How to Focus on Performance in Any Market Conditions

By Tyler Paré and Ryan Howsam

Position your business for long-term success by fine-tuning your company's operations, risk management, people and rewards practices.

"Only when the tide goes out do you discover who has been swimming naked," remarked Warren Buffett, reflecting on the financial institutions that had the largest exposures to the housing market through the financial crisis of 2007-08. Buffett was pointing out that although many Wall Street firms appeared to be financially strong on the surface, they lacked internal discipline and operational control.

Contractors today are happily swimming in a sea of opportunity. On the surface, success looks quite uniform—new hires, new offices, bigger jobs, higher revenues and higher margins. But what's really happening *below the surface*? If and when the tide goes out, as Buffett states, will some contractors be standing more proudly than others?

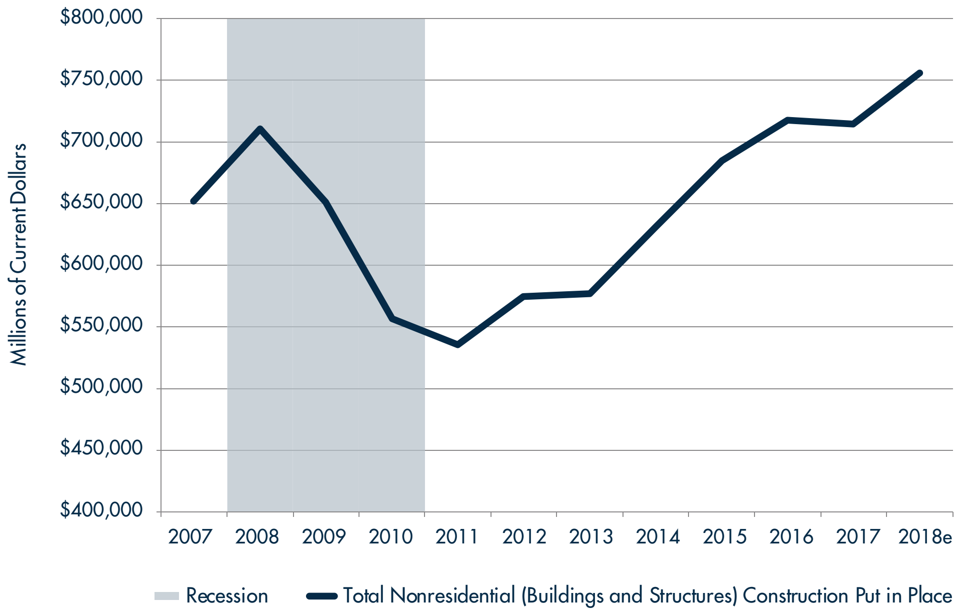
This is not a foreboding prediction of the next recession, rather a challenge to our readership to take a shrewd, introspective account of the efficacy of their business practices today. Ask yourself:

- Are your current results symptomatic of operational excellence or just a good market?
- As your business has grown, have you added the right infrastructure and people required to run a larger operation?
- Have your margins grown as a result of operational innovation, or are they simply rising with the flood tide?

Rising to the Top

Since "the bottom" of 2011, nonresidential construction put in place for U.S. markets has grown at 5% CAGR (see Exhibit 1). Growing construction spend across industry sectors has provided contractors a path to robust revenue and profit margin growth.

