Building Amid Uncertainty:
How Risk Management Became Everyone's Job

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How can contractors remain competitive as production costs rise?

By David Madison and Sabine Hoover

Executive Summary: A Volatile World

Construction firms shouldered a 21% rise in materials and services prices between March 2021 and March 2022, according to an analysis by the Associated General Contractors of America (AGC). Many adapted to the impacts of supply chain disruption with escalation clauses and longer lead times, only for the Russia-Ukraine war to put further pressure on energy and commodities prices.

Construction fees have not kept pace, which means that contractors are taking on a greater share of risk when they agree to a project, operating with no insights about what materials prices or labor will look like nine months from now.

"There is a belief by owners that contractors should be taking on owner-type financial risk for exposures such as today's supply chain," Don Naber, senior vice president at Gilbane Building Company, told FMI. He likens building a project in the current environment to taking out catastrophic coverage while building in zones at risk of hurricane or seismic activity. "You're talking a $5 million deductible if the loss happens at the end of the job. That risk should go back to the party who has decided to build this project in this area that is subject to hurricanes and earthquakes."

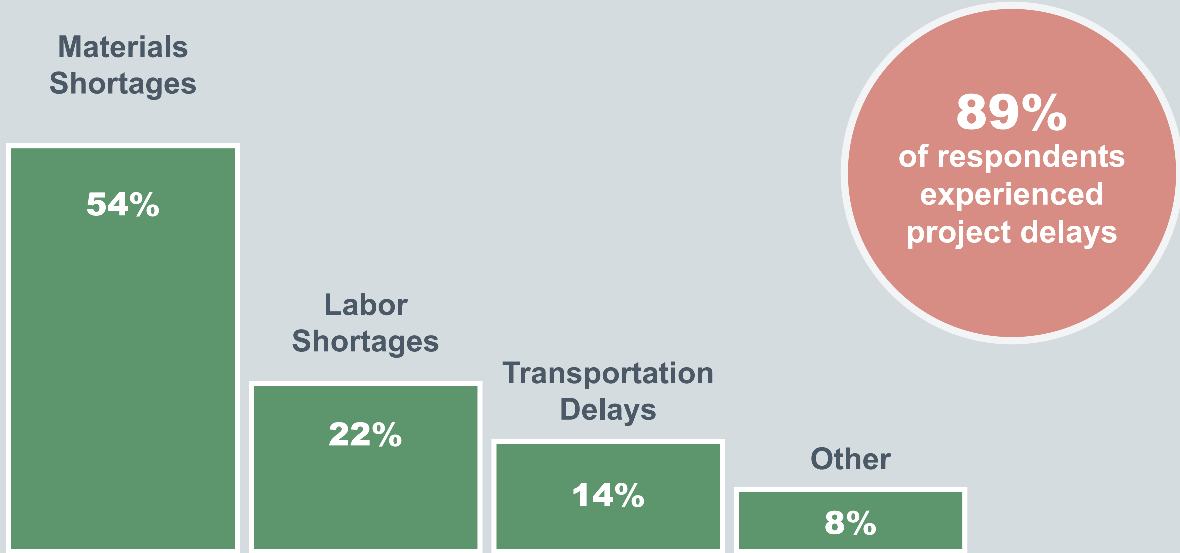
Beating initial expectations, 2021 was a strong year for construction. In a majority of U.S. states, construction employment is now above pre-pandemic levels, but labor shortages and static construction fees are constraining an otherwise healthy rebound from the 2020 blip.

"This should be a market where general contractors and construction managers have a great amount of negotiation and power and should be getting to more reasonable fees and terms and be making a lot of money," Tyler Henson, senior vice president and senior director of risk management at JE Dunn, told FMI. "But owner risk-shifting to the contractor side seems to be continuing unabated."

There are looming challenges with uncertainty over geopolitical, manufacturing, supply chain and economic dynamics, and opportunities are positioned tenuously on the availability of skilled labor. Unsurprisingly, risk management is top of mind, as the 2022 AGC/FMI risk survey and report shows.[1]

[1] Data collected at the end of 2021.

