Tips to help construction businesses control costs and improve profits

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Construction was clearly one of the most hard-hit sectors during the economic downturn. Overall spending on residential projects, nonresidential buildings and nonbuilding structures declined for five consecutive years before bottoming out at $788 million in 2011.

However, as the U.S. economy continues to improve, the construction market is gradually picking up steam. In fact, according to a spring 2014 report[1] by FMI, overall "put in place" construction projects are forecast to reach $959 million this year, a 7 percent increase over 2013. Investments in multifamily housing projects (21 percent increase), single-family homes (14 percent increase), and hotels and lodging facilities (14 percent increase) are expected to lead the way.

This period of slow, yet steady growth is an ideal time for construction companies to revisit the methods they use to control costs and improve profit margins. While extensive cost-cutting actions were often needed for survival a few years ago, this article will discuss a targeted approach for evaluating current state issues, maintaining specific cost control measures, implementing profitability improvement opportunities and leveraging profit improvement as the volume of construction work increases. Taken as a whole, these approaches can improve overall financial results and dramatically increase profitability as the construction industry recovers.

Evaluating current state issues

A successful current state review begins at the top. Your leaders must be focused on the bottom line, ready for change and able to manage profitability as volume increases. But, before getting into specific reviews of your company's operating model, costs and profit drivers, take time to conduct a high-level SWOT (strengths, weaknesses, opportunities and threats) analysis. A SWOT analysis helps leaders identify significant issues that could be holding back organizational performance. This tool is particularly useful for identifying and leveraging your company's strengths, while also uncovering areas for improvement. If your organization has not performed a recent SWOT review, now is an excellent time. Why? Because in many cases, the value proposition between your company, its customer base and other key stakeholder issues may well have changed.

What should these reviews include? Consider the following items:

- **Process assessment.** Each member of the management team should rate business processes that have gone well (or poorly) during the last 12 months. In a construction business, key processes to evaluate include estimating, pricing, project management, communication, scheduling, subcontractor management, job costing, and project closeout and lessons learned. Remember, ineffective processes can be strained after a period of employee reductions and that strain may only intensify as construction volume increases.
- **Financial assessment.** For this step, take time to benchmark your company's key past performance indicators, such as overall gross profit margin, gross profit margin by type of work performed and customer-specific opportunities (or lessons learned). In addition, study related financial performance indicators, which may include revenue and expense trends over time, estimated profit margins of jobs in process, actual margins of completed jobs and the dollar margins needed to cover overhead (nondirect) expenses for an acceptable profit level.
- **Customer type assessment.** Most commonly, this involves evaluating the types of customers you have (such as hard bid, not to exceed, negotiated, design-build, renovation or service), allowing you to quantify financial success within each type. This, in turn, helps you identify optimal customer niches to pursue. In addition, seek out building owner or architect input on recent projects, which can help you better understand the most important value drivers that customers believe distinguish your firm from its competitors. With a clear understanding of these specific value drivers, your business is in a stronger position to shift resources to these valued market niches, while pursuing increased pricing for your company's expertise.
- **Internal issues review.** Each member of the leadership team should identify perceived constraints and dependencies within their function and also within the company. For example, many construction companies sharply cut workforce and capital expenditures during the recession, and may now be scrambling to ramp up capacity as project opportunities increase. This can lead to a short-term risk of not being able to manage profitability on increased volume. By uncovering such key internal issues, your leaders can accurately identify sound operational improvements or other actions necessary to drive overall profitability.

With the current state evaluation work complete, the next step is to roll up your sleeves and focus on cost control and profit improvements. To do this, it's critical to identify the core and noncore drivers of operating activity, determine how those drivers can be enhanced by cost control or profit improvement activities, and reward leaders for their results. Let's take a closer look at each of these areas.

Key review areas for construction company cost control

To understand the importance of effective cost control, look no further than feedback from a recent industry survey of construction project owners, clients and investors. While low price was a core priority for this group, respondents to the 2013 U.S. Markets Construction Overview[2] also said they wanted "less contentious and more collaborative" options for managing project costs. When presented with choices, owners ranked the pre-construction service of "involving construction managers/contractors earlier on the project" as the most favorable cost control option (16.3 percent). This was closely followed by "changing delivery methods: design-build" (15.5 percent) and "considering alternative materials" (14.6 percent).

