From Fearless to Feeless: The Changing Value Proposition in the Construction Supply Chain

By Jay Bowman

Why some construction managers may decide to forgo fees in the traditional sense to disrupt competition.

Numerous industry evolutions—both the kind that take time to develop and those that emerge rapidly—are creating distinct competitive necessities and advantages for engineering and construction (E&C) firms. These developments could exclude certain contractors from their traditional pursuits, namely due to shifts in organizations' capital investment strategies, procurement practices and preferred project delivery approaches. For example, the influx of megaprojects (i.e., projects valued at $1 billion or more) has reduced market opportunities for contractors that are unable to compete due to size limitations, bonding capacity and/or a lack of demonstrated experience.

In this article, we'll explore key pricing trends in the E&C industry, show how more construction management firms are relying on non-fee revenues, and illustrate how these strategies can help companies shore up their bottom lines and plan for future growth and success.

The Big Fee Squeeze

Megaprojects may be a top-of-mind issue for E&C firms right now, but price is another area that can severely limit contractors' ability to secure contracts. Although not representative of all U.S. construction markets and segments, many project owners have become exceptionally aggressive at driving down the construction manager's fees in recent years. This has forced construction managers to become more creative with revenue and profit generation, relying on more non-fee sources than usual.

Meanwhile, there's been significant and accelerated industry disruption that's blurred the distinctions between services and providers and ultimately resulted in value migration. This outsized imbalance between project owner pressure on fees and the limited revenue and profit contribution fees provide could push construction managers to forgo fees in the traditional sense altogether. In turn, these construction managers may introduce new non-fee sources of revenue and profit—a move that can improve financial engineering capabilities and help firms remain competitive (and viable). Moreover,

we may be witnessing the elimination of fees altogether in certain corners of the industry within the next 10 to 15 years.

Historically, construction management fees have ranged from 3% to 5% of construction costs. Since 2008, however, pressure on construction management fees has become increasingly acute in several markets and segments. For example, it's not uncommon for construction managers to accept fees much lower than this "traditional" range, often at 1.5% or less.

A 2014 study by the Construction Management Association of America (CMAA), for instance, highlighted examples of construction management/program management (CM/PM) fees of almost 0.5%. At these levels, fees represent a mere 10% to 30% of a typical target of 5% gross project profit margin. Moreover, assuming most construction managers operate on a 3% project overhead structure, fees at 1.5% or less alone suggest a losing proposition (without other means of generating revenue and profits to cover a firm's fixed costs).

Fees have contracted significantly over the past several years in numerous markets and segments—a trend that's forcing construction managers to use alternative revenue and profit contribution strategies to compensate for this loss. To offset the lower fees, construction managers are looking to add value in new areas of the construction supply chain—a (paradigm) shift to non-fee sources.

Today, it's estimated that more than half of a typical construction manager's revenue and profit comes from non-fee sources. Some of the key drivers of this trend include clients' tighter budgets and fewer staff members as well as advancing technologies that require expertise beyond what most owners can support.

Based on several years of industry research and client work, FMI's research team has identified the following four key areas in which innovative and progressive construction managers are adding value to remain competitive.

Four Ways to Add Value to Clients Across the Supply Chain

1. **Exploring upstream opportunities.** The convergence of design and construction practices and other services (e.g., master planning, program management, asset management, etc.) has disrupted the industry and is resulting in value migration (away from construction in the traditional sense). This is not unique only to construction. Engineering is experiencing the same pattern of commoditization. Consequently, value is increasingly captured at the front end of projects, even before the design phase. This makes planning and design/preconstruction services increasingly important for construction managers to offer as part of their core services.

   At a recent Builders Roundtable, Andy Morgan, vice president at Vanir Construction Management of Sacramento, stated, "Construction management firms are evolving to offer more services. In California, for example, planning projects and interfacing with the state regulatory process to secure funding and approvals have become more complex with each funding cycle. Construction managers provide those services."[1]

2. **Capturing value beyond construction.** With the traditional function of design and engineering morphing into systems design and simulation, value migration is extending beyond construction. This includes business areas such as asset man-

[1] "Builders Roundtable: The Value of Construction Managers." Correctional News. 07/06/2016.

agement, facility management, marketing and leasing, capital expenditure forecasting, building commissioning, etc. Buildings, infrastructure and other components of the built environment are already being modeled and simulated using the vast computational power of the "cloud," which allows project stakeholders to analyze various performance issues and building characteristics.