Figure 1: Causes of project disruption



Source: 2022 AGC/FMI Survey

Almost 9 in 10 respondents had experienced project delays. Materials shortages were cited by 54% of respondents as a factor disrupting projects, followed by labor shortages (22%) and transportation delays (14%). This volatility has spurred adoption of formalized risk management strategies.

One of the key themes to come out of the 2022 study is the importance of project selectivity — a quarter of respondents now use formal go/no-go processes, and of those, 84% increased their reliance on this methodology.

This paper looks at other key strategies and the shifting nature of risk management in an era and industry defined by risk.

Key Findings: Opportunities as a Margin Call

A healthy competitive environment has seen backlogs grow, with $1.2 trillion in federal funds set to be disbursed under the Infrastructure Investment and Jobs Act. Business is booming, but the earnings calls for public construction firms in the first quarter of 2022 served as a reminder that there is a fine line between profit and loss.

Contractors work under incredibly tight margins, and price hikes have put added pressure on the equation. “Before, if a product was at a certain price [during bidding], it stayed in a pretty tight range,” said Naber. “The ranges in today’s market can be significant, which impacts cost, schedule and quality sub participation.”

Supply chain delays and premiums on materials can easily imperil subcontractors. “You can’t automatically expect subs to honor their price when something spikes,” Anthony Pecchio, senior vice president at The Christman Company, told FMI, “especially if it could put them out of business.”

Along the same lines, Henson said JE Dunn is mindful of how much work it gives to subcontractors. “We are on the precipice that we see post-recession of people overeating and not being able to perform.”

Project delays and escalations also put contractors at risk. “Usually when it’s a bad job, it has multiple factors, and the fee erosion tends to be substantial, so it takes you another 10 jobs to make up for that loss,” said Henson.

“A couple of bad jobs can put any contractor out of business,” said Pecchio. For that reason, it’s important to balance the basket of risk when looking at job selection.

The engineering and construction industry faced a different risk environment in 2016, when AGC and FMI conducted their first survey, finding at the time that 35% of respondents thought their organizations were ineffective in managing risk.

Formal risk management measures have increasingly been implemented into operations in the years since, and in 2022 around a quarter of respondents reported using at least one type of risk mitigation measure.

Twenty-five percent of respondents were locking in pricing early, 25% were adding contingencies to contracts, 23% were adding in price adjustment clauses, and 29% were using subcontractor default insurance to control for subcontractor exposure.

Figure 2: Supply chain risk management strategies ranked as top priority

Source: 2022 AGC/FMI Survey

Figure 3: Risk management tools ranked as top priority

Source: 2022 AGC/FMI Survey

Traditionally, risk management has been broken into offensive and defensive measures:

- **Offensive** risk management aims to increase the value of the business by formalizing risk tolerance, potentially increasing profit margins and stabilizing earnings.
- **Defensive** risk management protects the business by guarding the balance sheet, profits and legacy.

Pecchio has spent decades looking at risk and views it more broadly as a philosophy that impacts every office in an organization. “Contractors are constantly having to look at what the risk is, how you best mitigate it, and what you can pass on or buy insurance for or manage internally,” he said.

With insurance premiums rising, it doesn’t always make financial sense to simply pay to transfer risk, but rather to hone the organization’s skill at managing complex projects and the many challenges along the way. “At Christman, everybody manages risk, even though only a few people actually have ‘risk’ in their titles,” he said. Which brings us to perhaps the biggest known risk: your people.

Risky Business: The Labor Market

The shortage of labor across all areas of construction has been an abiding theme for the past decade, but labor shortages have amplified risk and volatility in the market. As JE Dunn’s Henson puts it, “We might think we have the staff for that project, but they are being targeted continually by competitors; so we have to be prepared to deal with attrition.”

“We’re all competing for this finite group of staff, and that pot is not growing bigger,” agreed Pecchio.

As a result, labor is a key piece of the risk management puzzle. At Gilbane Building Company, data analysts are looking at why people stay with the firm and why they leave. They then make decisions about which projects to take around the availability of workers who have the requisite skills.

