Get Lean and Mean: Preparing for 2021and Beyond

By Tyler Paré

What does increased competition mean for your business? How will you become more competitive?

While the impact of the coronavirus pandemic will vary by geography and market segment, broad-based demand for construction services is expected to decline over the next two to four years. The downcycle will increase competition; bull markets will attract new entrants while bear markets will offer fewer opportunities for established incumbents.

What does increased competition mean for your business? How will you become more competitive? In this article, we explore the current market challenges that are putting pressure on pricing and margins. We will also offer some guidance on how to navigate these challenging times:

1. Don't Panic
2. Get Lean and Mean
3. Execute

Perception vs. Reality

I recently listened to a developer bemoaning the lack of downward movement in construction prices in the wake of the pandemic. She argued that, with expected declines in demand for construction services (and increased competition as a corollary), the price of these services should also decline.

It is true that many contractors' book-to-burn ratios are underwater. In other words, they are booking work at a slower rate than they are burning backlog. If this trend persists for a protracted period, annual revenue will decline, and a construction business's economic model will be threatened if adjustments to fixed costs are not made proactively.

However, many contractors expressed having too much work and being stretched beyond capacity prior to the onset of the

pandemic. The pullback induced by the pandemic, for some, was a welcomed reprieve and a chance to slow down, reevaluate and get the organization caught up. Translation – we have yet to see a broad-based trend in dramatic price reduction for construction services.

That may only be temporary. Eventually, declining backlogs will place pressure on contractors to win more business and be more aggressive. The construction industry lags the broader economy by 12 to 18 months, and we have yet to see the true impacts on construction demand and contractor backlogs.

Pricing

Most construction companies employ a cost-based pricing methodology. They develop an estimate of the direct cost inputs (labor, equipment, material, subcontractors, etc.) and then add margin to cover overhead and sufficient net profit. For prices to retreat, it would require a reduction in one or more of these variables.

The Pandemic's Effect on Costs

Labor

- Labor wages are not expected to decline dramatically—rarely do these figures move backwards, particularly in an industry that is perpetually lacking talent.
- Productivity is likely to decrease because of increased COVID-related regulation (social distancing, point of entry control, sanitization, etc.).

Equipment

- With decreased utilization, the per-hour cost of ownership is likely to go up.

Materials

- Shocks to the global supply chain have created material shortages across the industry, increasing the cost of building products and construction materials worldwide.

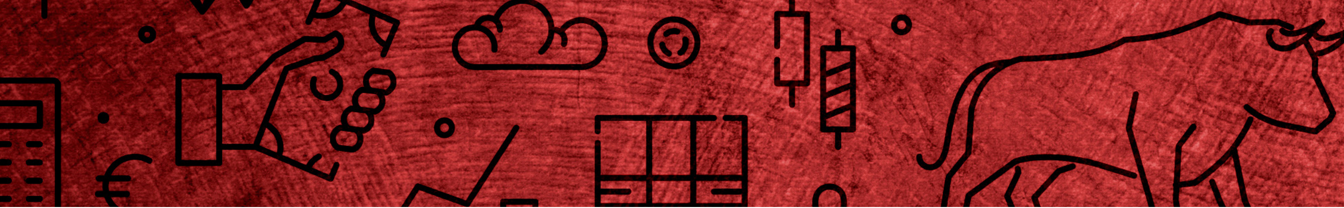
If direct costs are increasing, prices should also rise, not drop. The developer I spoke with did not like this rationale. "But won't contractors become hungry for work and lower their prices?" she rebutted. "I feel like they have been making money hand over fist in the last runup. Don't they have room to cut their margins?"

Pressure on Margins

If there is not expected to be much short-term relief in direct cost reductions, most of the price competition will come down to margins and how aggressive contractors are willing to be.

While contractor margins have crept up year over year for the past decade, average trade contractor net margins were still in the mid-single digits, and general contractor margins were roughly 50% of those margins prior to the pandemic.

Net margins for construction businesses have always been misaligned with the inherent risks in the industry. Growing margins for the construction industry are not a bad thing. Even if margins have increased (in some cases doubled) as FMI's financial benchmarking data would suggest, it would be difficult to argue that contractors were taking advantage of the bull market, let alone price gouging.



Additionally, falling revenue means that overhead as a percentage of revenue will increase. If significant adjustments to fixed costs are not made, contractors will actually need to increase gross margins to sustain normal levels of net profitability. Mathematically, the argument for contractors being able to drastically slash their margins begins to break down.

Theoretically, contractors have room to cut their margins, but not by much. Downward pressure on contractor margins spells risk for all project stakeholders. At a basic level, would you rather partner with a highly successful, profitable construction company or a desperate contractor operating on razor-thin margins, one hiccup away from default?

