FMI Consulting

Risk Management:

A Blueprint for Success

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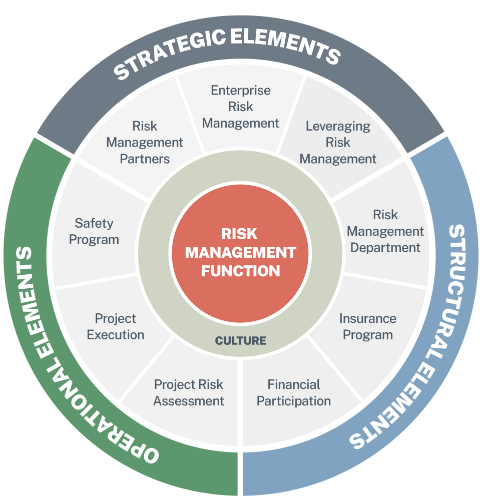
The correlation between risk and reward is fundamental in business and certainly a concept with which contractors are all too familiar, since, at the highest level, construction is all about managing risk. However, understanding the need to formalize the risk management function inside the contractor's business varies immensely.

Contractors work in an inherently risky business. Tight time frames, multiple stakeholders up and down the value chain and dangerous working conditions are all "just part of the job." All too easily, the mind of the contractors become numb to the risks they face. Considering the **risks** contractors face on a regular basis, most would agree that the **rewards** often fall short for the work they are performing. Adding to the challenge is that the construction market has changed. Good, bad or indifferent, the recession has painted a new landscape with tighter margins and less room for error. The days of high margins and favorable contractual language are gone. Owners are more educated and the competition is tougher. As a result, businesses are running fast and hard, and ironically increasing their risk exposure while decreasing their prices.

Insurance carriers have been hit hard in the recession as well. In the past, investment income on loss reserves provided significant additional margin for insurance carriers, which helped to overcome poor underwriting results. However, with decreasing investment returns, most carriers have to raise pricing and, in some instances, narrow the underlying coverage they are providing. Contractors need to be diligent in the reviews of their program pricing and terms and conditions. The combination of the overall recession, a changed construction market, other mega trends (e.g., globalization, etc.), as well as the changing insurance market, has led to an increasingly complex world. Effective risk management is more important now than ever — a trend that will not likely reverse itself.



As the landscape has changed, so has the role risk management plays inside many contractors. Rather than viewing risk as an unavoidable evil, firms have embraced risk management as a strategic opportunity. This adapted approach has contractors taking a holistic and strategic view of risk, while refining how they manage it to protect the balance sheet and legacy of the company, improve operations, increase margins and mitigate the effects of an occurrence. In reality, risk management is not a new concept for anyone in the industry; employees across organizations manage multiple sets of risks on a daily basis. However, FMI believes that risk management among leading organizations is intentional and formalized at an enterprise level, rather than piecemeal or reactive on an individual basis.

Risk management at its highest level has two overarching objectives, one being offensive and the second, defensive. Offensively, risk management aims to increase the value of the business by formalizing risk tolerance, potentially increasing profit margin and stabilizing earnings. Defensively, risk management serves to protect the business by guarding the balance sheet, profits and legacy of an organization. Through our work in the industry, FMI has identified nine elements that support both an offensive and defensive risk management strategy. The nine elements generally fall into three primary categories: strategic elements, structural elements and operational elements.

Strategic Elements

Enterprise Risk Management — The traditional approach to risk management involved a "siloed" approach in which individuals (or teams) were only responsible for risks in their silo, with the assumption that someone else would manage the other risks. An enterprise approach to risk involves the collective identification, assessment and management of risks that a business faces, not just on a local level or within its business sector, but on a global level in areas that may not have an obvious or direct correlation to its business. This global approach provides for a more clearly articulated risk tolerance level and serves as an important precursor to strategic planning.

Risk Management Partners — As in any business, the right partners are vital to a firm's success. In the construction industry, those partners include both insurance and surety partners that possess construction industry expertise, commitment to the construction industry, industry-focused research (e.g., emerging issues) and sufficient bench strength.

The top insurance brokers and companies in the industry have a deep understanding of their clients' business and serve as strategic partners, equipping companies with the right suite of products to fit an ever-changing marketplace.

Surety is often referred to as the "lifeblood" of the construction industry. The surety community provides essential credit instruments to construction firms, creating an indispensable, interdependent relationship. Surety providers and brokers serve as key advisors for contractors. The best contractor/surety firm/surety broker relationships help to mitigate construction risk and aid contractors in the avoidance and mitigation of common risks that can lead to default. Firms should maintain a strong relationship with their surety companies by demonstrating that the firm is not over-leveraged, has good management experience, and is not taking on more work than the balance sheet has the capacity to fund.

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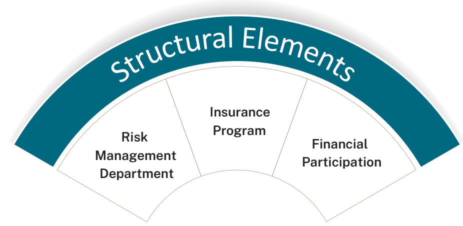
Leveraging Risk Management — As the industry has evolved, so has the need for contractors to change the way risk management is viewed. Evolving our mindset on risk management and thinking about it differently allows firms to protect themselves better and offers the potential of increasing the value of an organization as well as identifying additional margin. Essentially, the construction industry is increasingly embracing and managing appropriate risks that have the potential to add value to their business, unlike in the past when contractors had a fairly consistent knee-jerk reaction to risk, either refusing to accept it in the contract and/or immediately passing it on to others (i.e., subcontractors and suppliers).

