15th Weekly Crisis-era Message to Contractors from: Dr Tom Schleifer

**Market Brief - Recommended Defenses**

**Market Brief:** The construction market is unchanged in that recovery continues to be pushed out farther with each new event as the expected pandemic reactions begin a domino effect impacting other areas of the economy. (This is a change for those expecting a short V-shaped recovery.) Initially the depth of a construction market downturn is of less concern than the length because a modest loss incurred during a short-term recovery is worth the cost of remaining fully staffed in order to take immediate advantage of a rapid rebound. It is difficult to project when this construction market might get anywhere near pre-crisis levels but certainly not this year and possibly much longer. Stimulus funding and increased federal spending on infrastructure will help but not enough for a full recovery. The only thing that will turn this tide is a successful vaccine becoming available. Absent a vaccine, an effective cure for Covid-19 would help.

**Construction Firm Defenses:** I wish the three years of research on how to profit during a construction market downturn had discovered a litany of defenses to choose from. It did not. What it did do was to isolate and define the one viable defense/solution that works. The research substantiated that if the pre-downturn cost of doing business (overhead) is X dollars, to generate a profit producing less than pre-downturn sales required that the overhead costs must be equivalently less than X dollars. How much less is not a mystery. If sales drop 10% or 20%, overhead must drop proportionally 10% or 20%. If not, when fewer projects are contributing to overhead, profits have to help fund the overhead reducing overall profit which, depending on the depth and length of the downturn, can lead to losses or worse.

Each project performs differently but most rely on average profit percentage to calculate markup on future projects. We do the same with overhead expenses spreading the estimated cost over future projects by applying it as a percent of sales. The difference is that overhead is an actual cost, and profit, being what is left over after all incurred costs are accounted for, is a variable. A modest reduction in profit has limited impact but in the extreme there is an absolute limit when actual costs on a given project exceed what we are paid. Any project loss including missing contributions to overhead must be made up for from the other projects. In a declining market with fewer projects the short-fall must then be paid from the remaining projects reducing company-wide profitability.

In the early months of a market downturn the work on hand continues to be profitable because it was priced and captured during pre-downturn competitive conditions presumably with reasonable markups for the anticipated overhead contributions and profit. The research in question discovered that for the average construction enterprise there was almost no noticeable financial impact for the first one to three months of a downturn as the backlog of work diminished slowly. This can lead to a false sense of security until the shrinking market increases competitive pressure causing sales to fall off and profits to diminish while overhead costs remain. Because profit percentage is considerably less than the needed overhead contribution, noticeable reduction in profits typically occur within the first six months of a decline in sales. With fewer projects contributing, profit is quickly consumed by continuing overhead costs unless overhead expenses were reduced early on, which very few firms did in prior recessions preferring to wait and see what would happen.

In some cases, sales were attempted to be maintained by sacrificing markup in an effort to overcome competitive pressure and capture more work. This defense made matters worse because the greater amount of work had to be performed precluding timely reductions in overhead. Work taken with little or no profit margin should have been expected to break even at best. Most who took this route incurred critical reductions in liquidity, in many cases dangerous losses, and in some cases business failure.

In the eight major downturns since WWII aggressive competition drove down profit margins as expected for the duration of the market decline. However, the research uncovered an unexpected circumstance in that aggressive competition continued to hold down margins during the market recovery. When the declines in sales bottomed out and began to recover, the aggressive competition fueled by a determination to resist downsizing was succeeded by a determination to make up lost ground and return to prior sales volumes. This restrained margins until the markets got close to or achieved pre-downturn size. This research breakthrough helped to explain why market downturns in the construction industry are so destructive.

Margins in many industries begin to recover as their market recovers, and they continue to rebound as their market strengthens. For example, when retail sales decline their margins suffer but as sales rebound margins rebound. Margins in the construction industry do not recover until close to or achieved pre-downturn market size is achieved. This increases the length of time firms endure reduced income by double or more. In other words, in a construction downturn margins suffer during both the market decline and recovery which means we need to redefine "margin recovery" and separate it from "market recovery". A recovering construction market begins after the decline bottoms out and continues until the market returns to pre-downturn size. "Margin recovery" begins when the market approaches or achieves pre-downturn size. Understanding the huge difference between market and margin recovery is critical in planning for and operating a construction business during a market downturn. This information is crucial in that the construction market is cyclical at roughly ten-year intervals.

This reality is why I so strongly recommend reducing overhead as soon as it is recognized that a market decline will last six months or more. What needs to be understood is that anticipating a six-month market decline means that you can anticipate plus or minus twelve months of aggressive competition reducing margins and increasing risk. If one or two months or more into a market decline you realize it will likely last six months or longer, it is time for some serious defensive action. While you may be able to afford to maintain overhead until or beyond the six-month benchmark, the question is, should you? It is generous to employ people for the extra months, but the cost to a firm entering twelve months or more of reduced income or worse magnifies the firm's risk. It also impacts the remaining employees and affects the prime responsibility of top management which is to protect the company. Many firms have maintained full employment during market downturns for six months or longer, often taking cheap work to keep busy. In doing so they were eventually forced to lay off more people than would have been necessary after running their equity and working capital into the ground. They also minimized their financial capability to fund their expansion when the market did recover.

While emotions are certainly affected, this is a business decision. Caring for all of our employees is a loyalty exceeded by our responsibility to protect the company to the benefit of the remaining, re-employed, and future employees.

*Next week: Preparing for the next clycle.*

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