16th Weekly Crisis-era Message to Contractors from: Dr Tom Schleifer

Preparing for the Next Construction Market Cycle

It is almost impossible to run a business when the world economies are crashing around us for reasons so unique that there is no precedence. Our country and our industry have gone through 16 weeks of extraordinary uncertainty about the economy and about what might happen next. The suddenness of the crisis, stay-at-home orders, project interruptions, postponements, and cancellations seemingly at random created such confusion that how or when to react was inexplicable. With new and sometimes conflicting information daily from Washington and the media the only choice for many seemed to be to wait and see what develops.

This far along, with no end in sight, and the strong possibility that new work to fill backlogs will drop off before things get better; most construction professionals can see that a market downturn is inevitable. How deep and how long may still be uncertain, but I think we can agree that it has already been long enough that we need to make some decisions—we need to do something. Those that have been through a downturn before know that one of the first things that happens is aggressive competition sets in as firms resist downsizing and with just about everyone trying to capture more work in a declining market, profits suffer.

There are only two choices in a downturn. Fighting to capture enough work to maintain sales by any means possible is by far the most popular choice but presents the most risk. The less popular choice of downsizing the business to cooperate with (rather than fight) a declining market has far less risk but is more painful. Downsizing means reducing the cost of doing business (cutting overhead) which includes laying off people because, as we all know, overhead expenses for a construction enterprise are made up of plus or minus 90% employee related costs. Voluntarily cutting back the size of a firm is difficult, even distressing, which is why it is such an unpopular choice.

The most popular choice, chasing work while profits are spiraling down exposes an organization to serious risks. The difference is that in a growth market there are more profits from the other projects to help cover the lose from the occasional bad job. In a declining market diminished profits may not be enough to cover a losing project and a losing project is an increased possibility because of the aggressive pricing trying to capture the much-needed work. Even during a growing market construction is a low-profit business with the ever-present possibility of a losing project in both good and bad markets. This exposure is compounded when, motivated by the need for work, a firm decides to go after work in unfamiliar territory and/or work of a slightly different type or size than the organization is experienced with which increases project risk exponentially. There is no statistical data to calculate the likelihood of a losing project during a declining market. However, the construction industry has the second highest business failure rate in the country and the fact that the failure rate always increases significantly during downturns suggests a correlation.

Research confirms that one of the reasons the failure rate goes up in a declining market is that if a construction enterprise waits too long before reducing overhead they weaken their financial condition which makes them vulnerable if the downturn drags on and hinders their financial ability to fully participate when the market rebounds. Many have said, *"If I am forced to reduce overhead at some point(s) during a downturn I might as well have cut it sooner"*. It is disappointing to have spent a lot of money holding onto people only to have to let them go anyway. Many have tried to keep people busy by traveling far and wide taking work outside the organization's experience and core-capabilities but that often magnified underperformance and in too many cases resulted in losses. During many years of turn-around work I often heard *"What choice did I have?"* or *"I had to keep my people busy."*, or *"No one can make money during a downturn"*. For those determined to maintain sales or to reduce sales as little as possible in a declining market these statements are true, and I fully understand and admire the determination to retain your employees.

It is human nature to resist giving up hard-earned growth gained at great effort. The problem is the risk and cost, and it does not pass the logic test. Consider the following: If you asked a contractor why don't you increase your sales by say 10% or 20% during a favorable market most would explain that *"You can only grow as fast as the market grows. If the market is not expanding at 10% or 20% that amount of growth would be extremely difficult and to attempt it I would have to drop my prices, find additional resources, and have to secure them and pay for them"*. With this in mind it should also follow that in an unfavorable market severe adjustments in pricing will be forced into the marketplace and idled excess people and resources will need to be paid for or discontinued. Everyone seems to agree that growth requires an increase in overhead, but they do not seem to agree that the reciprocal is true. The reciprocal is that negative growth (a reduction in sales) requires a reduction in overhead.

A review of prior messages will demonstrate that the research information, data, and facts keep coming back to the same conclusions and formulas:

- A growing construction market reduces competition
- A declining market increases competition
- A growing market fosters increases in profits
- Declining market always causes decreases in profits
- In a growing market human and other resources become scarce
- In a declining market underutilized human and other resources have a continuing cost
- A consistent growing market becomes a *"sellers' market"* and the selling price of construction goes up
- A declining market quickly becomes a *"buyers' market"* and the selling price of construction goes down
- The US economy has been cyclical for as long as anyone can remember
- The US construction market follows and lags the economy
- The construction market has been cyclical since at least WW II
- The construction market will continue to be cyclical.

These truths combined with the fact that the construction industry has the second highest failure rate in the country demonstrate that the current construction business model of permanent fixed overhead is inappropriate and illogical. It does not, cannot, and will not support consistent profitability in a cyclical market. There is a solution, *Flexible Overhead*. Developed in 2014 this progressive concept will be described next week.

Next week: The concept and processes of Flexible Overhead.

To assure you will continue to receive the free weekly Crisis Message to Contractors, send your email address to tom@schleifer.com. - or questions/comments.

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