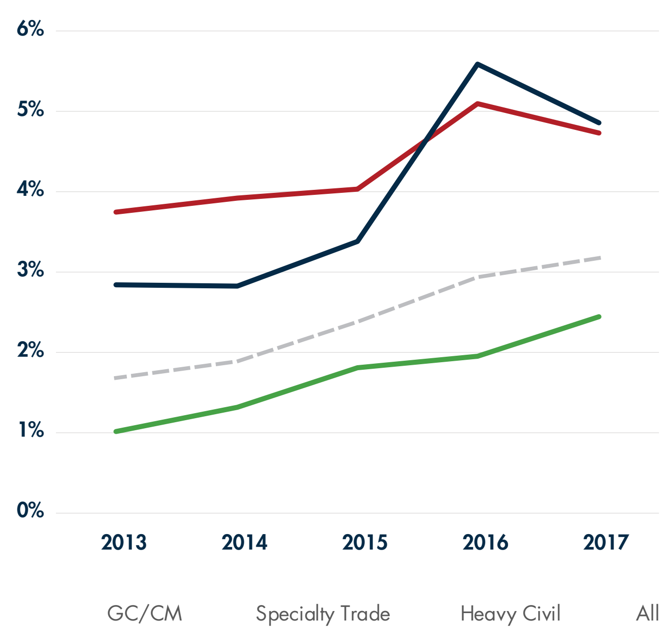
Exhibit 1. Nonresidential Construction Put in Place



Source: FMI Overview

During this broad expansionary cycle for U.S. engineering and construction (E&C) markets, operating profit margins of nonresidential construction firms analyzed by FMI grew at 17.3% CAGR (24.7% for general contractors, 5.9% for specialty trade contractors and 15.3% for heavy/civil contractors) between 2013 and 2017.[1] In aggregate, operating profit margins have nearly doubled over the last four years. And as contractors close the books on 2018, many anticipate last year's numbers to be even stronger than in 2017 (Exhibit 2).

Exhibit 2. Operating Profit Margin (EBIT/Revenue)



Source: FMI Corporation

[1] The average sample size used was 200.

Profitable growth certainly provides a lot of advantages to contractors, including:

- Increased profits can be plowed back into the company to invest in people, technologies, equipment and more. Done right, these investments can yield improved competitive positioning long-term.
- Growth also provides opportunity. An expanding work program helps contractors promote, challenge and empower their employees to manage broader purviews of project and organizational risk.
- Perhaps most noticeably, growth is good for morale. People like working at a company that continuously wins work, and they take comfort in the notion of a growing backlog, which means they will have projects to manage for the foreseeable future (i.e., job security).

Growth Risks

Growth can also present significant challenges and risks for construction companies, and progressive firms in today's market are not resting on their laurels. Below, we highlight four areas (operations, risk management, people and rewards) that should be at the forefront of every E&C leader's agenda, even (and especially) when times are good:

1. Operations

Project Performance. Broad-based margin expansion can mask many operational flaws. Margin fade from 5% to 4% is much more palatable than margin fade from 1% to 0%, but any reduction should be cause for concern. Even if a project has an acceptable profit, did the project perform as estimated? Were there opportunities to potentially improve gross margin?

Project Controls. To understand true project performance, contractors need extreme clarity and transparency on project controls, including schedule, budget, labor productivity, equipment utilization, etc. Project controls must also be repeatable and scalable, particularly as contractors grow and onboard new talent. The controls themselves are easy enough to develop, but creating management buy-in and establishing a culture of accountability can elude contractors. Are your people consistently executing for steady results?

Labor. The national craft labor shortage has made it difficult for contractors to maintain historical production expectations. To execute work profitably in this "new normal," construction firms must intentionally optimize communication and collaboration in their planning efforts, ensuring that even the newest crew member understands budget expectations and quantifiable production goals. Labor management is the top driver of project success or failure for self-performing contractors. As your work program and craft labor workforce grows, is your labor productivity management getting stronger or weaker?

Equipment. This can be a multi-seven-figure cost center in an equipment-intensive construction business. Unfortunately, many equipment departments do not receive the same level of cost scrutiny and management attention as multimillion-dollar projects do. Tracking equipment hours and understanding utilization are critical for optimizing fleet performance and yielding a return on capital-intensive assets. For the millions of dollars you've invested in equipment, are you realizing an acceptable return?

If your performance in today's market is good, but not great, challenge your operational executives to fine-tune their team's approach to project controls, labor and equipment management.