At Christman, Pecchio factors in the human costs of a bad job in terms of stress and burnout. “The cost to our people is in some ways more than the cost to us financially,” he said. A bad job can hit your bottom line, but “if you have a bad job and lose two key people, that’s disastrous.”

This means training staff and educating people across the organization about risk tolerance. It also means looking at what you say no to as much as you look at what you pursue.

Increased Project Selectivity

FMI strongly encourages firms to develop a bespoke set of selectivity factors unique to their organization and strategic context. These factors, commonly referred to as go/no-go criteria, should be aligned with the company's competitive strategy and informed by past experiences, and were a key strategy pursued by respondents to this year's survey.

Codifying a decision with so many moving parts is something of an art. Many companies have a rubric through which they can evaluate a potential project, often with multiple points of signoff. "We are closely evaluating [an owner's] financials, confirming their funding, and determining if their project is ready to go," says Naber.

Stage one of the go/no-go decision might look at whether a project aligns with a company's decision-making criteria and whether the firm has a high likelihood of winning the work.

Firms may look at the project size and location, design requirements, financial model, availability of subcontractors and personal history with that owner. The quality and nature of the owner-contractor relationship, alongside in-house staffing capabilities (14%) and margin opportunity (13%), are important deciding factors for 16% of firms who responded to the risk survey.

"If a Gilbane division or business unit is presenting to corporate for a project with a developer we have not worked with in the past, the executive leadership is keen on understanding the owner history, their relationships and their long-term opportunities as we determine how best to invest our capital. We are really taking a close look at new relationship opportunities," says Naber.

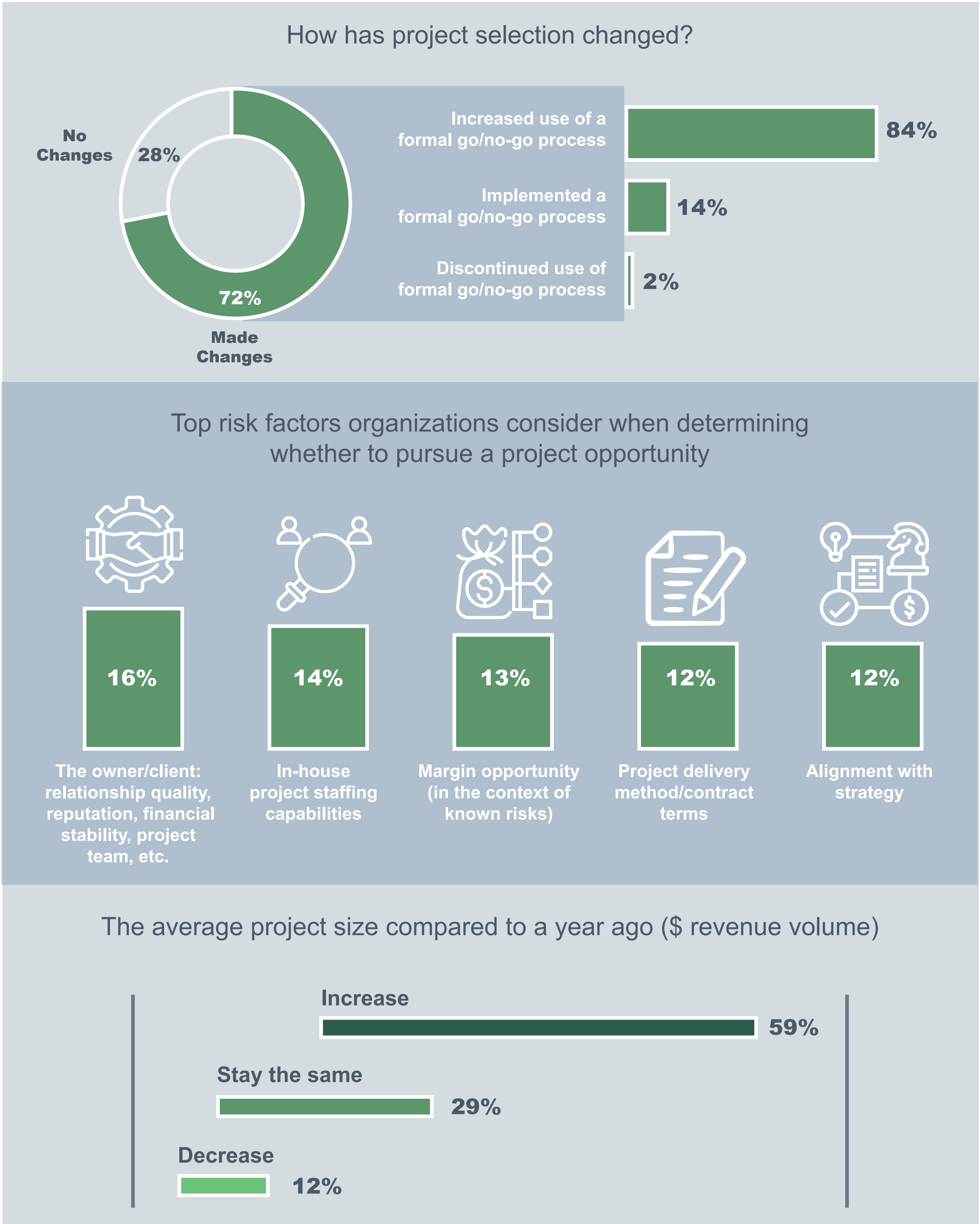
If the owner is new, there are ways to minimize the level of risk. For example, working in a geography where you know the subcontractors might prove a better use of labor capital than putting your staff into a new geography where you don't have solid subcontractor relationships.

