What Happens to Construction Tech During an Economic Downturn?

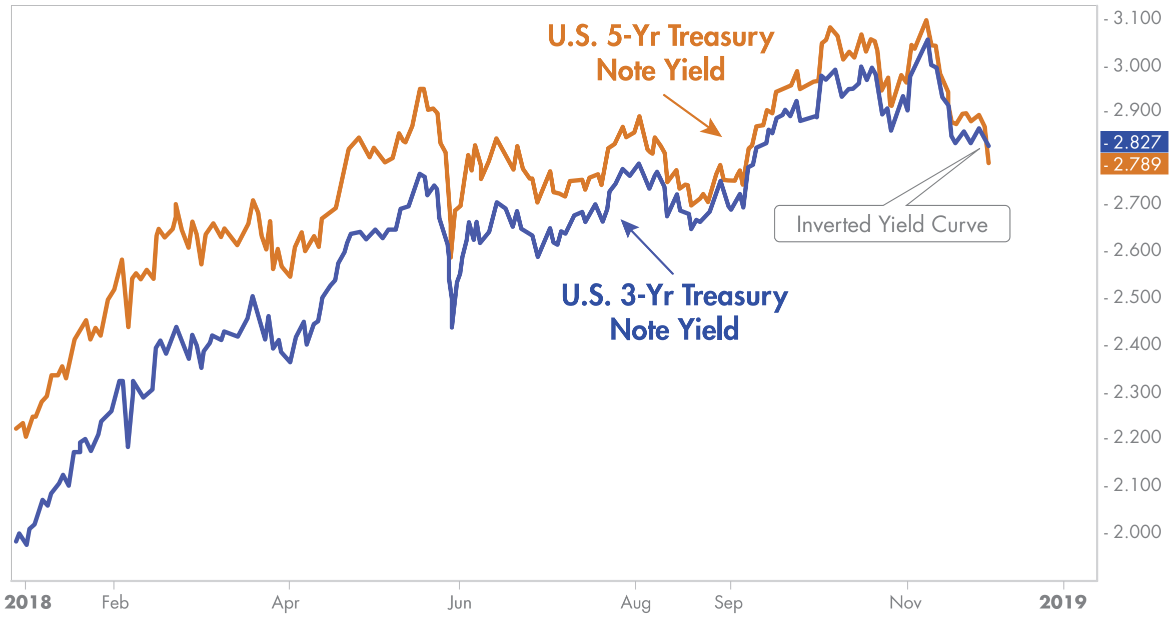
Here's how past recessions have influenced the technology industry and what new construction tech companies need to be doing now to get ready for the next one.

Although the U.S. technology market has been on a full growth swing since the Great Recession, most economists agree that a global economic downturn is likely to happen in the near future. Just a few months ago, it looked like the current boom might go on forever, with no real end in sight. However, when we turned the calendar over to 2019, issues like trade wars, a possible softening of the housing market, potential increases in interest rates, and other social disruptions began to measurably affect the stock market.

Add realities like global terrorism, geopolitical strife and natural disasters to the mix, and it's easy to see just how quickly the "good times" can shift over to a less than desirable business climate. For example, we track the yield curve—which is the yield of fixed-interest securities versus the length of time they have to run to maturity—very closely. When the yield curve inverts, longer-term debt carries a lower yield than shorter-term debt does. Healthy economies generally sport a noninverted yield curve, and it has long been a telltale sign of an oncoming recession when the yield curve does invert. As of December 2018, the five-and three-year note yield curve briefly inverted, and the yields have been neck and neck ever since (**Exhibit 1**).

"It should be noted that when most market watchers and economists warn about inverted yield curves, they're talking more about the 10-year and two-year note yields the vast majority of the time, and not the five- and three-year yields," Investopedia points out. "With that being said, although the 10-year and two-year note yields have not yet inverted, the spread between the two has become the narrowest it has been since 2007 (when the yield curve was actually inverted). This means that the possibility of an impending inversion has very likely increased."

