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Avoid Concentrations to Maintain a Diverse, Successful Construction Company

By Robert Mercado and Christopher Sisk | Thursday, October 10, 2019

The current political climate has the stock market and international trade in permanent flux. Given this vulnerability, businesses should examine the various factors that contribute to the success of the company. Concentrations can exist in a variety of forms:

1. The volume of business transacted with a customer, supplier or lender;
2. Revenue from products or services;
3. The available sources of supply of materials, labor or services; and
4. The market or geographic area.

It is important for contractors to identify the critical components of their business and what ultimately makes them profitable. Contractors should analyze their customers, vendors, labor force and geographic operational area while remaining current on laws or regulations that will affect business operations.

CUSTOMER CONCENTRATION

The largest concentration focus is based on customers, which drives contractor revenue. It is important to understand who customers are and understand their demographic, as well as the general business and economic environment in the contractor's area. This is an easier task for those solely conducting business in the United States; however, state and local economies are not immune to global economic factors and events. The largest issue locally can be conducting business across state lines and understanding business practices in each respective state, such as income and sales tax laws, and union or labor laws or regulations.

Companies should determine the amount of revenue derived from each customer on a yearly basis. If a majority of a company's revenue is derived from one or a few major customer(s), the loss of those major customers could have a devastating impact on the viability of the company. This analysis should be done on a yearly basis to understand the risk. Business owners and management should focus attention on diversifying the company's customer base to minimize the impact of having all or most of the company's revenue reliant on one or a few customers.

GEOGRAPHIC CONCENTRATION

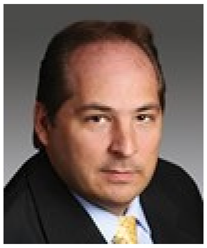
Due to current economic conditions, contractors are experiencing the largest backlogs that they have in years, if not ever. This may prove positive for now; however, should the economy begin to soften, backlogs will start to retreat. This may force contractors to secure work outside of their home state or states where they normally work. It's imperative that contractors research the states in which they bid. Without clear understanding of local conditions and proper guidance, businesses risk failure in uncharted territory.

Conducting business internationally can be a far greater challenge for business owners when concentration issues are taken into account. Consider this real world example: Contractor XYZ purchases approximately 80% of its steel from China. As soon as the trade wars with China began in 2018, the cost of the steel increased as the result of the new U.S. tariff of 15% to 25%, thus forcing Contractor XYZ to use local vendors. While a less expensive option than importing steel from China, the local vendors were still priced higher than the pre-tariff Chinese steel, adding 10% to Contractor XYZ's cost of materials. Contractor XYZ is unable to pass along the additional cost to its customer, and its profit margin on the job has been squeezed.

SUBCONTRACTOR CONCENTRATION

Another example of a risky concentration is a general contractor that fails to diversify by sourcing multiple subcontractors in a particular specialty, for example, electrical contracting. Over-relying on one specific subcontractor to handle all of its electrical work poses substantial risk to the general contractor if that electrical sub cannot handle the work load or, worse, goes out of business.

Construction companies face a litany of challenges in their daily operation. To mitigate risk, it is vital to diversify where possible and actively manage potential concentration issues. Global economic affairs can affect economic conditions at the state and local level in the United States, so even contractors who do not operate internationally need to take steps to mitigate their risks. It is especially advisable to be alert to a single customer, supplier, or other concentration that can potentially have a dramatic effect on the survival of the business, should market conditions change.



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