Structural Elements



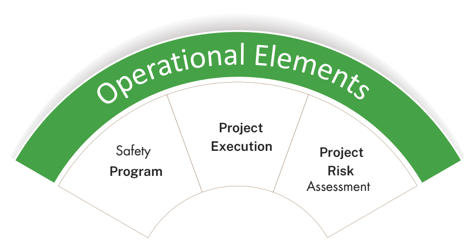
Financial Participation — Determining your enterprise risk tolerance on an annual basis as it relates to your overall ability to absorb individual and aggregate losses is essential to an effective risk management function. Many firms make business decisions without the benefit of this understanding, resulting in over- or under-participation. Over-participation refers to unknowingly being exposed to more potential economic loss than a business can tolerate, either reputational or financial. Under-participation is the idea that the benefits of the organization's risk management function and overall business practices are benefiting others more than they should (e.g., owners, insurance carriers, competitors, etc.) Internally, leading organizations are deliberate about how they communicate, manage, account and job-cost the risk management function. By doing so, they leverage opportunities provided by the risk management function to incent desired behaviors and outcomes within the or-ganization. The notion of balancing risk versus protecting the balance sheet will loom large when analyzing the work that one solicits. In addition, changing the way firms think about risk management requires serious internal effort; the intent is to be positioned to benefit from all of the effort.

In organizations that cannot absorb the overhead to support an entire department or even a fully dedicated risk manager, significant space on the CEO's desk must be allocated to risk management, and various roles and responsibilities within the organization must be risk-management focused.

Risk Management Department — Leading contractors have a formalized risk management department embedded in their organization, led by a professional, usually full-time, risk manager with a defined role and specific responsibilities. This role should not be relegated to an outside broker, de facto safety manager or somewhere else in the organization. Risk managers contribute significantly to the overall management of a construction business and should have a seat at the table with the executive team. In organizations that cannot absorb the overhead to support an entire department or even a fully dedicated risk manager, significant space on the CEO's desk must be allocated to risk management, and various roles and responsibilities within the organization must be risk-management-focused. Risk management discussions and processes must be embedded across the organization and all departments should be supported by a risk management plan that dovetails with the company's short-term and long-term strategic plan.

Insurance Program — The role of insurance is simply to allow companies to "rent" the insurance company's balance sheet when risks and the potential losses exceed an organization's risk tolerance. Understanding that need for protection, companies must ensure that the suite of insurance products sufficiently protects their balance sheet and earnings stream should something undesirable occur. The key is to have an insurance program that appropriately matches the risks of the company's specific business and exposures.

Operational Elements



Project Risk Assessment — Leading contractors have a systematic and consistent process to evaluate and analyze potential project risks prior to pursuing a project award. This process involves a team of internal experts with specialized experience who review key specialty areas of project risk, such as contract terms, constructability, financing, partners, location, logistical issues, equipment needs, etc. Contractors that have a clear understanding of their enterprise risk tolerance as well as a strong project risk assessment are better equipped to put in the appropriate contingency and margin on projects. This allows them to avoid over-pricing and thus not being competitive on projects with less risk and underpricing (and potentially winning) work with higher levels of risk.

Not surprisingly, challenges with subcontractors are one of the most often cited reasons for project overruns; but digging a little deeper often uncovers issues that could have been avoided with proper management.

Safety Program — Today, even average contractors have safety programs in place. Leading contractors have created a culture of safety throughout not only their organization, but also for all others involved on their projects. Leading organizations also aggressively track and manage claims, focusing on the process and the costs, including robust return-to-work programs, and understand that safe jobs tend to be profitable jobs. A strong safety program has not only the "right" components, but also the appropriate measurements and metrics in place to monitor performance and accountability.

Although zero incidents is what the industry strives for, until a company reaches that goal, it must be in the best position to prevent and aggressively manage claims when they occur. A strong internal claims process can go a long way in protecting a company's balance sheet.

Project Execution — Up to this point, all of the risks we have discussed have been ancillary to the actual act of constructing a project. Whether acting as a subcontractor or a general contractor, there is an inherent and obvious risk in executing a project.

When contractors' operations involve subcontractors and vendors, contractors still have finances and reputations at risk, but someone else is performing the work. Because of this dynamic, it is easy to understand why subcontractor management is a key element of leading firms.

A strong prequalification process and a robust subcontractor management program help contractors identify potential risks that can be mitigated, thus minimizing potential impacts from resulting issues. Not surprisingly, challenges with subcontractors are one of the most often cited reasons for project overruns; but digging a little deeper often uncovers issues that could have been avoided with proper management. Not all subcontractors have the same risk profile. Yet, once awarded the work, many contractors will manage the subcontractors as if they had identical risk profiles. Best-in-class prequalification and subcontractor management programs manage the risks at hand, avoiding margin fade.

When working as a subcontractor, managing up and out is often a critical part of managing risk. Understanding the way each trade works in concert to complete a project and recog-nizing the importance of strong communication and collaboration are critical.

Conclusion

The idea of managing risk as an "offensive" strategy is not a new concept. Best-in-class companies understand the value of a formalized and intentional risk management program and long ago embraced the idea of managing risk strategically.

Whether in reaction to tight markets with demanding and impatient stakeholders, or with the foresight to see the advantage it provides, the industry is evolving its view of risk management. As the industry continues to change and executives spend increased time considering risk, this model of best-in-class risk management should serve as a blueprint for success.

About FMI

Founded in 1953 by Dr. Emol A. Fails, FMI is the leading management consulting and investment banking firm dedicated exclusively to the engineering and construction industry. FMI professionals serve all sectors of the industry and combine more than 65 years of industry context and leading insights to achieve transformational outcomes for clients.

For more information, please contact any one of our Risk Management team members below:

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