Exhibit 1. U.S. Treasury Note Yields (three-year and five-year)



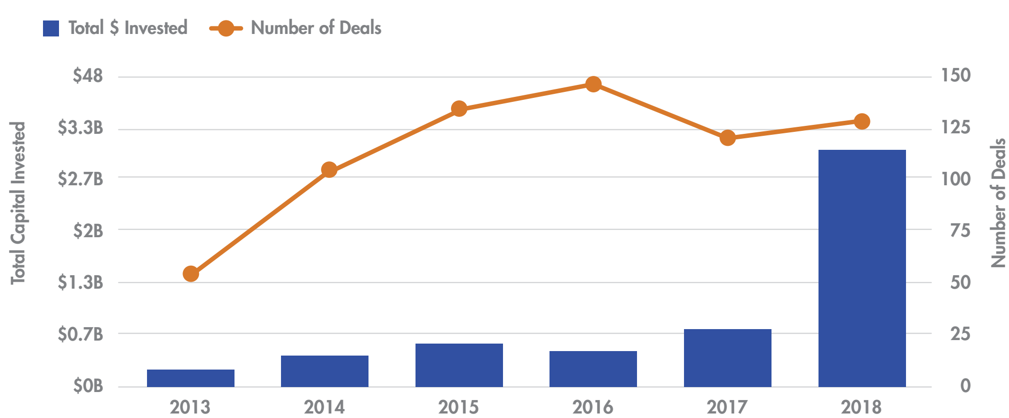
Source: Investopedia

What Does This Mean for Technology Startups?

Last year was one for the record books on the fundraising front. More than 5,000 startups in the U.S. collectively raised nearly $100 billion, and global venture capital funding increased to $207 billion. New York and San Francisco set entirely new historical records for funding in an environment that we haven't witnessed since the infamous dot-com boom in 2000.

Exhibit 2. VC Investment in U.S. Construction and Building Companies

Based on reported venture funding data for companies in Crunchbase's construction, building material, smart building and green building categories. Excludes PE, debt, post-IPO, and non-equity transactions.



Source: Crunchbase News

In this sea of historical growth, we also watched seed-stage deal share fall for the third consecutive year as investors concentrate more of their funding on later-stage deals, according to CB Insights. As a result, funding opportunities for new startups are becoming more and more limited—a sign that venture capitalists are steering clear of riskier investments in favor of later-stage companies that are already starting to see monetary returns.

This could pose a problem going forward. In an economic downturn, many startups fail because they are "default-dead" to begin with and depend on each funding round to survive or risk running out of cash; this is what killed a lot of tech startups during the dot-com boom and eventual bust.

An example of a probable default-dead startup is WeWork (recently rebranded as "The We Company")—the workspace sharing company that burst onto the scene in 2017 as another creative addition to the sharing economy. While undeniably popular with the gig economy worker who enjoys rubbing shoulders with other entrepreneurs (and having a beer in the office on Friday), WeWork simply isn't making any money.

Here's proof: According to Crunchbase, WeWork has posted around a -105% net margin for two years in a row. In 2018 the company had a revenue of $1.82 billion, and net losses totaled $1.9 billion, with assurances from its CFO that growth will "turn positive once the company's infrastructure costs are out of the way," the publication reports. Long term, WeWork is expecting to experience massive returns, but this is a model that's very much at risk during a downturn.

Default-dead startups have become increasingly more common in the past few years because of the sheer abundance and accessibility of venture capital, Crunchbase asserts. But for a company to weather an economic downturn, it needs to have enough cash in the bank to outlast the recession, or it will be forced to raise money on less than ideal terms.

Haven't We Done This Before?

When we think of downturns, the Great Recession of 2008 immediately comes to mind. It was the most recent major downturn, and it affected nearly every business and citizen in the U.S. For the tech industry, however, a far worse recession occurred in 2001 after the internet boom suddenly burst. When this happened between March 2000 and December 2002, the tech-heavy NASDAQ index lost three-quarters of its value.

"If the NASDAQ today experienced a drop like it did in 2000-2002 and the index lost [three-quarters] of its value," Axios reports, "it would fall to 2000, squashing today's cushy portfolios, beheading unicorns and destroying trillion-dollar valuations."

Of course, there weren't too many construction tech companies around prior to the dot-com frenzy of 2001. Of the companies that did exist, several of the largest players were internationally based firms (e.g., Sage and CMiC) and therefore weren't hit as hard when the bubble popped in the U.S. market. The few companies that were publicly traded at the time saw a spike in their stock value toward the end of 2000, and a corresponding drop in 2001.