Stage two comes after gathering more information and assessing the project's attractiveness. Firms should then evaluate if it's appropriate to move forward with a formal proposal response or bid. Pursuing some jobs will mean bypassing others. The risk survey results showed that projects are trending larger, promising greater risk for involved parties.

"Communication is really key in deciding which projects we will pursue and which projects we take a pass on, because [maybe] then we won't have capacity for a long-term client or for an opportunity with a client we want to pursue; and we always want to send in the best team for the job," says Pecchio.

During the go/no-go process, Gilbane assigns possible opportunities to a level 1, 2 or 3, depending on how large or complex the project is. At level 3 all the business units convene regularly to discuss the opportunity.

Figure 4: Project Selectivity Criteria



Source: 2022 AGC/FMI Survey

"All members of Gilbane's executive leadership have input on if we proceed with a project and how we proceed," says Naber. "It allows for a great deal of interaction with leadership (sales, operations, legal, safety, financial, risk management) of the company for the best interests of the company. Everyone has a voice."

This risk-savvy mindset permeates a company's culture, honing the focus on strategic purpose. At JE Dunn, what used to be an annual strategy meeting is now an annual meeting plus check-ins throughout the year. "Five-year plans just don't make sense anymore," said Henson.

Looking Ahead: Finding Balance

When everything teeters on a landscape of risk, success comes down to balance. Companies that operate with strong alignment between owner and general contractor, and between general contractor and subcontractors, can minimize the surprises that threaten to derail a project. Firms that prioritize talent will be able to capitalize on the opportunities of the post-pandemic boom, both in terms of being able to staff jobs and instill in their people a risk management mindset.

Many risks remain. Energy prices are a key unknown in a complex geopolitical landscape, as are supply chain hijinks, tightening of U.S. monetary policy, climate events and subcontractor balance sheets 12 months from now.

The challenge for those charged with managing risk in all its forms is the same. You need to know why you are going after a job and how you will deliver.

ABOUT THE AUTHORS

David Madison leads our risk management discipline. By partnering with clients within the engineering and construction industry on risk management, strategy development and prequalification design, he helps position firms for stronger performance and increased profitability.

David also leads FMI's captive insurance consulting discipline, providing advisory services and risk management support to clients exploring the potential of a captive insurance program. He serves on the board of directors for FMI Insurance Limited and regularly collaborates with insurance carriers and others to provide thought leadership and research on subcontractor risk management and captive insurance strategies.

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