WHY CONTRACTORS FAIL

BY HUGH RICE

Construction involves more risks than other industries, and the company failure rate is higher as well. Successful contractors must learn to manage risk. The following are the top 10 reasons contractors fail, as identified by FMI, a construction consulting firm based in Raleigh, N.C., in conjunction with the Construction Users Roundtable:

1. Overexpansion/flawed strategy;
2. Volume obsession;
3. Poor project selection, onerous contracts, unrealistic commitments and risk concentration;
4. Insufficient "real" capital or profits;
5. Poor business acumen;
6. Poor leadership and succession;
7. Poor field performance;
8. Problem owners;
9. Economic volatility; and
10. Credit market changes.

Most of these problems are seldom recognized until it is too late to save the company.

STRATEGIC ISSUES

One of the most common flawed strategies is overexpansion. Growing too fast and beyond the financial and human resources capabilities of the firm is a classic reason for contractor failure. Eternal optimism frequently leads to over-committing the firm. Instead, having a rational, sustainable business strategy is key to survival and success.

Unfortunately, revenue and sales volume are not always related to profitability.

Like overexpansion, volume obsession can blind a contractor to underlying problems and remove the necessary financial cushion to soften the blow when problems arise.

Poor project selection, onerous contracts, unrealistic commitments and risk concentration all can lead to rapid business failure. Contractors anxious to fill their backlogs seldom think they have a choice of owners to work with, so they sign contracts without considering all of the risks and make commitments they are unlikely to keep. Often contractors think:

- We have to keep our employees busy.
- We'll make it up on changes.
- We need to put our money to work.
- We're right, and we'll win in court.
- We'll figure out how to staff it once we get the job.
- That won't affect our market.
- I'm not sure where our work will come from next month, much less next year.

Sometimes a contractor's best job is the one it does not get. One bad project can put a contractor out of business. While there are times to take risks—for instance, entering new markets, working with new owners or taking on larger projects than normal—those risks should be part of a broader strategy. Spreading risk through diversification can help avoid catastrophic failure.

ORGANIZATIONAL ISSUES

People, processes and management errors represent a breakdown in the system. Insufficient "real" capital or profit indicates the accounting system produces insufficient information for decision-making.

Construction company financial statements are notoriously suspect because of the large number of estimates used to prepare them. Frequently, a substantial portion of a contractor's equity is based on percentage-of-completion estimates of projects, and the actual results are not known until the projects are complete. Phantom profits or equity can disappear and leave the firm in financial distress.

Another organizational issue is a lack of business acumen. Many good builders may not be skilled businesspeople. Financial management capability, marketing knowledge, business strategy and risk management skills may be lacking in the management of construction companies.

Construction firms often fail when moving into the next generation, whether the company is a family business, partnership or publicly owned. If the success of the firm revolves around a single, strong leader, it also may be in a position to fail if that leader can no longer lead. If the construction firm does not have a leadership succession plan in place, the business is at risk. Leadership succession is not only a question for top executives, but for those throughout the firm.

Great execution can overcome a poor strategy, and the wrong project manager or superintendent—or high turnover in these positions—can make a good strategy go bad. Adequate project control systems are critical to identifying problems early and making mid-course corrections. Even good project managers may not perform well if the systems for success are not in place.

Working with a difficult owner is a frequent reason cited for contractor failure. A poorly financed owner may cause slow pay or no pay and create liquidity problems. Disputes resulting in claims, litigation and unsigned change orders can leave the contractor in a poor negotiating position, with substantial cash tied up in a project susceptible to bankruptcy.

UNCONTROLLABLE ISSUES

Contractors can control strategic and organizational issues, but economic volatility and changes in the credit market are out of their hands. Downturns in construction tend to be sudden and severe, and can catch an unprepared firm with too much overhead or precipitate taking very low-margin work. To avoid crashing, contractors should monitor economic trends and prepare contingency strategies.

Credit markets, including surety bonding and banking credit, are the lifeblood of the contractor. Changes in the underwriting standards, like those that occurred after 2001, can create difficulties for contractors pressing the outer limits of their credit availability. In fact, several firms have sold or downsized in the past few years due to changes in the credit markets.

Firms can be more successful by studying past failures. Understanding the reasons contractors fail will help improve the industry's reputation and the credit market response, leading to a better industry for all.

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