bid work? Have you analyzed whether your company is in a position to be competitive and profitable in this new market?

It's also important to develop more than one budget and forecast – one should represent what the company realistically hopes to achieve, and the other should outline a worst-case scenario. In other words, what would the cash burn look like if your company were unable to obtain the contracts necessary to create the revenue you'd hoped for? Where would cuts need to be made to maintain its survival?

### Cash Is King

This is one of the truisms of any business, especially construction. If your company is fortunate enough to have adequate cash reserves, it will have the staying power to ride out the recession and avoid the crazy bidding scene. Plus, having available cash means you can take advantage of many bargains on equipment, materials, and services.

The best way to maintain cash is to invoice in a timely fashion, collect quickly, and make payments effectively. Monitoring this cycle is imperative – even contractors with positive net income have failed because they didn't pay attention to cash flow.

For example, let's assume you're a subcontractor and you begin work on a contract starting January 1. That means you have to pay your employees for one month of labor before being able to bill the GC for it. Once the GC receives the bill, then he or she bills the owner. If the owner pays the GC within 30 days, then you've paid yet another month's worth of wages. And, if the GC then pays you within 30 days, that's another month of paid labor. That equals three months of wages that you've paid (not to mention all related costs and benefits) before you receive any cash in return.

Would your company be able to handle this drain on cash for a three-month period? It's one thing when work is plentiful, since new jobs help provide cash flow for work already in backlog. But when work is scarce, cash flow decelerates. If you don't have enough cash reserved, your company might find itself in a financial crisis.

Here are some best practices to help improve your company's cash flow:

- **Understand the terms of the contracts you're working on and be sure to submit your invoices in a timely manner.** If a contract states that an invoice must be received by the 10th of the month to be submitted for payment, ensure it arrives on time. Don't allow another 30 days to elapse before payment by submitting it after the 10th of the month. And, pre-bill when possible.
- **Ensure your invoices are free of disputes.** Some companies will hold up an entire invoice because of one disputed item – even if the item is a small amount on the invoice.
- **Check your cost accounting system.** Does it allow for the timely capture of all costs so that you can bill for them in a timely fashion?
- **Closely monitor your receivables and collections.** Hold customers accountable. Too often, subcontractors worry that an owner or GC will get upset if they're asked for payment. The work has been performed, so be sure you're paid for it. It's a right, not a privilege, to collect your money.
- **Bill for retention.** If you've had 5-10% of your contract withheld for retention, in many cases that represents your profit. At the end of the contract, bill for the retention – after all, it's money you're owed.
- **Time your payments well.** Maintaining strong relationships with your best subcontractors and suppliers is crucial to your business, since you want strong companies working for you.
- **Discover bad jobs as early as possible.** Figure out what's gone wrong and correct it immediately. Don't let the contract become less profitable than initially estimated.
- **Review your operations.** Use an independent, objective advisor (such as a construction industry consultant, your accounting firm, or another professional services firm) to help evaluate your company's internal controls, costs, cash flow, and business procedures to make sure it's operating at maximum efficiency, and not spending money that could be saved.

(For more on the importance of cash, see "Cash: The Lifeblood of Every Contractor" in the September/October 2008 issue.)

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## CONCLUSION

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Using the same strategies that have been successful in the past may no longer produce success. Therefore, it's vital to assess the economy and market conditions, make appropriate changes, and act quickly. This could mean making some very tough decisions, since most meaningful cost reductions will involve people.

It also means going back to basics. This is something that best in class contractors never lose sight of. They know that the difference between survival and failure boils down to the



fundamentals of good business: strategic planning, budgeting, and cash management – which, after all, are always sound business practices. **BP**

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