NASBP White Paper

MITIGATING THE HIDDEN RISKS

In the "New Normal" Construction Environment

by Thomas C. Schleifer, Ph.D.

The construction industry, high risk to begin with, is operating in a new post-recession landscape, characterized by tighter margins and serious labor shortages with less room for error. The unprecedented market downturn has weakened some construction organizations to the extent that they may have difficulty financing the growth that comes with market recovery, which, in turn, increases the potential for business failures and contract defaults.

Now more than ever, owners, contractors and designers need to increase risk awareness and risk protection. They should be concerned about the fact that construction business failures are far worse during market recoveries than during market slowdowns. At the beginning of a downturn the balance sheet blossoms as old receivables continue to come in and less money goes out for job costs when less work is performed. The opposite occurs during growth, which eats cash, when spending for current work exceeds money coming in from the lesser amount of backlog. The sustained downturn has financially weakened some companies to the point that they will not be able to finance their increased workload. When this occurs, it is possible for contractors to "cash flow" themselves out of business.

There is risk in any commercial transaction, but the construction industry has more than its fair share. Much of the risk in the building process is poorly defined and often misunderstood, with considerable ambiguity as to who is responsible for it. Designers avoid it, owners prefer to pass it along and contractors absorb it. To contractors, *risk* is not a dirty word. After researching the causes of contractor failure for more than thirty years, I have uncovered a noteworthy truth:

The assumption of risk is part of every successful contractor's DNA.

Today's construction risk environment is dramatically different than it was even ten years ago, and the attendant risk factors are mutating just enough to be almost unrecognizable. The inherent construction risks of changes in project size, type, geographic area, key personnel and/or managerial maturity were documented in my first book, *Construction Contractors' Survival Guide* (John Wiley & Sons), 27 years ago and are recognized by most construction professionals. The risks evolved over time and were updated in my latest book, *Managing the Profitable Construction Business* (Wiley RSMeans, 2014). However, there are developments in this new environment that will appreciably increase the risk of project and contractor failure. The obvious risks are skilled labor shortage, growth in general and subcontractor risk:

- **Shortage of Skilled Labor Risk** – Following the construction market collapse, a huge number of workers left the industry. Now that the industry is starting to grow again, companies that are short on skilled labor are already straining to complete quality work on time and on budget.
- **Company Growth Risk** – Since the recession, the market has begun to grow again. At such a time, growth is always welcome and rarely seen as a major cause of impending failure. However, research reveals that, when a construction company expands in size, it requires careful management decisions to reduce the risks inherent in the

change. Growth itself impacts failure rate and the potential for financial distress.

- **Subcontractor Risk** – Subcontractors are a fundamental part of the construction process and are subject to these same market changes. Each subcontractor is critical to project success, so it only takes one to disrupt the entire process, thus intensifying project risk.

There are other current industry developments that impact business and project risks:

- **Capital Risk** – Secured equipment loans and unsecured working capital lines of credit, as well as surety credit for bid, payment, and performance bonds, are vital to the growing construction enterprises. The length of the market downturn has financially weakened some companies and impacted their credit worthiness. A construction company may show positive income on its financial statement, yet suddenly have a financial crisis due to a lack of cash and limited borrowing power. A considerable number of construction companies exit the business yearly because they run out of credit.
- **Commodity Risk** – Construction is a custom service and product that owners are beginning to think is a commodity, which causes them to believe that all construction companies perform alike. This in turn can cause owners to be less discriminating about contractor selection and to think price is all that separates them. This is one of the reasons profit margins are low compared with the historic norms of 10 and 20 years ago. When buyers of construction services believe a product is a commodity, they generally expect to pay less.
- **Contract Risk** – In this highly competitive new growth market, contract terms concerning the responsibility of each party to the agreement attempt to shift risk in varying, and sometimes unrecognizable, directions. At the same time, case law (court rulings concerning construction disputes) seem to further cloud the issue of which party is responsible for what.
- **Change Risk** – When an organization expands in size, it is, in effect, becoming a different organization. Change always has risks associated with it, which can make or break a company. For example, growth-related changes impact the amount of capital required, the time and attention management can spend on multiple projects, and the expertise required to complete new types of projects. Change can be threatening.

Advancements in field and office technology and developments in project funding methods introduce risk potential. Selecting and implementing new technology consumes management time, and, if the selected technology does not perform as expected, can be costly. Innovative project financing methods, combining private and public funding present risk simply because they are new and there is limited experience with them.

Dealing with all these changes, and with an industry that continues to evolve, demands considerable management attention and exposes the organization to increased and, sometimes, unrecognized risks.

