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How contractors can survive a downturn

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There have been construction industry rumblings for some time now that the boom that many contractors have been enjoying for years might be coming to an end or at least slowing down.

Yet contractors are still reporting that they're busier than ever and, according to the Associated Builders and Contractors, are enjoying near-record backlogs.

One theory is that the lack of skilled trade workers is creating a project logjam that is camouflaging a less-than-sunny outlook. Nevertheless, preparation for the worst never hurts, and there are ways that contractors can protect themselves from potentially rockier economic conditions ahead

"I don't think you can ever recession-proof anybody in this business, but there are certainly ways to be smart — ways to plan and not to be taken by surprise," said Jack Callahan, construction industry leader at financial consultancy firm CohnReznick LLP. "You just can't let it sneak up on you again." Recalling the Great Recession, he said, plenty of contractors were forced out of business by not taking the proper precautions.

Many of these measures represent strategies that contractors should consider implementing no matter the economic landscape.

Cash flow management

"When contractors get in trouble," Callahan said, "it's usually because they run out of cash."

First, he said, contractors should make sure that the ultimate funding for their projects is secure and that there are no issues that would keep an owner from paying bills in a timely manner.

One way this can be accomplished, if the contract allows, is to simply ask for proof that the owner's financing is in place. In the American Institute of Architects' A201-2017 General Conditions of the Contract for Construction, for instance, contractors have the right to ask for financing information before they start work and if there are late payments made during the course of the project. If the owner does not provide that information within the time specified in the contract, then contractors don't have to start work — or can stop it — and bill for delay-related costs.

Now is also the time for contractors to get their own financing in order, said James Miller, partner and member of Marcum LLP's national construction industry group. That includes going after a line of credit before they need it. Business owners should also take the time to reevaluate their current loans and, even though it's still early, keep them termed out as long as they can so that they have the ability to preserve working capital if the industry does take a hit. Extending a loan or negotiating new terms will be more difficult if banks tighten up their lending policies in reaction to market conditions.

Contractors also might want to think about being a little more conservative with their cash right now, Miller said, and forego investments into unrelated businesses and personal luxury purchases. "From a construction standpoint, that cash should be used ... to invest back into the construction company, not to fund other ventures," Miller said.

This is also a good time, said Joshua Atlas, partner at Saul Ewing Arnstein & Lehr in Ft. Lauderdale, Florida, to be proactive in the collection of accounts receivable, in relation to both past-due invoices and current billings.

General and administrative expenses

How contractors handle their general and administrative expenses also tie into cash flow, since this category of costs mostly remains constant regardless of how much work there is — or isn't. Typical G&A expenses include rent, utilities, office supplies, lawyer fees and executive salaries.

"You always want to make sure you have backlog with a gross profit that's going to cover expenses for at least a year," Miller said. Then, since G&A expenses are usually consistent, contractors want to make those as lean as possible.

"If you've been thinking of trying to make your business more efficient and streamlined," Atlas said, "[a potential downturn] would be a good incentive to take a little bit more of a proactive approach, whether it's trimming operations or consolidating programs and functions."

Monitor financial health and keep tabs on project changes

"A contractor that doesn't have financial information readily available — that puts them behind the eight ball," Miller said. "If they are looking at a December financial statement in June of the following year, what is that really telling them?"

And if a contractor is not getting regular job cost reports, Callahan said, that can become especially problematic. Real-time reports are the only way contractors can react and make any necessary adjustments to their operations.

In addition, smaller contractors should have a construction accounting professional to whom they can turn for timely, up-to-date information about the financial state of their businesses, Miller said. Most beneficial, he said, for those contractors that can afford it, would be a full-time, seasoned construction CFO who can not only analyze financial information but can help develop company-wide best practices.

That person is invaluable, Miller said, because he or she also can help manage the financial stability of the company while the owners are out doing what they do best, like managing field operations or procuring work.

The CFO or business owner should also take time to set rules around project updates, if they aren't in place already. "Having timely project manager meetings," Miller said, "can significantly impact a contractor's business." These are meetings during which project managers can alert ownership to change orders or any other issues that will have a future financial or logistical impact.

Stay in your lane

Some contractors get growth hungry, Miller said, and chase projects outside their geographical region or their expertise. At the end of the day, he said, the types of projects with which contractors have the most experience — the ones they're hopefully making high margins on right now — are the ones they want to keep pursuing. Too many contractors, he said, get caught chasing the top line when there are plenty making a good amount of money sticking to what they already do well.

Even if the project is within the contractor's area of expertise, though, a shift from the private to public sector can mean trouble, Miller said. Those contractors will find themselves competing against companies experienced with public work and all that entails, such as paperwork, possibly project labor agreements and union labor, lower margins and payment terms that could extend to 120 days. This could be particularly hard on specialty trade contractors that have to pay their own labor every week or two.

Then again, Atlas said, public work can offer steady revenue during slower times, so it's not an option that contractors might want to dismiss entirely. It depends on their backlog and how their niche is faring.

Be it in the public or private sector, Callahan said, one thing contractors don't want to do is engage in a "death spiral" race to the bottom by lowering their pricing just to get work.

Review legal aspects of the work

Contractors should take the time to review legal options, Callahan said, and get squared away on the terms of their contracts. Is there a bond that contractors can look to if they don't get paid? How do they protect their lien rights? The rules around filing and perfecting a mechanic's lien can vary significantly from state to state, so contractors have to make sure to do a little research on the notice requirements and filing deadlines in the jurisdiction where the project is located.

For new contracts, Atlas said, contractors should focus on negotiating the most favorable terms in case of a termination for convenience if the project is canceled for lack of financing. The things to shoot for are a termination fee and costs related to demobilization, he said, as well as overhead and profit.

In addition, escalation clauses can be useful to help mitigate the effects of rising material prices. Whether related to tariffs, supply chain concerns or a volatile raw materials market, fluctuations can negatively impact the bottom line.

This period of time leading up to what might or might not end up being a recession, Atlas said, gives contractors a chance to reevaluate their business platforms, get lean and focus on their strengths — whatever made them successful in the first place. Contractors that go into a downturn strong, he said, also have a better chance of surviving it. In addition, many construction industry leaders — including lenders and developers — learned some hard lessons during the Great Recession and will be less likely to repeat them.

"The whole process, from top to bottom, is more capable of withstanding a downturn because it is more solid to begin with," Atlas said.