

14th Weekly Crisis-era Message to Contractors from: Dr Tom Schleifer  
**Construction Market Downturn's Impact on Profitability**

Most industries prosper during growth and many also profit when sales decline. Logic would suggest that if a business makes \$X profit while operating at full capacity it would make 80% or 90% of \$X profit when operating at 80% or 90% of capacity which is exactly what happens in most industries. The construction industry is a unique exception in that its profitability is connected to and dependent on growth. When sales decline in construction, profits suffer almost immediately. Contrast this with most other industries. Manufacturing is a good example.

If a manufacturer's market drops off 10% and production is reduced by the same amount, total profit diminishes by 10% but profit as a percent of sales remains roughly the same. In some cases the profit percentage increases during a production decline because efficiencies improve with a more manageable manufacturing pace. When these companies produce 90% of product capacity they enjoy 90% of the profit they had been earning. Fixed costs continue but are usually budgeted to average annual production needs which takes into account periodic or seasonal fluctuations in sales. These types of industries profit at variable outputs and their profit as a percent of sales is a constant. Production rates are not tied to fluctuations in sales because manufacturers warehouse excess production during a sales decline which is then available for peak sales periods. Profit is, for all practical purposes, a constant and production rates do not need to be adjusted to market conditions.

Compare this with the construction industry starting with the reality that net profit margins for general contractors and construction managers at plus or minus 2% are considerably less than manufacturing profits. Fixed overhead costs for these contractors at an average of 4% to 6% or twice to three times their average profits leaves little room for error. Trade contractors have a little higher profit margin and overhead costs, but the ratios are similar. In a construction firm if any job underperforms, the other projects have to contribute to overhead and possibly other costs on that project reducing companywide profitability. In a downturn, when there is a reduction in sales fewer projects contribute to annual fixed overhead costs which immediately and often substantially reduces companywide profits. Construction industry overhead costs are commonly referred to as a percent of sales, but they are for most firms a permanent fixed cost with a minimum, if any, ability to be reduced on short notice.

In construction, when there is less work available, competition increases overnight reducing the selling price because the same number of contractors are trying to maintain sales with less work available. For this reason, every construction enterprise becomes vulnerable in a market downturn. The cause is threefold: With overhead a fixed cost made up of plus or minus 90% highly trained and highly valued employees, it is difficult to cut on short notice. It is close to impossible to increase profitability in the production of work on hand. And you can't add additional profits to the pricing of new work when everyone else is lowering their prices trying to capture the fewer available projects. If a market declines, margins move quickly in the wrong direction.

If this circumstance were to be subjected to a "logic test" by persons totally unfamiliar with the construction industry they might ask:

- if the overall construction market at, for example, \$1 trillion was profitable before a downturn
- if some years prior to that it was profitable at \$900 billion
- if years prior to that it was profitable at \$800 billion
- Why, when the trillion-dollar construction market retreats to \$900 or \$800 billion where it had been profitable in years past, is it not profitable again?

The answer is *aggressive competition*. The construction process is unique in that competition is a primary driver of the selling price of construction services. Competition is dramatically affected by the amount of work available which is what drives the selling price of construction. Profitability is dependent on the amount of work available. In a growth market there is work available to satisfy contractor's appetites for the volume of work they want. When that occurs the quantity of work a firm can go after is restricted only by their available resources of labor, equipment, etc. In a strong growth market when the "want and need" for work is satisfied, competition loosens up and the number of contractors pursuing each project drops precipitously. With a lesser number of bidders, who do not really need the additional work, it becomes a seller's market and prices inflate significantly. Construction profits accelerate.

In a declining market the reverse occurs. The number of bidders goes up, the need of each bidder for the work increases which amplifies competition and very rapidly drives down the selling price of construction as it shifts to a buyer's market. In theory, if the construction market declined 10% and every contractor was satisfied with 10% less work conducting themselves accordingly, the percent of profit would remain unchanged allowing each to enjoy 90% of the profit they were earning prior to the downturn. Competition would be balanced easing pressure on pricing. However, what has occurred in the past has been a reluctance to downsize generating aggressive competition as each firm attempts to maintain sales in a shrinking market. This (to use an old fashion term) causes a "price war" that no one wins and the selling price of construction plummets.

History will repeat itself if this happens during the current downturn, and there is little reason to think it will not. The US economy is cyclical so about every 10 years the construction market will cycle down. If this pattern of losses and business failures is to be avoided in the future, the construction industry will need to embrace the concept and process of *Flexible Overhead*.

*Next week: Construction market update and defenses recommendations.*

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*Note: Information on overhead management can be found on [letstalkbusiness.net](http://letstalkbusiness.net) click on "Manual" and go to Managing Overhead in the table of contents.*