Put simply, value no longer resides solely (or primarily) in traditional construction or construction management. Because this varies significantly by project owner type, market and segment, construction managers must understand their clients' needs, value perceptions and likely procurement practices and preferences. In the future, no construction manager's business strategy will be complete without this deeper system-thinking approach.

3. **Leveraging technology to integrate and streamline.** In addition to value migration as a disruptor to traditional construction management fee structures, technology will likely have a significant impact, further commoditizing the "construction only" aspect. Companies are developing software programs that integrate planning, estimating, cost management and project controls. These programs provide an integrated, one-stop solution—something project owners have desired for decades. As such, technology consulting is becoming as important a service offering as preconstruction for some project owners.

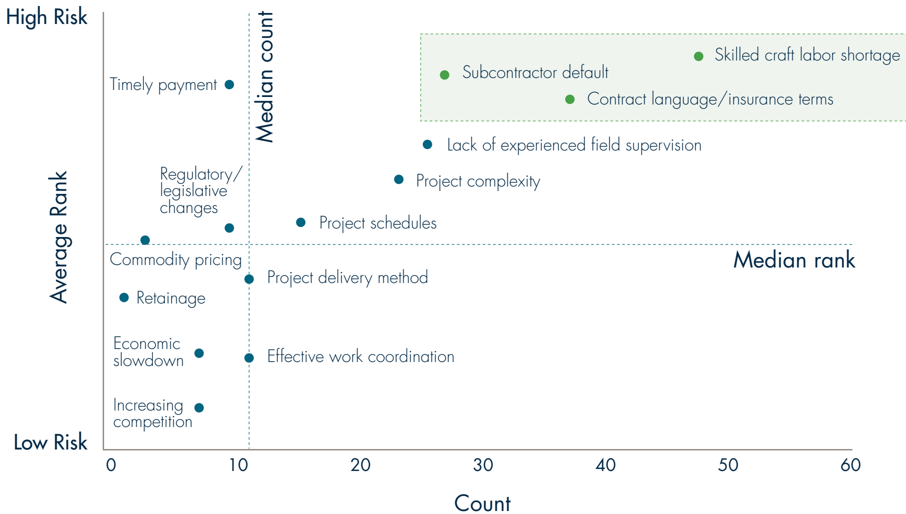
   Similar advances are occurring in the realm of Building Information Modeling (BIM), where project owners have long been frustrated by the multitude of models employed and the lack of integration. The solutions now being introduced could reduce construction bidding to simple unit pricing—a big shift from traditional estimating and bidding practices. As this new ability is introduced, construction managers must either find other, higher-value services to offer or distinguish their ability to deliver projects more efficiently and cost-effectively than the competition. Otherwise, all contract award decisions will be based solely on price.

4. **Understanding risk transfer.** Fees have contracted significantly over the past several years in numerous markets and segments—a trend that's forcing construction managers to use multiple other revenue and profit contribution strategies to compensate for this loss. To offset the lower fees, construction managers are using general conditions reimbursements, insurance and risk management (e.g., Contractor Controlled Insurance Program—CCIP, SubguardTM), project buyouts and performance bonuses.

   Understanding risk and how it's transferred are key areas that construction managers can use to differentiate themselves. According to a recent industry risk study conducted by AGC and FMI, owners are putting more pressure on project costs and schedules while modifying contract terms to place greater risk on all contractor levels (CMs, GCs and specialty trade contractors) – see Exhibit 1. As a result, contractors must identify and assess risk more carefully and understand how that risk is allocated among all project stakeholders. In short, the risk environment is becoming increasingly complex, thus enhancing the importance of risk management programs for today's construction firms. Our study findings also indicate that many contractors lack solid methods for understanding the appropriate risk transfer and processes to effectively manage risk.

EXHIBIT 1

Top risks today include skilled labor shortage, contract language/insurance terms and subcontractor default



Source: 2016 AGC/FMI Risk Survey

Strategic Move or Competitive Response?

