CONSTRUCTOR

THE CONSTRUCTION MANAGEMENT MAGAZINE / APRIL 2000 SKILL, INTEGRITY, RESPONSIBILITY

ARE YOU RISKING YOUR COMPANY BY GROWING TOO FAST?

WHAT GOES UP MUST COME DOWN.
IT'S A SIMPLE, TIMELESS RULE OF ECONOMICS.
TROUBLE IS, WE OFTEN FORGET THAT LESSON IN TIMES OF PLENTY.
NOW IS A GOOD TIME TO EVALUATE YOUR COMPANY.
ARE YOU GROWING TOO FAST?

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.

The U.S. economy continues on a steady growth path, the Asian economies are rebounding, and most European and South American economies are growing again. A healthy construction industry shows profits finally improving—slowly but measurably.

The United States enters the new millennium in great shape. Strong retail sales, industrial production, and consumer spending are helping to maintain economic growth. At the end of the 20th century, plentiful jobs, low inflation, and technology pushed productivity in the right direction. All conditions look good with the exception of the trade balance, and even there, improvement is in sight.

SO WHAT'S THE PROBLEM?—THE POWER OF NEGATIVE THINKING

The construction economy is neck and neck with and—in many areas—overtaking the general economy. Industry margins are up in most areas of the country, but (and here's the rub) not nearly as much as they should be. Current margin increases should actually reflect the favorable market we are enjoying rather than simply the phenomenon of contractors bidding as if they expect no other jobs to come

along. Some contractors are growing at such a rate that they need tremendous amounts of work, and this forces them to remain aggressive.

So what spurs this breakneck growth? The answer has to do with expectations. With regard to forecasting its market, the construction industry is its own worst enemy, continually undermined by negative thinking. All indicators suggest that it should be a seller's market, but it's not, primarily because the industry is fragmented into so many separate businesses. With 1.3 million construction businesses in the U.S., contractors cannot easily get an overview of how the industry as a whole is doing. As a result, they tend to make very pessimistic, short-sighted guesses. Before each of the past several very good years, contractor opinion polls have continually predicted a slowing construction market. The consensus opinions appear to be more guesswork than research because the market indicators at the times of the surveys were quite positive. Inaccurate, negative forecasts create a problem because the sense that there may be less work in the near future causes many contractors to bid more aggressively, defeating the probability of market-driven margin increases.

EARLY WARNING SIGNS

An unfortunate number of construction companies are experiencing adverse affects from good markets. Many small and mid-size organizations are taking on more work than they can efficiently handle and finance, suffering financial distress or worse.

I wish my 1998 forecast had been less accurate. In the October 1998 *Schleifer's Construction Forecast,* I wrote: "Some construction companies are experiencing adverse effects from good markets—An increase in business failures is around the corner if the trend continues." I repeated this warning in the January 1999 and October 1999 newsletters, hoping that, "around the corner" would take longer and

(continued on page 60)

"some contractors" would mean a few. But around the corner is now, and some is already too many.

Difficulties in several of the largest, oldest, and most sophisticated construction companies in the world have made the press lately, and an *Engineering News Record*, December 6, 1999, article suggested: "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." Given this continuing trend, it is now more accurate to say that financial distress increases in direct proportion to market growth!

It is extremely difficult for a closely held construction enterprise to project how much it can effectively perform and finance, but certainly, every organization has a limit. Unfortunately, industry record-keeping can obscure 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 given today's labor market. If our industry is incurring these disasters in good times, what will happen if a slowdown occurs?

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 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. 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 because margins are suffering. 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.

TOO MANY ORGANIZATIONS PURSUE GROWTH WITHOUT MEASURING PERFORMANCE UNTIL IT IS TOO LATE

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, 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 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. However, the failure of several companies—that during their meteoric growth stage were household words in the industry—suggests that restrictive factors exist. Although critics may point to

(continued on page 62)

other reasons for failures during growth, the reality is that in 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, 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 growth is to succeed, it must preserve quality as it grows larger. Organizational growth that does not dilute quality takes time and needs to occur before 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 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, 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 prudence, test as they go, and be prepared to withdraw from bad decisions.

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. And 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. Laboring to gain forward progress, 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. To draw an analogy 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.

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. 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: 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 can be found in the February 1996 issue of CONSTRUCTOR, p. 50.)

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

—By **Thomas C. Schleifer, Ph.D.**, *an author, lecturer, and turnaround expert. Dr. Schleifer advises construction firms on performance improvements and profitability enhancement. He has developed the RScore Financial Risk Measurement, and contractors nationally rely on his Construction Industry Forecast newsletter for business planning and industry trends.*

FOR MORE INFORMATION

Contact the author at (480) 945-7680, fax (480) 970-8021, or e-mail tschleifer@aol.com. Website: www.schleifer.com.