RISK is not a dirty word
Designers avoid it
Owners prefer to pass it along
Contractors absorb it

- **Management Risk** – Management decisions will determine whether an organization will succeed or fail in this ever-changing construction business environment. The decision-making process begins with beliefs that must be regularly reexamined as the business environment evolves. Beliefs that were appropriate in the past may not be so in this new normal. Some unexamined beliefs in place for a long time are no longer valid, such as *growth is always good; having some unprofitable work is unavoidable; and past success implies future success.* These beliefs should be reevaluated because they are not true and cannot be embraced by the "Successful Contractor of the Future."

(This term defines contractors who will react quickly to evolving market conditions as distinguished from those who will continue with business-as-usual.)

Thirty years of accumulated study as a contractor, work-out specialist, consultant, and research professor have verified the following realities about risk in the construction industry:

- Construction is basically risk assumption.
- Risk-taking is embedded in a contractor's DNA.
- When a contractor signs a new contract, it's like the contractor's first day in business again.
- Every time a contractor starts a new project, the contractor voluntarily assumes risks that are not fully defined.

Construction is a highly complex endeavor that is worked out over a relatively long period-of-time, the success or failure of which is affected by weather conditions, labor problems, inflation, unexpected rises in interest rates, the high cost of equipment, a tightening or shrinking of the market, or simply bad luck. These factors, combined with the risks detailed above, make measuring project risk in advance enormously difficult and requires considerable knowledge about the construction enterprise and the current construction environment—a specialized field in itself. Management can test its beliefs by seeking information and perspective from internal and external accountants, attorneys and insurance and surety partners.

Risk and construction are synonymous. Risk cannot be eliminated, but it can be mitigated. However, risks cannot be mitigated until they are identified, measured and thoroughly understood. This is easier said than done because the various parties to the construction process see their respective roles in addressing risk differently. Many construction risks are attributed to more than one entity, making identification difficult, elimination impossible, and mitigation the only viable alternative. The challenge for owners, contractors, sureties, bankers and designers is to:

- Recognize and identify specific risks in advance
- Assess and quantify their importance and the exposure
- Mitigate and manage their impact and cost

To accomplish this requires specialized knowledge, industry intelligence and experience with large numbers of similar projects. It is also necessary to have access to hard-to-find, and sometimes very confidential, information. The primary source for this information is sureties, which have extensive experience and data from prequalifying firms in all types of construction in various locations.

Owners have the easiest mitigation route, as they can bond around their exposures, and have a knowledgeable surety do the critical pre-qualification process, screening out ill-equipped enterprises, and cover the costs if things do not work out.

MITIGATING RISK

The willingness to take risk is at the very core of the construction enterprise, and it is unlikely that risk will ever be eliminated from the building process. The ability to recognize the true nature of risk, assess its impact on an organization, and take steps to mitigate that impact will be a fundamental skillset of successful industry participants – owners, contractors, sureties, bankers and designers.

- Owners have the easiest mitigation route, as they can bond around their exposures, and have a knowledgeable surety do the critical pre-qualification process, screening out ill-equipped enterprises, and cover the costs if things do not work out.
- The contractor of the future needs to elevate risk management within its organization and embrace formal risk management processes, which, fortunately, are becoming the construction industry's newest discipline.
- Sureties have an important role to play in the construction process and bring a unique

perspective to contractor and subcontractor screening through the underwriting process, along with financial capability when there is a problem.

- Bankers can have the same protection as owners by requiring payment and performance bonds on the projects they finance.
- Designers will want to assist clients with the selection of contracting methods and project participants, while encouraging collaboration among all parties to the construction process.

HIDDEN RISK

- Diligence is required because construction business risks and project risks are often not apparent and may be disguised in many forms. For example, top-line growth may appear to be an avenue to success, but can also lead to failure.
- More tightly drawn contracts pushing any-and-all risk to others may appear to be needed protection, but can create more problems than they solve.
- An expanding market looks like an opportunity, but can also be a mine-field.

The contractor of the future needs to learn an entirely new skillset to recognize risks hidden in the market, hidden in their own management decisions, and hidden in the economic climate. Too often what looks like good news has the potential to be hazardous.

RATE OF GROWTH

Unfortunately, in the construction business, past success is not necessarily an indicator of future success. In fact, my research on the causes of construction business failures indicates that every change in a successful organization, particularly growth, creates a period of risk in spite of all previous success. When a construction organization substantially increases in size, it is no longer the same company it was before growth and often will not be successful if it maintains pre-growth management methods. A construction enterprise growing at what appears to be a modest rate of 15% per year is actually a significant rate if it is continuous because it compounds quickly. At 15% a company doubles in size in five years and triples in eight. The successful construction enterprise of the future will be organized to be market driven and not volume driven. It will strive for carefully planned growth but be prepared to level off or fall back on volume if the marketplace tightens or shrinks. It will use its markup flexibly as a competitive tool but not be forced to take break-even work to maintain sales. It would have some flexible overhead built into the organization that could be cut immediately when not needed, and the contractor would not hesitate to cut permanent overhead when downsizing is necessary. The successful contractor of the future will be willing to reduce in size to survive.