Is the reduction in fees simply a competitive response (i.e., construction managers are influencing this trend), or does it reflect the project owner's perceived value of construction management? While the former will hold true in many situations as a competitive reality, there is evidence that suggests the latter will have increasing influence on the construction manager's ability to increase fees. Regardless of what's pushing E&C firms to rethink their fee structures, the reality is that both competition and owners' perceived value are impacting traditional industry pricing structures.

For example, consider the fact that larger construction managers are more likely to pursue non-fee or low-fee competitive strategies since they have the necessary capital to sustain this kind of pricing strategy. They may choose this approach to displace smaller construction managers or to prevent them from competing successfully. They may also pursue this type of pricing strategy because they can achieve higher profit margins on non-fee revenue and profit sources.

Also, scale does provide an advantage. Larger construction managers can leverage insurance and risk management as revenue and profit contributions as well as general conditions. For example, larger construction managers can typically get more people staffed on a project and secure higher variables on these people's rates. Moreover, these people may be double- or triple-staffed. Last, maximizing the contribution of non-fee sources may be more profitable than trying to compete on fees.

Regardless what the future holds for contractor fees, whether they remain where they currently are or return to historic norms, project owner expectations have changed. The expanding services that construction managers must often provide to differentiate themselves and achieve competitive advantage are not cheap. Moreover, the level of risk that is increasingly being transferred to contractors (across all levels) must be compensated for in some way or another. Therefore, construction managers should always explore and pursue non-fee opportunities. The question company leaders should ask is, "If fees do not increase, will the company be able to achieve its financial targets in

the long run?" If the answer is no, then taking a hard look at your non-fee opportunities should be one of your first steps.

Point of Differentiation

The concept of a fee-less construction manager is not novel. Following the Great Recession, many construction managers were not only fee-less but also had negative fees. The decision to have zero or negative fees was born out of necessity and pure survival. Those construction managers would then rely on non-fee revenue and profit sources to either break even or achieve limited margins. Construction managers may decide to go fee-less in the future, regardless of current economic and market conditions. What may differentiate these construction managers from others could also extend to the breadth of services offered and project roles assumed.

Construction management has always been, and always will be, a high-risk business, particularly today where risk is increasing exponentially along with changing industry dynamics and introductions of new technologies. The delivery of services and compensation for those services will also evolve. What will not change is the construction manager's responsibility to understand clients' needs and perceptions of value and then to maximize opportunities in a quest to find the meeting point between the two. Therefore, construction managers should contemplate where their perceived value lies in the service chain and whether they've truly maximized their own company's non-fee revenue and profit sources.

Jay Bowman is a principal with FMI. Jay assists a broad range of stakeholders in the construction industry, from program managers and general contractors to specialty trades and materials producers, with the identification and assessment of the risks influencing the strategic and tactical decisions they face. He can be reached at *jbowman@fminet.com*.

About FMI

For over 60 years, FMI has been the leading **management consulting and investment banking**† firm dedicated exclusively to **engineering and construction, infrastructure and the built environment**.

FMI serves all sectors of the industry as a trusted advisor. More than six decades of context, connections, and insights lead to transformational outcomes for our clients and the industry.

Sector Expertise

- A/E and Environmental
- General Contractors/CM
- Heavy Civil
- Industrial
- Specialty Trades
- Utility T&D
- Clean Tech and Energy Services
- Construction Materials
- Building Products
- Oil and Gas
- Private Equity
- Owners

Denver
210 University Boulevard
Suite 800
Denver, CO 80206
303.377.4740

Houston
9303 New Trails Drive
Suite 350
The Woodlands, TX 77381
713.936.5400

Phoenix
7639 East Pinnacle Peak Road
Suite 100
Scottsdale, AZ 85255
602.381.8108

Raleigh (headquarters)
5171 Glenwood Avenue
Suite 200
Raleigh, NC 27612
919.787.8400

Tampa
308 South Boulevard
Tampa, FL 33606
813.636.1364

† Investment banking services provided by FMI Capital Advisors, Inc., a registered broker-dealer and wholly owned subsidiary of FMI.

Industry Focus. Powerful Results.™

www.fminet.com

Copyright © 2016 FMI Corporation

Notice of Rights: No part of this publication may be reproduced or transmitted in any form, or by any means, without permission from the publisher.