

17th Weekly Crisis-era Message to Contractors from: Dr Tom Schleifer
The Concept of “Flexible Overhead”

The US economy has always been and continues to be cyclical, therefore the construction market as an integral part of the economy will continue to be cyclical. When the construction market is growing the industry prospers, however, when the market declines, the industry suffers reductions in profits and exposure to loss. The reason is that growth requires additional overhead expenses in the form of personnel and resources which are brought on as permanent fixed costs. When the market declines it is extremely difficult to reduce fixed overhead because you cannot eliminate half a person or half a truck. The current construction business model of permanent fixed overhead is the cause of the industry’s boom and bust cycle. This raises the question: If a firm earns a certain percentage of profit putting X amount of work in place in a year, shouldn’t it earn the same percentage of profit the following year when it puts in place, perhaps 15% less work? Most don’t.

Construction enterprises make more money in good markets than they make or lose in downturns and because the length of growth periods have been longer than the downturns, most come out ahead. This has been going on so long it is generally accepted as a cost of doing business. However, the cyclical nature of the business is one of the reasons the construction industry has the second highest failure rate in the nation. The business model must be modified to a process that allows construction organizations to prosper in both good markets and bad. It makes no sense that a growing company that has been profitable at eight, then nine, then \$10 million in sales would automatically lose money if it is forced back to nine or eight million dollars by a decline in the market.

If the company made money growing to \$10 million, is it forever barred from profiting if it is forced to downsize? No, but to be profitable after reduced sales of 10% or 20% they would have to immediately reduce overhead costs by a similar amount. Most say: “Impossible! It can’t be done” and they are correct if overhead remains the same. Whether they recognize it or not, if a construction enterprise is forced to reduced sales they are also “forced” (if they choose to make a profit) to reduce overhead expenses accordingly. I say “choose” because this is a management decision, and they have a choice, but reducing overhead is painstaking. *Flexible overhead* is a process that allows the reduction of overhead costs without the stress of laying off core key people and incurring the cost of disposing of idled resources, both of which will be needed in the future when the market recovers.

Planning on continuous growth cannot work in a cyclical market. The successful construction enterprise of the future will be organized to go up and down in sales to cope with cycles and other market conditions, and never feel compelled to chase inappropriate work just to maintain volume. The contractor of the future will be profitable in good markets and bad and the drive for size will be substituted with a drive for prosperity. The *Flexible Overhead* concept is a method of managing overhead that enables you to reduce it by 15% to 25% in a week or less. The process allows you to do that without disrupting your organization or losing core key people. The 15% to 25% range is dependent on individual circumstances and choice. Most organizations start the process small to be comfortable that it works and then increase towards the upper limit. Flexible overhead can be introduced during a growth market or at the end of a declining market where it may actually be easier if a firm has been forced to lay off personnel (as many will before this crisis is over). Implementation requires minimal effort and the benefits are immediate, such as being able to profit in good markets or bad, and experiencing the satisfaction of never wasting hard-earned profits from good years to pay for surplus overhead you don’t need in bad years.

It is natural and understandable to resist voluntarily giving up hard-earned growth. When I ask a contractor audience to select one project from a prior year that they wish they never had, most pick a job that lost money. They are wishing for smaller volume and more profit which suggests that downsizing is an appropriate choice. The marketplace is unpredictable, affected by so many variables that it is difficult to accurately forecast even a few years out or to predict the next down cycle. While a growing enterprise cannot be sure of a favorable market in the future it does need to add overhead to expand. That risk can be controlled by putting on overhead that can effortlessly be removed if the market turns down. With a portion of your overhead being adjustable, you are no longer compelled to maintain sales at any cost but can fall back if necessary and concentrate on profit.

Companies using flexible overhead manage their profit not their volume. They can also manage sudden increases in volume of 25% or more because they are able to adjust overhead resources up or down quickly, temporarily and economically faster than the average firm can secure permanent resources. This practice is a departure from the norm but is clearly the profile of the successful contractor of the future.

The research has been completed, measurements made, and the reality tested. *Flexible overhead* is no-cost or low-cost insurance against profit shrinkage and losses by being able to shed overhead instantly in a market cycle downturn, It also enables you to turn off overhead costs for a few weeks or months for short-term eventualities that slow the work. Such as: When a major project is delayed, when an exceptional number of bids are missed in a row, or when for any reason work falls off. Continually profiting in good times and bad offers a whole new appreciation for the construction business. The only downside is we won't be able to complain as much about what a tough business this is. Details on how to implement *flexible overhead* next week.

Next week: Embracing Flexible Overhead.

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Note: Information on overhead management can be found on letstalkbusiness.net click on "Manual" and go to Managing Overhead in the table of contents.