While all businesses can benefit from stronger cost control measures, there are specific areas within most construction companies that merit early review. These include:

- **Looking closely at efficiency and productivity.** This area is described as the "new normal" in the 2013 U.S. Markets Construction Overview[3], largely because of the combination of a lengthy market slowdown and increased pricing pressure. That makes it imperative for construction company leaders to take a hard look at the processes, procedures and systems they use to measure job efficiency and worker productivity. For instance, many construction firms do not do enough to maximize field employee efficiency and minimize time paid while not working on a construction project. Without close monitoring of this activity, it will be difficult to maximize the value-added activity of your company's labor force.
- **Planning for variable demand.** For the past several years, most construction business leaders have managed for survival—not for growth. While residential and nonresidential construction markets are finally showing some signs of life, forecasters are still skittish about labeling any movement as long-term recovery. For that reason, leadership teams need to develop a game plan that can accommodate both sudden increases and decreases in construction volume. A key component of that plan is to increase the company's percentage of variable costs, which may involve using more subcontractors on projects or renting (rather than buying) more pieces of equipment. This move keeps cost structures more flexible and operational activity easier to scale up or down on short notice as market demand changes.
- **Minimizing—or better managing—unprofitable jobs.** Most construction companies manage a majority of their jobs to be profitable each year. However, since just a handful of bad jobs can really hurt profitability, reducing those risks can be vital to your success. Generally, there are two key ways in which construction businesses can try to avoid low- or no-margin jobs. First, develop screening criteria for each potential bid or invitation to determine if the prospective job fits your company's core niche, is within the scope of your firm's labor and technological resources, and offers bid criteria that allows your company to take an acceptable profit margin. Second, do a monthly detailed profit margin review on all projects not going well or those considered to have a high risk of noncompletion. Remember, a lot of job site activity isn't positive if projects are delivering little or no incremental profitability on your company's investment of labor, materials and management expertise.

Core review areas for profitability in construction businesses

While overall economic conditions continue to improve, margins for U.S. construction businesses are still under pressure. In its 2013 Annual Financial Survey[4], the Construction Financial Management Association (CFMA) reports that the average return on assets was 5 percent last year, down from 5.5 percent in 2012 and 11.1 percent in 2011. Average return on equity stood at 14.2 percent in 2013, also down from the previous two years. More specifically, gross profits fell to 9.1 percent in 2013, which CFMA notes is below the five-year average of 10.2 percent. Similarly, net income stood at 2.1 percent, also below the five-year average of 2.7 percent.

In construction companies, some primary areas to review for potential profit improvement actions include:

- **Strengthening cash flow.** In the CFMA survey, the average construction business waited nearly 52 days for payment on accounts receivable, an increase of nearly two days from 2012. That delay slows the cash conversion cycle, hindering day-to-day operations. Companies can boost cash flow by tightening customers' payment windows, adding penalties for late payment and more assertively following up on overdue invoices.

- **Enforcing margin management.** As previously noted, unprofitable jobs add little value and stretch precious resources. That's why it's important for your leadership team to establish a disciplined approach to pursuing and winning work in market niches where your company has a competitive advantage. By taking this route, your firm can attempt to pursue and win work with good margins instead of operating in the commodity bid spaces where jobs may be plentiful—but competitors are many and margins are thin or nonexistent.
- **Driving operational improvements.** In many construction businesses, there's only a loose connection between key operational areas, such as estimating, job costing, field employee productivity, subcontractor selection and oversight, and overall project management. By designing a series of handoff steps or assigning an overall project manager to coordinate all these activities, your company can shorten construction timelines, cut duplicate efforts, minimize miscommunication and boost the odds of successful job completion. Those benefits, in turn, boost overall profitability.

How to get there:
Build and reward profit improvement with leaders and team

Whenever a business works toward these kinds of cultural changes, a critical first step is to gain organization-wide support. To do this, your leadership team must clearly explain any planned changes, show how they benefit the business, and why teamwork and collaboration are required to reduce costs and improve profitability.

Before moving forward with an incremental profit improvement focus, make sure all planned initiatives have been prioritized for bottom-line impact, required implementation effort and potential ripple effects on business operations. Each construction job team should be assigned key cost or profitability focus areas identified by your leaders, and team members should be chosen based on their specific expertise in addressing those challenges. Once teams are selected and assigned, the next step is to integrate their activities, which helps you capture and leverage successes as best practices across the company.

A final point: While the work of profit improvement teams should be measured, remember that many times these roles are in addition to employees' normal jobs. For that reason, consider rewarding those teams that deliver workable ideas for improving productivity, decreasing costs or developing new (or more profitable) markets. This type of incentive is a terrific way to gain employee buy-in at all organizational levels, and it sends a strong signal that your leadership team is fully invested in cost control and profit improvement activities.

Ready to learn more?

Are you interested in learning more about how your construction company can design and implement a sound cost control and profit improvement program? Contact Scott Hauser at 319.298.5299 or Casey Chapman at 816.751.1871.

Sources:

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