2. Risk Management

More contractors go bankrupt in a boom cycle than in a downturn, primarily due to overaggressive growth and poor cash flow management (see "Why Large Contractors Fail: A Fresh Perspective"). Rapid growth can also result in contractors' management and manpower resources being stretched thin. As your business has grown over the last few years, have you maintained a healthy balance sheet, properly managed cash flow and adequately staffed projects? If so, could you say the same about your subcontractor partners or your general contractor customers? Now, more than ever, you need tight prequalification controls and go/no-go processes around project, customer and subcontractor selections. It's also prudent for general contractors to monitor and manage their risk exposure associated with one particular subcontractor or general contractor. According to our latest industry study,[2] conducted in collaboration with AGC's surety and construction risk management forum, the top-three most popular practices used to manage risk today include:

- Formal project risk assessment (56%)
- Subcontractor performance evaluations (38%)
- Captive insurance (32%)

A risk is just a problem that hasn't happened yet. If you sense that your grip on risk controls is slipping as your organization grows, circle the wagons internally on your risk management strategy and protocols. It's much easier to manage a problem before it happens.

3. People

To manage growth, many contractors have imported early-career employees with relatively little experience and skill. They've also hired midcareer professionals who may have developed less than ideal habits and practices from previous employers. Undoubtedly, as your business has grown, you've had to bring in new people as well. Has your culture (and ingrained behaviors and values) remained consistent, or has it been "diluted" since the beginning of the up cycle?

Not all hires end up being good hires. Invariably, underperformers slip through the cracks of even the best recruiting filters. Unfortunately, many contractors struggle to cull the herd. The theory is that an underperforming employee is better than no employee at all, and particularly when

[2] The 2019 AGC/FMI Industry Risk Study will be released in February 2019.

available talent in the market is scant. However, it's much easier to build an objective performance management culture and infrastructure in a good economy. Having fact-based insights into your employees' performance will give you confidence and reduce legal risks if and when you have to face organizational belt-tightening.

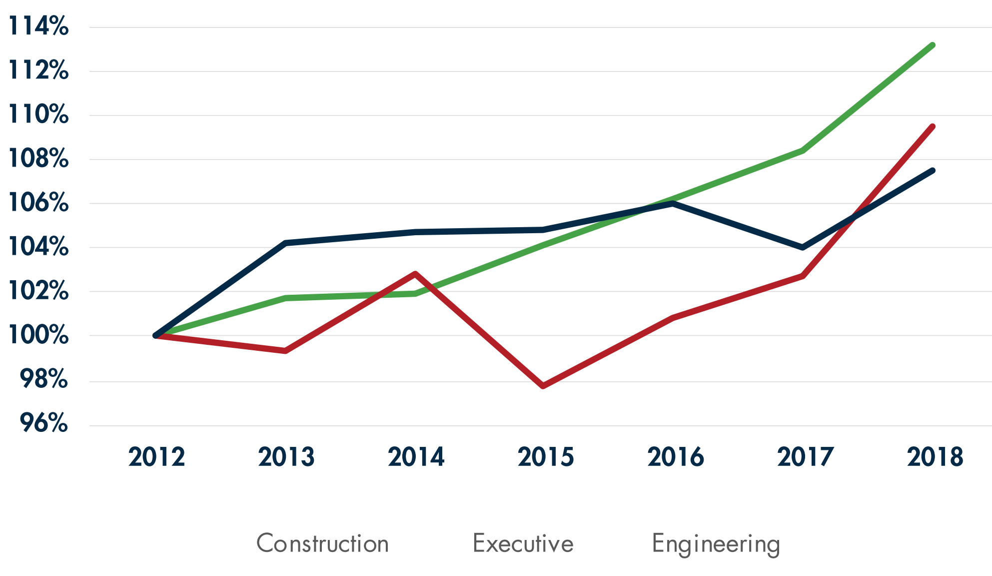
This leads us to the millennials. Believe it or not, millennials now represent the majority demographic group in the workforce. They catch plenty of flack in our industry (as being entitled, lazy, etc.), but these burgeoning professionals are the future of the industry. When asked what worries them most about the millennial generation, executives commonly cite a lack of interpersonal skills, leadership skills and business acumen. Contractors that address these areas head-on and intentionally accelerate the leadership readiness of their young professionals will gain sustained competitive advantage in the years ahead—regardless of economic conditions.