The handful of domestic industry giants that existed prior to 2000—and that are still around today (e.g., Viewpoint, Trimble and HCSS)—may have avoided the complete and catastrophic failure that the rest of the tech world experienced in 2001 because of the dependence on the construction industry. As it happens, construction wasn't in a down cycle during that period and was, in fact, going pretty strong.

How's the Market Reacting?

The greater tech industry recovered slightly during the early 2000s, but it wasn't immune to the Great Recession that took hold just eight years later. Even though technology as a whole bounced back from the recession faster than the rest of the economy and has been in full bull market territory since then, construction tech companies weren't as resilient: Those founded prior to 2007 actually witnessed a sharp decline in valuations in 2008. History repeated itself a year later as those valuations dropped further in 2009.

In the construction tech world, this translated into a drastic contraction in revenue for a lot of companies. Some went bankrupt, and others were forced to significantly reduce overhead. According to Forbes, Procore's staff, which today numbers 1,300-plus full-time employees, shrank to seven people, and both the CEO and his No. 2 were forced to forgo their salaries.

Fast-forward to 2019 and the environment is decidedly more nurturing for technological innovators and the E&C industry, both of which have been enjoying a robust U.S. economy for several years now. The good times may not last. Having recently exited a bear market that reared its head in late 2018, thoughts of recession are clearly on everyone's minds: A recent analysis of Google search terms reveals that the keyword "recession" is at its highest search volume since 2009, with a noticeable spike in the trend in December 2018, when the five- and three-year treasury bond yield curves inverted.

"I'm 100 percent sure there's some kind of downturn on the horizon," Lux Capital's Bilal Zuberi told Bloomberg. "It will be a massive correction." To prepare for the inevitable, he's been encouraging startups to raise as much money as they can right now, trim their costs where possible, and become more disciplined with their financial reporting. He's also advising companies to stockpile cash for acquisitions in case less prepared competitors are forced to sell themselves or their assets on the cheap, according to his interview with Bloomberg.

This advice is already resonating in the market, where many startups are raising funds to have as much padding for the looming recession as possible, regardless of whether they're already hitting (and sometimes surpassing) their growth targets. Procore, the unicorn-status project management software platform, just raised an additional $75 million in December, thus tripling its valuation despite nearly doubling its revenue and reaching growth goals year over year since 2014, Crunchbase reports.

So What Do We Do About It?

Since 2009, cash has flooded into the technology industry as global investors sought out higher returns during a long era of near-zero interest rates set by central banks trying to encourage broader economic recovery, Axios notes. Looking forward, many economists predict a downturn in late 2019 or sometime in

2020. In “Here Comes the Downturn,” Jon Evans writes that “startups and initiatives with experimental initial offerings and potential long-term value will be hardest hit by a sudden unavailability of funding.” So what can startup construction tech companies do now to prepare? Here are five good rules to follow:

1. **Don’t deepen your debt.** Don’t deepen your bench farther than it needs to go. Don’t bet the company on a new project/product offering, and don’t completely pivot your company’s go-to-market strategy and raise money while you can.

2. **Build a painkiller, not a vitamin.** “Creating something foundational that people really need as an essential element of their business will allow your company to thrive when the markets are low and when they’re high,” Techcrunch adds.

3. **Hold onto your cash.** As we’ve seen in the past, companies that don’t have enough cash to make it to the next round of funding before going bankrupt are the first companies to fail in an economic downturn. Having positive cash flow is essential for continued growth in a recession.

4. **Prove you don’t need the money.** “By proving you don’t need outside investment to survive, you are making yourself much more appealing to potential investors,” Techcrunch states, “even if their access to capital is limited while market activity is low.”

5. **Embrace the shakeout.** Back in 2000, the landscape of the construction technology industry was littered with tiny companies like Procore, which, at the time, did not relish the competition but recognized that a downturn represented a unique opportunity if it could make it to the other side. “Every single one of them disappeared,” Procore’s Craig Courtemanche tells Forbes. “If it wasn’t for 2009, that landscape wouldn’t have been eviscerated, and I can’t tell you that Procore would’ve been the one that emerged.”

With the next economic downturn lurking around the corner, now is the time for construction technology firms to shore up their financial reserves and factor in hard lessons from the past when making business decisions. Even when the business environment is robust and promising, good planning and preparation are the perpetual keys to success.

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