

## Liquidity Management

### **Liquidity Management – The Ultimate Risk Defense** ([Back to Table of Contents](#))

Conservative liquidity management provides fundamental protection from financial distress and should be included in the business philosophy of every construction company. It should be a part of a contractor's DNA. The idea of having some cash or credit reserved for a time when it may be unexpected, but critically needed is not a standard element in construction business accounting. However, for an industry with the second highest failure rate in the country, it should be. Many of the hundreds of failed construction firms analyzed would not be out of business if they had set aside a rescue fund to save their company from financial disaster.

This paper advocates liquidity reserves as a necessary element of risk control in the prudently managed construction business. The recognition, measurement and management of risk are critical skill-sets in this perilous business, however, even with consistent application of these skills, mistakes happen and things occur outside our control. Sometimes just bad luck results in financial distress or catastrophic losses. If all else fails, cash reserves are the only defense. If you would not go on a ship without life boats why would you operate a high risk business without some reserves?

Some will argue that warehousing liquidity will slow the growth of a company and would be better reinvested the business. However, total reinvestment means being continually one misstep away from financial distress. It only takes one horrific job, mistake or unforeseen crisis to push the company close to the edge; or a market turndown when the company is over extended. The list goes on, and, if you have been in business a while, you already know of someone it happened to. Thinking it can't happen to you offers little protection.

If you welcome a chance to reduce the risks in your business consider the advantages of liquidity reserves. The primary considerations in the measurement of risk are the likelihood of the event occurring and the magnitude of the penalty if the event occurs. The likelihood is commonly measured in odds, such as it is a million to one to be hit by lightning. However, the penalty is huge so no one knowingly puts themselves in a position to be hit by lightning because while the odds are extremely in your favor, the penalty is too high. The odds on the flip of a coin are 50/50 which is pretty good so if you bet a dollar both the odds and penalty are reasonable, even safe. However if you bet a million dollars the odds remain reasonable but it is now a high risk that few would take.

You can't measure risk without evaluating the odds and the penalty or reward. For example, if the odds were six to one in your favor would you take the bet? This can't be answered without knowing what the event is. If it is a hundred dollar bet it is a good risk that most would take because of the excellent odds and nominal penalty or reward. However the same odds exist in a game of Russian Roulette. With one bullet in a six-cylinder revolver the game requires you to pull the trigger aimed at your head. Good odds but much too sever a penalty--so bad risk.

For the skilled construction professional the odds of mistakes, things occurring outside your control or just bad luck are fairly small. However, if anyone of these things happens in the

extreme, it could put a business into financial distress or worse which is obviously a serious penalty. In construction we face these risks every day and don't get to opt out of them, however, we do get to hone our skills at recognizing, measuring and managing risk and we are now being offered another risk control option--establishing liquidity reserves to counter the eventuality if all else fails. We can build a safety net, a protective shield against financial distress. Professional high-wire performers never intend to fall, but they have a net below them anyway. Contractors work without a net. Historically high margins (rewards) probably made that a good bet. However, today's slim margins have shifted the risk/reward balance to the extent that protection against failure is practically a necessity?

The amount of reserve will vary, depending on your appetite for risk and the amount of liquidity you are comfortable with (ability to meet short-term obligation). While it differs for each company, average comfortable liquidity is when Debt to Worth is around 1 to 1 or less while Net Quick is around 1.5 to 1 or more. For individual companies I use an average from the prior three year-end financial statements as a benchmark, assuming the company was profitable and increasing in value during those years. If not, I go backwards until there are three consecutive years of increasing value. When this occurs there will have been cash, cash-equivalents or unused credit available. The average of that amount over the three years is what I refer to as "Liquidity Reserves"; available to pay the bills in the event of unexpected financial difficulty. Most construction companies are liquid in good times, but only prudent contractors remains liquid in bad times. They can still pay their bills on time because they are failure protected--they have a net.

If the potential of a decision exposes your life's work and net worth to disaster, is that a risk you want to take? As you can imagine I am regularly accused of being risk adverse which is actually not the case. I just do not see any advantage in betting everything, or to playing Russian Roulette with your livelihood. Having seen too many contractors and their families lose it all I am certain that prudent management of liquidity is the best long-term strategy for the contractor of the future.