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DOWNSIZING

A PROFITABLE ALTERNATIVE IN A SICK ECONOMY

Downsizing. In a country where bigger has always meant better, the word is loaded with negative connotations. This need not be the case. Objectively speaking, downsizing is simply a deliberate shrinkage of a company's overhead in anticipation of a decline in volume. Downsizing may be the intelligent response to today's tough economy.

MOBILITY MODIFIES MARGIN

Forty years ago the construction industry was fixed. People didn't come from other cities or states to help bid the work. When there was a lot of work locally, all area contractors reaped big benefits. When there wasn't, local and regional contractors still made money, just less of it.

Today, constructors come from all over the country to bid work. As a result, the margin, the mark-up on our work, goes down—the margin is controlled by a simple ratio: the available amount of work divided by the available number of bidders. In the non-mobile 1940s, 1950s, and less-mobile 1960s, when there was more available work and a fixed number of bidders the margin went up; in times of less work when there was a fixed number of bidders the margin went down.

In the 1990s, there is an almost unlimited number of bidders. If everyone would agree to stake out a territory and stay within it, the margin would go up. But, because this mobility trend is not likely to change, we need to look at the dynamics of what is taking place today, and respond to new realities.

Author Tom Schleiffer

A THIRD TECHNOLOGICAL REVOLUTION

Nationwide and worldwide we're facing more than just a modest depression; it's more like a third technological, economic revolution—the first technological revolution since the industrial revolution in 1857, in which we went from water power to steam power. The second brought the switch from steam to electro-mechanical power. Today, we seem to be in the third technological, economic revolution as we attempt to become a service economy.

Two factors are true of any technological revolution:

1) The revolution happens faster than we can react. As a result, we are not able to make full use of the new technological ideas quickly enough to advance to the next level without major economic disruptions.

2) The change does not happen in the one-to-three years of an "average" recession. The last two revolutions lasted 30 to 40 years—but the world was not as technically advanced at that time. The present revolution should take less than 15 years—and we are already five years into it.

WHEN THE NUMBERS DON'T ADD UP

Statistics say construction contractors make 1 percent before taxes, but I am seeing jobs where we go in at 3 percent on the bid and come out with 5 percent, with overhead at 5.5 or 6 percent. Most of us know we can't go on for long like this. The swing is too close: one piece of bad luck on any job takes down two or three other profitable jobs. It isn't worth the effort. We're not exactly working shorter hours; and we're going further in debt.

A careful study of the debt structure of our industry shows we're trying to borrow our future. I contend that the debt-to-sales ratio should be a constant. If you owe $1 million at a time, you do $10 million in volume; then when you're at $20 million in volume, you shouldn't owe more than $2 million. Yet, a study of a 20-year period shows that our debt-to-sales ratio is going up, particularly for equipment-intensive contractors. We actually owe more money per dollar of gross volume; that means we eventually will owe more than we produce. The borrowing has to stop. This debt structure is threatening the stability of our companies, creating the survival crisis.

SLIMMING DOWN AFTER BULKING UP

The trends are not in our direction, and probably will not be for some years. What's happening now is that we're coming off the wave of the 1980s, when some of us got a little bulky. One of the problems with riding a wave is if action is not taken at the crest, we ultimately find ourselves in trouble as the waves break. It really shouldn't matter if the industry is going up or down: a down market should only be able to hurt us if we don't know it's coming.

Our management decisions, based on our reactions to the economy, the marketplace, and the margin structure, will determine our success or failure. Every statistic I see says the economy will continue to decline. But since we see it coming, we can take action.

To increase market share, you must decrease the margin in today's market. If your volume last year and the year before was "X," and you continue to do "X" in a level market, you're not increasing market share; you're staying with the market. If the market is going down--and you intend to hold volume in

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spite of that declining market—you are, in fact, increasing your market share because by holding your volume, your piece of the market as a percentage of the total will actually increase.

For example, a contractor wants to do last year's volume. His market was declining such that doing last year's market means a nine percent volume increase. If he could get 100 percent at his fair mark-up and then only the nine percent of his work at a lower mark-up, it might make sense, but that's not how we get work. We have to go out and fight for every job, so every job is bid tighter.

