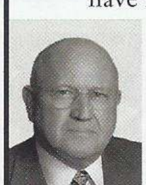
 By Thomas C. Schleifer, PhD

Overhead: A Silent Killer

As part of our research into the recent downturn, my Arizona State University colleagues and I surveyed U.S. construction companies to discover what overhead they chose to cut and when. The results are interesting because they can help your company to anticipate what cuts it may need to make in future market downturns. Construction companies traditionally have held to the belief that they had to keep together their entire organization during slow periods. Because it took so long to find and train their staff and get them to work as a team, contractors believed it would be impossible to replace those workers when the market rebounded.

Since, during the downturn, almost all construction organizations had to cut overhead eventually, the real question is whether they should have made the cuts earlier. Now that the market has begun to recover, the challenge is to determine what overhead to put back into place, in what order and when. Should this overhead have been added in the first place? Did it enhance efficiency and profitability, or was it just a way of maintaining a comfort zone or safety margin?



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I conducted the research project with Professor Kenneth T. Sullivan and Jake Smithwick, a PhD candidate at Arizona State University. As part of that research, we sent out questionnaires, and about 500 construction enterprises responded. The overwhelming number of respondents were contractors.

More than nine out of 10, or 92%, cut some overhead. Almost three out of four, or 73%, reduced bonuses, company functions and charitable donations. A sizable chunk, 41%, reduced business development.

Almost one out of four respondents, 24%, cut overhead by as much as 25%, and 15% of respondents cut overhead more than 75%. The respondents said they cut corporate salaries, training, education and travel. They also say they made large cuts in retirement plans. What do we learn from this?

General and administrative expenses, commonly referred to as overhead, are obviously necessary to the efficient management of an organization. For a cyclical industry such as design and construction, in which sales often fluctuate considerably, the question is how much overhead is necessary or appropriate relative to sales volume, which differs each year and sometimes each month?

A large percentage of overhead expenses are made up of salary and related costs, which are almost always considered permanent positions necessary to the management and potential growth of the organization. With so many small to midsize, closely held companies, construction contractors often run their companies as if they were a family, rather than a business. This approach is noticeable when it comes to bonuses and perks, especially during good years when profits often are shared more generously than in larger or publicly traded enterprises.

When the market slows, the reality sets in: It is much easier to put on overhead than to take it off. Many closely held enterprises simply accept the resulting poor performance, even losses, as a cost of doing business.

Every category of overhead expense should be scrutinized regularly, and overhead costs need to be adjusted at least annually in anticipation of next year's sales. Decreases should not be made after market downturns but in anticipation of downturns. U.S. company performance data from 2008 to 2013 indicate a serious and continuous reduction in sales and profitability across the industry—a clear sign that many design and construction enterprises should have cut overhead sooner.

I am convinced that the profitable contractor of the future will need to manage overhead through much stricter controls and ease the pain of cutting overhead by maintaining 15% to 25% of all overhead as "flexible overhead"—that is, overhead that can be turned off with a maximum of one month's notice or, in many cases, a week or less. A cyclical market such as construction practically demands that an enterprise be able to do what it considers "regular" volume one year, 120% of that volume another year, and 80% another year, rather than fill in the gaps with low- or no-profit work.

Looking back over the recession, the evidence is clear that the sacrifices in profitability could have been avoided by cutting overhead sooner. ■

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