More Room For Gloom

At the beginning of the year, I wrote that while no one liked the recession, some contractors and sureties were going to hate the recovery, too. A new set of risks will arise as contractors price their work aggressively, I wrote, and profit margins lag and some companies take on too much and burn through their capital.

That's pretty gloomy, but I didn't give the complete picture about what can go wrong during the unfolding recovery. Because contractors will price their work aggressively and will be hungry for the cash needed for growth, financing will be essential.

Unfortunately, the response from banks and sureties will be uncertain, labor will be in short supply and labor skill will diminish. Material shortages, too, have already begun and labor and material cost inflation will increase.

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One problem is that for even a financially healthy company, contractors will need more bank financing to pay for the work in progress and bond credit demands will rise immediately. In this economy many companies' credit lines are already stretched and assets already pledged. In addition, most banks are not particularly enamored with the construction industry and it may take some time for them to become interested in returning to contractor lending. Banks' response to requests for more lending is uncertain at best.

Sureties also will be a problem. Similar to banks, sureties rely on the financial strength of an enterprise to extend or increase bond credit. The bond underwriters, which are profit-minded insurance companies, are confronted with an industry that has been weakened by almost four years of slumping sales at a time when construction owners are increasingly looking to protect their investments by expanding bonding requirements.

There's another concern. The skill level of the construction work force has been a common complaint among industry observers since I can remember. If a large percentage will be new entrants during the recovery, the skill level is unlikely to improve. The construction work force, at all levels, is down. Some will return as they are needed, but some have moved on to other occupations, retired or departed for lack of work.

Playing Catch-Up

Even skilled workers who return to the industry after years of doing something else will have a lot of catching up to do with new technology. Diminishing skills at all levels makes it that much harder to profit from work captured at extremely low margins--and in some cases unrealistic pricing.

Materials pose another challenge. In a market rebound, capacity needed to produce materials does not immediately reappear. It takes time to bring production back on line and its costs money to do it. Manufacturers and suppliers are not likely to respond to shortages until there is a sure and certain recovery creating a sustainable demand for their products.

The availability of labor and materials respond rapidly to the realities of "supply and demand." If there is a shortage of an item, even for a limited time, the price of that item goes up almost instantly. In the current circumstance, the beginning of material shortages is already pushing prices up and the sure-to-follow labor shortages will do the same. Manufactures have little incentive to resist price increases and the common reaction to a labor shortage is to overpay for in order to attract or keep them.

I wish I could say that "some" of these issues will impact "some" projects. However, the reality is that all of these issues have either occurred or will occur and will, without question, impact all projects. With these factors affecting work captured with already thin margins, profits will suffer and the escalating potential for loss could be disastrous—particularly in an industry where inflation clauses are difficult to get.

The effects of these issues on an industry attempting to come out of a terribly challenging market may seem unfair, but they are definitely predictable. Construction is the second riskiest industry in the country, second only to the restaurant business, and the risks are magnified during a market recovery, particularly after a long downturn.

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