What are we going to do about it? Most of us have built companies on solid overhead. We have drop dead numbers we have to reach. In the '90s, we're going to have to redefine "drop dead." In some cases, that number means death. We've got to look at our volume and overhead and determine what our profit base is made up of and what part of our market is the best and most profitable. Then, if we're going to take work with a slim margin (and I guarantee that if you're going to take any work, it's going to be a slim margin), we're going to have to start taking it closer to home so we can control it.

We need to embrace some downsizing concepts, because we need to put a bottom line back in our companies, even if we become a smaller company. We need to remember a simple rule of economics: the primary objective of the owner of a closely held company is to maximize the value of the company in the marketplace. As owners of closely held companies, we're supposed to protect our company, protect its survival, protect its security, and increase its value.

By going smaller, you can make a legitimate profit and increase the net worth of your company. The net worth goes up when you add today's profit to the old net worth.

We need to do survival planning, which is protect-the-company kind of planning. It takes a while to become good planners and trust our forecasting. It's important when predicting the market to guard against planning too close to the optimum, when the safe haven is somewhere below it.

We need to look at the potential for determining success or failure in our business during a declining market. In spite of the bad market, we will be okay because our businesses are not that complicated.

There are only three functional areas in our companies: 1) Marketing and sales, or getting the work, 2) Operations and production, or doing the work, and 3) Administrative and accounting, or accounting for the work. So when you look and think about downsizing, consider that these three areas are the only segments that need to be covered.

INTERNAL FORCES ON DOWNSIZING

Our families. They rely on these businesses, and we become so close to our senior people that they are like family. Family pressures are intense in good times and even more so in bad ones.

But downsizing also has an interesting side-effect: we keep the best people. We personally—the contractor and partners—get closer to the work because we eliminate layers of people. Downsizing increases efficiency to the point where it increases profitability.

Time allocation. One problem is that we work long hours already. We need to be careful when downsizing that our time is allocated appropriately.

Owner's ability, strengths, and weaknesses. In downsizing, we need to compensate for our weaknesses. The only weaknesses that will hurt you are the ones you don't recognize. Once recognized, we can either work around them or correct them.

Financial resources. We need to really evaluate these resources. Downsizing, fortunately, generates cash—not profits—but cash.

If we decide next year is a lousy market, and we might be healthier and safer at $15 million than at $20 million, then it must be decided what the appropriate overhead for a $15 million company is from scratch, from zero budgeting. Then an overhead package must be developed. We need to look internally to see who has to go, what equipment actually gets sold—not put up on blocks, continuing to be insured and depreciated. If we eventually go back to $20 million, we will have no intention of putting on the same permanent overhead.

FLEXIBLE OVERHEAD

One of the things we do in this industry is put on permanent, full-time overhead for the new, larger company that we want to be. But the company that will be successful in the '90s and into the year 2000 has to be able to do less work in one year, more work in another year, less work in the next year, and more work in the year after that. The successful company will be *driven by* the marketplace, not be demanding a steady volume of work *from* the marketplace.

We must think in terms of "flexible overhead" when it comes to the sales volume that creates our drop dead number. To be flexible, you rent and lease equipment that goes back when the work slows down. You hire temporary office and accounting clerks you're not afraid to lay off. It might be a little expensive, but the differential in cost buys flexibility—survival insurance.

Avoid taking jobs that offend your plan. Don't knowingly embrace work that changes your flexibility. Downsizing brings the work area closer to home, allowing you to watch it closely, increasing efficiency and profits.

Those who embrace innovation in the field and in the office will get through this. To a certain extent, we have become office-centered in our industry to the point that we have ignored the work force. In some hard production companies more than 50 percent of the employees are white collar workers who do not build anything. Look at ways of having fewer people to insure, fewer desks, fewer telephones. Turn off a few computers that have too many people collecting and managing data that is not making product.

We talk about Partnering with owners. Employees as partners is back to basics, the way it used to be 15 or 20 years ago, when you could turn your back on the field forces and they would continue to produce.

We need to get back in control of our companies and our field forces. We are going to have to be leaders. Leadership is growing and enhancing—growing people, not size of sales, not size of companies.

I am not frightened about what's going on in this country; the free enterprise system works. Our gross national product is 25 percent of the world's gross national product. The national debt is at an all-time high, but as a ratio to the gross national product, it is less than one-third what it was in 1983. We are just going through a 15-year technical, economic revolution, not a long-term decline. What we have is a short-term problem that we are capable of managing if we're willing to do a little less volume for a little longer.

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