Beware the Recovery

In 2008, I predicted the recession would be deep and long. I said so in seminars, but few people believed it. When taking questions from the audience at those seminars, staff from sureties would ask, "Where are the failures?" The failures come at the end of the recovery, I would answer. Now, we're starting to see more failures.

And just as no one liked the recession, some contractors and sureties are going to hate the recovery, too. Companies will fail at a faster rate than anything we've seen since 2008. Inflation also will rear its ugly head.

The construction market recovery is going to be a financial struggle for most contractors because growth eats cash, and many have been straining financially during this unprecedented downturn.

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Contractors, as a result, may have difficulty financing the growth.

I've been studying the construction economy during past downturns over a period of 40 years, and what I've learned is conclusive. The unprecedented length and depth of the recent market slowdown has produced extremely aggressive pricing, changes in owner attitudes and declining margins.

During much of the recovery, margins will remain low because aggressive bidding will continue until the appetite of construction organizations has been satisfied.

The research also confirms that the failure rate of construction enterprises is three times worse during recovery than during the downturn.

This triple failure rate is a sobering, unavoidable fact. Contractors need to be warned and understand how to approach the dangerous period ahead.

In a shrinking market, the ideal would be for each contractor to accept proportionately less work so that the market share of each business is maintained. However, there is a tendency in our industry to resist, often strenuously, any reduction in sales and vigorously fight for the fewer available projects, driving down prices for everyone.

This tendency persists, perhaps even more strongly, through the initial and intermediate stages of recovery, when every project looks like the last project bidders will see. Trying to maintain volume in a declining market is, in effect, an attempt to increase market share, and any increase in market share is universally "bought" at a cost.

History Is No Mystery

Trying to be the first business to return to its prior size creates the same effect, limiting profit potential and magnifying risk in an already risky business.

This exposure is compounded by the fact that, in each stage of recovery—particularly after a sustained downturn—labor shortages as well as materials cost escalation and shortages drive prices higher.

This sticky situation occurs because some laid-off construction tradespeople and managers, who have vacated the industry, do not return or return only after becoming confident the recovery will be sustained. Materials manufactures and suppliers, who have suffered the same financial difficulties as contractors, are forced to cut back capacity and hold the line on prices. Regaining capacity requires investment and takes time, causing materials shortages that lead to rapid price increases.

To survive the recovery, contractors must avoid losses, keep their capital bases intact and avoid diminishing the equity in their companies. That means they must manage cash flow judiciously during the recovery to remain financially viable and credit-worthy.

Further, contractors need to develop effective strategies to deal with the significant cash-flow demands of growth, particularly after a protracted weak market. They must resist the "feeding frenzy" of small-margin, aggressive bidding during the early recovery.

Prospering in cyclical markets and surviving both a recession and a recovery in the construction industry starts with recognizing the realities in the marketplace. The results are totally predictable and have occurred without fail in every industry cycle for the past 40 years.

If history repeats itself, contractors will try to regain lost ground by loading up on cheap work, but this will only increase their risk in already difficult circumstances. We cannot control the market, but we can control our response to it. ■

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