$2 million. My experience is that our debt-to-sales ratio is going up, particularly for equipment-intensive contractors. This trend will threaten the stability of industry and if it continues will have the potential to lead to crisis proportion.

Planning for a Declining Market

While it takes a while to become good planners and trust your forecasting, it is important when predicting the market to guard against too much optimism and accept a downturn id that is what it looks like. We need to look at the potential for determining success or failure in our business during both growing and declining market and know how to downsize the organization. The options are fight for every job or reduce overhead and brace for the decline which can increase efficiency and productivity because you keep the best people. Top management, the contractor and partners get closer to the work when layers of people are reduced. We work long hours already so we need to be careful when downsizing that time is allocated appropriately. Fortunately downsizing generates cash because money comes in for the greater amount of prior work and spending is less for the lesser amount of current work

If we see poor market coming we might be decided it is healthier and safer at $15 million that at $20 million. We would then immediately reduce overhead to fit a $15 million company. Because is overhead is mostly people, the difficulty is determining who has to go and what equipment needs to be sold. Putting it up on blocks doesn’t work well because of continuing insurance costs and depreciated. If we eventually go back to $20 million we may not want the same permanent overhead. The steps are difficult and can be painful, but many who refuse to downsize face serious risk of losses or worse.

Downsizing Can Lead to Success

While the economy may be improving, I believe the recovery is fragile. Any trouble in the financial markets could be serious enough to force the whole process to begin again. Whatever happens, contractors should realize that while they can't control the market, they can control their response, including making layoffs when needed.

Prospering in cyclical markets and surviving a downturn in the construction industry starts with recognizing what will happen when the markets soften and backlog falls off. The same thing has happened without fail in every industry down cycle for the last 50 years.

The potential for profit, measured as a percent of sales, is almost the same during a down market as it is in an up market—it's just more painful.

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The contractor's responsibility is to react to and manage risks and maintain financial strength and profit during the downturn to be ready for the rebound. The market always returns, but it is difficult to accurately predict when it will.

The Myth of 'Drop Dead' Volume

I regularly hear from contractors who say, "I have a drop-dead volume I have to maintain to be viable." My typical response is, as you grew your business from $5 million to $15 million, were you profitable at $5 million? Or to put it another way, as you grew your business to $100 million, were you profitable at $50 million and $70 million? Most contractors were, and they celebrated their success at those smaller volumes. The point is, if you have to go back to one of those reduced volumes, you need to size and configure the organization to exactly what it looked like when it was profitable at that size.

Reduce equipment fleets through sales or mothballing is one way. But there is a tendency to hold on to equipment (and people) with the idea of being prepared when the market returns. Sometimes these decisions can't be avoided, and risk-control mandates these steps be taken sooner rather than later.

The largest by far of all overhead costs are employee salaries. While it is appropriate to cut back non-essential costs—subscriptions, bonuses, travel, entertainment and so on—because it signals to employees a new attitude, those contractions never amount to enough to really make a difference. Reduction in overhead requires a proportional reduction in management and administrative personnel.

For a company to downsize 10%, it must eliminate 10% or more of overhead salaries, a move that also reduces the associated payroll, insurance and benefits costs. Managing risk protects the jobs of the larger number of employees who remain. Downsizing also provides an opportunity to weed out weaker employees and profit from a reduced volume with an organization's best people.

Capturing, training and retaining good people has been a major issue for many contractors during the recent good years, and serious resistance to these suggestions is understandable. However, timing is critical because there are real and significant costs to reacting late. However, if the market rebounds later rather than sooner, some organizations that have spent heavily to retain resources may eventually have to give them up anyway. That is the greater risk.

When there are fewer projects in a market, competition intensifies, and prices and potential profits diminish. Ideally, in a shrinking market, each contractor would accept proportionately less work; in that way, the market share of each business would be maintained.

However, there is a tendency in our industry to resist, sometimes strenuously, any reduction in sales, and to fight vigorously for the fewer available projects, which drives down prices for everyone.

Unless all competitors react by accepting and expecting proportionally less work, this is very unlikely. The result is that contractors resisting a reduction in their sales will "load up on cheap work," which increases their risk in an already difficult circumstance. Conversely, cooperating with the market and downsizing to align your organization with market realities is appropriate risk management. We can't control the environment.

Downsizing is difficult but necessary for contractors to prosper in cyclical markets. ■

Thomas Schleifer, Ph.D., is a management consultant and turnaround expert as well as a Visiting Eminent Scholar at Del E. Webb School of Construction, Arizona State University in Tempe. He can be reached at tschleifer@aol.com or by calling 480-945-7680.

If you have an idea for a column, please contact Viewpoint editor Richard Korman at richard_korman@mcgraw-hill.com