If you have a mixed bag of talent, lack of clarity on individual performance, and a growing demographic of millennials in your workforce generations, it may be time to take a step back and assess and improve your talent development strategies.

4. Rewards

Compensation levels for U.S. construction professionals (across all positions and regions) have risen 14% (or 2.65% CAGR) since 2012 (Exhibit 3). You may have experienced even higher wage growth in your own market. Very active markets such as Seattle, north and central Texas, and the Bay Area, among others, have required notably higher increases in order to attract and retain

Exhibit 3. National Average Compensation Increases (2012 - 2018)



Source: FMI Compensation

high-quality employees.

As you've staffed up, you've probably had to pay more than you would like, or possibly "top of market" pay, to recruit certain individuals. On the other end of the spectrum, you may have experienced regrettable losses of employees who left your business for higher pay. We sometimes dismiss those departing individuals as "lacking loyalty" or being "just in it for the money." While there are usually other reasons that contribute to an employee choosing to leave, compensation is a highly visible factor. Without real-time market data, contractors can't confidently confirm whether their employees are compensated commensurate with market expectations.

The balance of fixed versus variable compensation should also be considered in the context of cash management and corporate risk. High fixed (base wages) and low variable (bonus) compensation are appealing to some contractors today because they instill a sense of financial predictability in employees and can mitigate handwringing at bonus time. However, a compensation philosophy that dictates high base wages also increases fixed overhead and the overall risk posture of a construction company. Under any approach, an important question to ask is, "will our compensation philosophy mitigate or exacerbate profitability challenges in a year of poor performance."

Beyond the breakdown of base wages and bonuses, industry executives are also concerned about how to derive incentive rewards. FMI research indicates that contractors that clearly align incentive plans with their corporate strategic objectives can better measure their ROI on bonuses than those firms that use purely discretionary plans. More importantly, those with structured, goals-based incentive plans are significantly more likely to report positive results in the form of more cohesive teams, greater employee accountability and improved financial performance. Additionally, structured incentive plans help employees understand how much they can earn in a given year and how it can be earned as a result of company, business unit/team or individual performance.

Finally, once key leaders and successors are brought into the company, it is essential that they are retained for future success. Many contractors are exploring various ways to ensure top performers remain motivated and engaged in achieving corporate goals. Two increasingly common approaches are total rewards assessments and long-term incentive plans. The purpose of evaluating total rewards is to gauge the competitiveness of all aspects of the work experience offered by the contractor—from base wages to bonus to vehicle allowances to insurance to workplace amenities. This way the contractor knows (and can inform employees about) the total value of their employment. Long-term incentive plans are aimed at encouraging executive behaviors and performance that advance shareholder objectives; in many instances, improvement in corporate wealth or profitability results in an equitable reward to plan participants. Because the plan's design is long-term in nature, employees receiving long-term incentive awards must think about the impact of their decisions over time and focus on optimizing performance in all market circumstances.

It's Time to Act

Contractors are often reluctant to focus their attention on internal improvements to their businesses in a robust market. However, now may be precisely the opportune time to take inventory of your company's strengths and opportunities for improvement.

For starters, challenge your executive committee to provide a candid assessment of the current state of your business relative to the four areas highlighted in this article: operations, risk management, people and rewards. Fine-tune these areas today to position your business for success long-term. In other words, don't be caught naked when the tide goes out.

Tyler Paré leads FMI Consulting's Performance Practice, which assists E&C firms in the areas of operational excellence, risk management, compensation and rewards, and peer groups. As a principal with FMI, Tyler leverages his construction experience, coupled with his advanced knowledge of business mechanics, to help clients manage risk and optimize profitability. His consulting work focuses on linking work acquisition processes with project execution best practices in support of competitive strategy. He can be reached at *tpare@fminet.com*.

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