If contractors are willing to slash their bid margins to zero, they are going to have to make it up somewhere else – cutting resources in an attempt to reduce direct costs can lead to potential production and schedule issues; cutting overhead costs can decrease overall project support relative to quality, safety and schedule; and trying to make it all up on change orders can lead to strained relationships and potential delays.

FMI's guidance for navigating a market downcycle:

1. Don't Panic

Knowing that we are facing a multiyear downcycle, temper your work acquisition urgency accordingly. Panicking too early and loading up on cheap work (i.e., poorly, aggressively or emotionally estimated) is a bad strategy that can result in years of headaches.

Every construction market has irrational players—those that will torpedo the market and come in screaming low on bid day—taking work and forsaking margins, sending reverberations through the market and causing the competition's estimators to scratch their heads. Don't be that contractor.

2. Get Lean and Mean

a) Be selective.

Increase your project selectivity (go/no-go process) discipline. Get competitive on the work that you know you want, know you can win and you know can deliver on. Don't swing at every pitch, especially those in the dirt. Chasing too many low probability opportunities can burn out your estimating department, leading to low-quality estimates fraught with mistakes and award of troubled jobs that can could haunt you and hamstring your organization for years.

b) Know your true costs on bid day.

Oftentimes, there is hidden margin in the direct cost line items of construction estimates. Estimators will call this contingency or waste factors; others might call it sandbagging. In good times, you can still win work with overly conservative estimates. When job costs underrun budgets, these savings directly translate into margin. Estimators and project managers both lay claim to these victories.

In reality there is probably room to tighten your estimates. We encourage contractors to base these adjustments in historical data and facts, not just intuition. By analyzing the direct cost variances across a large sample of work (the last three to four years), you can identify trends and areas where you consistently pick up margin and theoretically have room to tighten estimating practices. (Caution: Equal scrutiny should be given to those line items that consistently overrun budgeted costs).

Avoid the Compounding Effect of "Sharpening Your Pencil"

Example

An estimator knows that he/she must get more competitive to win work. He/she removes all the "fluff" from the estimate and may even factor in overly aggressive productivity estimates. The chief estimator reviews the cost estimate, then skinnies down the additional pricing factors such as contingency, overhead markup and margin. The president then steps in and says, "We really need to win this job; let's cut the margin." You now have aggressive pricing behavior at three different levels. Often these measures are taken in isolation, without discussion or consultation among all the players. This can create a highly risky estimate. Ensure your work teams and decision-making are closely aligned when getting competitive on bid day.

In a bull market, overstressed estimating departments can become lax in their processes and procedures. "Plug" numbers and "SF" numbers may have been sufficient for small items in the past, but it is now critical to have detailed costs for all budget items. It's also important to carefully validate your subcontractor costs by increasing coverage, leveling efforts and prequalifying. Stay close with your key subs and vendors—leverage those relationships to get advantages on bid day. Reevaluate contract terms that may garner advantageous prices from your subs.

c) Focus on operations.

Tighten operational processes, controls and productivity. Get back to basics with respect to pre-job planning, scheduling and look-ahead,

manpower coordination and project closeout. If you are tightening your estimating practices, there is less room for error, and projects need to be have a high degree of discipline and adherence to proven best practices.

Ensure you have robust project controls that can help you and your management team identity troubled projects early, affording enough time and opportunity to course-correct before things spiral out of control.

Productivity is a journey, not a destination. If you have made steps to improve productivity in the past, now is the time to revisit and double down on those efforts. FMI recommends establishing a task force of your operational leaders to improve labor productivity and equipment utilization.

Also, ensure that your field leaders and subcontractor partners feel appreciated and supported. Stay close to them and listen to what is going on in the field. They are the lifeblood of your business and will be the ultimate differentiators in winning or losing in the current environment.

d) Rightsize.

Interrogate your fixed-cost infrastructure. Cutting overhead alone is not a sound strategy for maintaining profitability in a downturn. However, all aspects of your G&A need to be highly scrutinized, including your organizational structure, roles, compensation, real estate, owned equipment and technology. Understanding your key efficiency ratios of revenue, gross profit and net profit-per-head by employee classification can help you make prudent cost adjustments and right-size the organization.

3. Execute

These strategies are not unique. In fact remove the challenges of 2020, and you can argue that most of these tactics make good business sense no matter the economic climate. The difference we are hearing from firms in the industry today is the level of focus and urgency related to these strategies. Contractors understand that they need newfound levels of intensity and intentionality in addressing their companies' performances.

Wayne Gretzky famously said, "I skate to where the puck is going to be, not where it has been." Now that the industry is aligning on "where the puck is going to be," contractors are all skating in the same direction. Who can skate there (i.e., get lean and mean) the fastest will be the competitive differentiator in the post-COVID era.

Assess your executive team's ability to execute on change management initiatives necessary to win in an increasingly competitive market.

About the Author

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