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Evaluating Resilience: How Construction Firms are Responding to Economic Shifts

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Macroeconomic factors continue to drive change within the construction industry. In an economic environment defined by unpredictable movement and high volatility, surety professionals and their construction clients must recognize the warning signs. This article will examine the financial issues contractors are confronting, the means they are employing to navigate those changes, and the potential pitfalls associated with their favored methods. A more holistic understanding of how contractors are adapting to today's market provides a better chance of accurately identifying the pressing risks of the moment.

The Challenge: Materials

By the time the first COVID-19 case was discovered in the U.S, it had already wreaked havoc across much of the world, including the U.S.'s top trading partner, China. The resulting production and shipping complications were immediately clear to all, and the latent weakness in the just-in-time supply chain turned into a gaping wound. "Supply chain disruption" became a ubiquitous term to describe an issue that was challenging virtually every sector, but it may have been particularly devastating for construction. That's because remote work arrangements resulted in a glut of contracting work. More people suddenly found themselves spending more time at home, so they finally got around to tackling home improvement projects themselves or hiring contractors. Unfortunately, that work stalled for many as a result of shipping and production bottlenecks caused by factories running with reduced workforces and waterfronts littered with undelivered crates.

The Solution: Stockpiling

Enterprising construction firms were quick to stock up on those sorely missed parts and materials as soon as they became available. Some went so far as to purchase materials for months in advance – requiring the purchase or lease of warehousing space. This helped ensure that current backlogs would be completed on time and within budget. And, as supply chains recovered, there was a clear advantage for those that stocked up – competitors might still be fighting over materials while they were back at work and winning more bids. But it wasn't too long until the dust settled, prices on materials started evening back out, and interest rate increases slowed the demand for new construction and home improvement projects.

The Risk: Increasing Liabilities

Now those same contractors that looked ahead of the curve may appear to have overreacted. To be sure, their efforts likely served them well during a difficult time; but it now seems as if they may have invited new headaches. In hindsight those large quantities of goods purchased for future projects were likely bought at vastly inflated rates while storage and transportation contracts may have added large liabilities to their balance sheets. The rental of warehousing space is one factor but consider that these contractors also started paying twice as much for transportation. Instead of paying for the transportation of materials directly to a job site, they now go to a warehouse for storage until they can be used, at which time they are loaded and shipped again.

From a surety's perspective, it's important to see how the company in question adapted to changing conditions, not only during the pandemic but also now that supply chain issues have settled somewhat. It may be worth asking: did construction firms manage to move excess stock while supply chains were showing signs of recovery but demand for materials was still high? Have construction firms managed to work with the owners of rented warehouse space to reduce or renegotiate contracts? Are they using material stockpiles to their advantage by prefabricating some components, so time spent on site is more efficient? If the answer to the questions above is "no," ask this: did the firm inadvertently respond to short-term risk by incurring long-term risk?

The Challenge: Labor Shortages

Labor shortages are nothing new for the construction industry, and most companies have been and continue to struggle to find ways of resolving their labor headaches. The rise of joint ventures in construction serves as testament to just how important the labor situation currently is. It wasn't that long ago that the prospect of a joint venture between fiercely competitive construction firms would have been a non-starter, but the advantages of a combined workforce have quickly become clear.

The Solution: Joint Ventures

For companies that recognize they need substantially stronger labor resources, establishing a joint venture–and all that entails, including shared profits and the bifurcation of responsibilities–is a bitter pill made easier to swallow. By combining forces, capabilities, and resources increase; and large projects are immediately more realistic. With trends suggesting that the demand for industrial and manufacturing work will continue leading the demand for residential and commercial work, there's a big incentive for many small and mid-sized firms to strike up more collaborative relationships and seek more expansive projects.

The Risk: Relationship Issues

When it comes to joint ventures, a share of the profits also means a share of the risk. Obviously, joint ventures open a whole new world as far as the paperwork associated with projects. The new entity needs to be created and there will be new financing agreements, indemnities, pay structures, union and non-union labor considerations, and other agreements. That's assuming things go swimmingly and the prospect of litigation never arises. But beyond those concerns, there are other aspects of joint ventures that require serious consideration.

Minimizing exposure to risks associated with joint ventures requires the early involvement of a qualified lawyer and thorough knowledge of how each partner organization operates. If anyone is cutting corners or less than ethically spotless, every organization involved could be (at least partially) on the hook for unscrupulous actions.

The Challenge: The Number Game

Balance sheets have always been a crucial source of insight into a firm's operations; that's certainly nothing new. But we're coming off a period of huge monetary intervention in the forms of the Paycheck Protection Program, Employee Retention Credit, and other forms of government assistance. Not every business thinks ahead to leaner times. Now that those programs are off the balance sheet, many contractors are looking at less robust financials and need to closely manage their capital expenditures and cash reserves, among other key areas. That affects every aspect of their business, from their financing applications to transaction negotiations.

The Solution: Exits and Consolidation

With money sloshing and demand sky-high, it's easy to understand why many in the construction business executed exit strategies and sold their businesses to competitors or investors. In retrospect, they may have secured top dollar for their firms as demand was peaking and interest from private equity was growing. Now, companies that are similar in size—and even similar in terms of performance—are looking at the other end of the macroeconomic spectrum but expecting similar pay-outs. Because backlogs are still long, it's entirely possible that the long-predicted recession will have come and gone by the time it threatens construction. Let's err on the side of optimism and hope that's the case. But even if the industry avoids any long-term recession-related threat, for those that haven't sold and still remain in the business, it's still a much tougher environment for all sorts of financial activity.

The Risk: Expectations and Comparisons

Whether it's a sale or financing deal, the contracts that would have closed at a 4% interest rate are non-starters at 6%. As rates rise, investors are seeing similar returns (with none of the risk) in treasury products. Plus, we've all seen the headlines and understand some banks are struggling. Factor in that the reckoning has yet to arrive for commercial real estate, and it seems safe to assume that (a) demand in

certain sectors may never reach its former heights, (b) liquidity will remain as tight or tighter for some time, and (c) in every financial context, each dollar makes a difference.

Contractors need to forget about the deals that went through two years ago and recognize that it's a whole new ballgame. Those that take a forward-looking, realistic approach over a three to six month-period and put together a strong financial foundation increase their chances of success.

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