

22nd Weekly Crisis-era Message to Contractors from: Dr Tom Schleifer
Reader Questions and Answers

Question: *Tom, You say less work/less risk. That's a hard concept to sell. Could you elaborate on how you would plan the top line if you were running a construction company during this pandemic?*

Answer: The construction market, like most markets, functions logically and is, therefore, predictable. In a growth market there is an increasing amount of work available with the same number of contractors competing for it which reduces the pressure on pricing and produces a seller's market (through natural commercial dynamisms). In a seller's market prices escalate and profits grow.

The opposite occurs in a downturn. When the same number of contractors compete for less available work, a buyer's market develops and the selling price of work goes down with (self-inflicted) aggressive competition for the lesser amount of work. Profits suffer as contractors fight vigorously to maintain their hard-earned size or to at least capture as much work as possible. With less work to choose from contractors tend to expand the area they work in and many feel they have no choice but to go after whatever work is available even it is not the type of work they are normally successful at. Both of these changes compound the risk, further reduce profits, and escalate the potential for losses at a time when profitability is already suffering.

I say less work/less risk because under declining market circumstances, loading up a cheap work, or taking work outside a firm's normal area or of a different type seriously magnifies risk in an already high-risk business. If I were running a construction company during a downturn (as I have in the past), I would look for work in areas and in type that I am almost always profitable at. History assures that construction profits will shrink across the board in a downturn, so I know I am going to have to reduce margins to get any work. Therefore, I need work that I know I can execute well, and if I work hard, I may be able to squeeze another point or two out of it, particularly if I have the time to concentrate on it. For that reason, I don't want a lot of cheap work and I certainly don't want cheap work in an unfamiliar area or of a different type than I am use to because the odds of improving on bid profit are nil.

While some would never use the term "too much work", there is such a thing in a down market (and in a growth market). I am reasonably sure we all agree that project profit is directly proportional to the amount of time and effort put into pricing, execution and attention to detail, all of which improve with less work and suffer with too much work, particularly when selling prices are falling. To drive home the point let's recall that prior to 2008 our industry put in place nine hundred billion dollars of construction in a year at record high profits and went on to do the same at one trillion dollars. During the subsequent recession, our industry again put in place nine hundred billion dollars in a year but at record low profits.

We seem to excel as long as we are doing more work than we did the year before. But when we produce the identical amount of work but it is less than we did the year before we suffer reduced profits. It does not have to be logical—it is fact. Why? The business model based on continuous growth does not work in an industry with a cyclical market. When the market downsizes, we have to downsize with it. If there is less work available and a contractor insists on maintaining size, he or she is going to have to take the work off another contractor who will then have to get that much smaller. However, other contractors don't give that work up without a fight, so the price war begins. I hope this is responsive to your question and I welcome comments.

Question: *Dr Schleifer, You say that during this downturn, buyers will be adjusting prices downward and margins will be slim. What do you suggest we do about that?*

Answer: As I discussed above, during a down market aggressive pricing drives prices down and buyers of construction services (owners) know that. In a downturn it becomes obvious when jobs put out for bid immediately experience an increase in the number of bidders and bid spreads (the difference between low and high bidder) get farther apart. I periodically monitor the numbers of bidders and bid spreads around the country using a formula that defines the market and assists in projecting which way it is trending. In a good market you might see three to five bidders and very tight bid spreads. In a down market 15 plus bidders is common and 20 or more happen. Bid spreads widen to as much as double or more. Owner's reactions are what you might expect. During the 2008 recession numerous public and private owners that had been using Construction Management, Design Build, and other alternative contracting methods switch back to lump-sum bidding. While the reasons seemed obvious, I studied the issue and was told consistently by owners, their representatives, and other buyers of construction services, in one form or another, that construction had become a buyer's market and the best way they could see to take advantage of it was to go out for bids and save money.

As to what I suggest we do about it: There has been a huge effort for many years by Simplar Institute at Arizona State University and others to explain and promote to owners and buyers the value of alternative contracting methods such as "Best Value" and other methods. The construction industry has been slow to get behind this movement but if contractors would unite they can prevail. My opinion is that the best way to promote alternative contracting methods is to explain and define the many shortcomings and disadvantages lump sum bidding has for owners. The "low bid gets it" method is long past its "use by" date. I hope this is responsive to your question and I welcome comments.

The questions allow readers to steer the subjects addressed. There was not enough space to get to all the questions so we will continue next week.

Next week: **Continued response to questions and comments from readers. Send questions/comments to tom@schleifer.com.**

To assure you will continue to receive the free weekly Crisis Message send your email address to tom@schleifer.com.

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

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