The construction industry has not demonstrated proficiency at recognizing, managing and mitigating hidden risks, which compounds problems and escalates the potential for business and project failures, making the third-party screening and financial protection of surety bonds more critical than ever.

TRADITIONAL RISK MANAGEMENT

Historically, risk management was considered by many to be an insurance issue; however, there are significant business risks that are not addressed by insurance. The hidden risks in market expansion such as skilled labor shortage, limited access to capital, and the ability of management to keep up with a rapidly changing business environment have rendered traditional insurance tools and risk management approaches inadequate. The successful contractor of the future will develop internal risk management policies, procedures, and protocols throughout the organization. Some will engage or employ risk professionals.

CONCLUSION

Construction is a complicated business that should only be attempted by owners, contractors and subcontractors with strong capabilities in risk recognition, risk management, and risk mitigation, because the nature of construction risks are changing every day, increasing the potential for business and project failures. The dramatic swing in the marketplace since 2008 has challenged construction firms to manage fluctuating sales. The boom may be back, but market conditions are very different in this growth cycle.

The skilled labor force was already being diminished when baby boomers began retiring at a rapid pace at the same time that workers, laid off during the recession, found other employment and left the industry, never to return. At a time when construction enterprises have been forced to downsize and had to spread their skilled labor force thin, they now need to hire new people who will be unfamiliar with their methods and systems and may have limited experience. Some firms will find that they have inadequate access to capital and that construction buyers have sharpened their contract negotiation skills, as construction continues to be viewed as a commodity and contractors are in turn relegated to low margins—the "new normal."

When the market changed from contraction to expansion, unexpected and unrecognized risks were introduced. In this environment, hanging on to old beliefs is a dangerous mindset. There are few choices when it comes to risk: assume it, manage it or transfer it. The construction industry has not demonstrated proficiency at recognizing, managing and mitigating hidden risks, which compounds problems and escalates the potential for business and project failures, making the third-party screening and financial protection of surety bonds more critical than ever. Owners will likely manage risk by increased bonding of prime contractors, while construction managers may seek protection by increased bonding of trade contractors.

The successful contractor of the future will establish formal risk assessment processes and protocols and will adopt a strategy of flexible overhead that can easily adjust to a cyclical construction market that invariably presents new risks.

The successful owner of the future may choose to transfer risk by relying more heavily on sureties to pre-qualify contractors and provide financial protection against defaults.

ABOUT THE AUTHOR

Thomas C. Schleifer, Ph.D.

Tom Schleifer joined the construction industry at age 16 and brings more than 45 years of contracting and consulting experience to his presentation. He has Bachelor of Science and Masters of Science degrees in construction management from East Carolina University, and a Ph.D., also in construction management, from Heriot-Watt University, Edinburgh, Scotland. Dr. Schleifer's experience includes serving as foreman, field superintendent, project manager, and vice president of a construction company which he owned with his brother. From 1976 to 1986 he was the Founder and President of the largest international consultancy firm serving the contract surety industry. During this period, he assisted in the resolution or salvage of hundreds of distressed or failed construction firms and projects.

This combination of practical, hands-on experience as a contractor and assisting financially distressed companies has given Dr. Schleifer a unique perspective on the causes of business failure and how to avoid them. He wrote the book Construction Contractors' Survival Guide which has been acclaimed by thousands of contractors and used as a text in numerous university graduate and undergraduate courses and for many years published Schleifer's Construction Forecast newsletter. Dr. Schleifer, sometimes referred to as a "turn around" expert because of the number of companies that he has rescued from financial distress, advises contractors on organization, structure, and strategic planning while he also writes, lectures, and teaches.

The importance of education in the construction industry is one of Tom Schleifer's favorite themes. He is a former chairman of the continuing education committee of the Associated General Contractors of America and has lectured extensively at universities, professional and trade associations, and authored numerous articles and publications on construction and business management. Dr. Schleifer has been listed in "Who's Who in Finance and Industry," "Who's Who in America" and "Who's Who in the World." He was the first Eminent Scholar of the Del E. Webb School of Construction, Arizona State University in 1993 and currently serves part time as Visiting Eminent Scholar. Books by Dr. Schleifer include: *Managing the Profitable Construction Business, Construction Contractors' Survival Guide*, both published by John Wiley and Sons; *Glossary of Suretyship and Related Terms*, CMA Press; Schleifer's Construction Profit Series, video and audio tapes; Schleifer's Construction.

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