

Guest Article

What Steps Not To Take From A Financial Standpoint

FMI Articles Outline Reasons Contractors Go Bankrupt

Note: The following is the first in a two-part series from FMI on why contractors fail financially. The installment in the next Builder will cover business development, picking the right customers and managing risks.

BY HUGH RICE
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Construction is a risky business. Often that risk rears its ugly head and causes life-threatening losses for construction firms. The ultimate reason that contractors go broke is that they run out of money to meet payroll and pay bills. But, what events lead up to that point? What are the underlying causes of contractor failure?

In conjunction with the Construction Industry Round Table (CIRT), FMI is currently researching the causes of contractor failure. The first part of this research involved a study of the existing literature to determine what is known about business failure. The initial research confirms that the failure rate for construction firms is higher than most other industries. The following compilation represents FMI's "Top 10 Reasons Contractors Fail."

STRATEGIC ISSUES
OVEREXPANSION/FLAWED STRATEGY

Growing too fast and beyond the financial and human resources of the firm is a classic reason for contractor failure. Eternal optimism is part of the contractor mentality and frequently leads to over-committing the firm. Having a rational, sustainable business strategy is key to survival and success.

VOLUME OBSESSION

Contractors define their success by their ENR ranking in terms of revenue or sales. Unfortunately, size and profitability

are not necessarily related. Focusing on volume instead of profits causes over-leverage and a lack of a financial cushion when inevitable problems arise. Perhaps ENR should publish a Top 400 list of the most profitable contractors.

**POOR PROJECT SELECTION,
ONEROUS CONTRACTS, UNREALISTIC
COMMITMENTS, AND RISK
CONCENTRATION**

Sometimes a contractor's "best" job is the one they did not get. Very often one bad project can put a contractor

out of business. Doing the wrong job, for the wrong owner, under the wrong contract terms can be terminal. Spreading risk through diversification can avoid catastrophic failure.

ORGANIZATIONAL ISSUES
**INSUFFICIENT "REAL"
CAPITAL OR PROFITS**

Construction company financial statements are notoriously suspect due

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FMI Example Chain Of Failure



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to the large amount of estimates used to prepare them. Not infrequently, a substantial portion of a contractor's equity is based on percentage of completion estimates of projects, the actual results of which will not be known until the projects are completed. "Phantom" profits or equity can disappear and leave the firm in financial distress.

POOR BUSINESS ACUMEN

Many good builders are poor businesspeople. More and more, business skills determine success. Financial management capability, marketing knowledge, business strategy, and risk management are frequently lacking. Even good technical builders can go broke.

POOR LEADERSHIP AND SUCCESSION

Construction is a people business. Frequently, it is a "person" business because of the importance of a single strong leader. The most common denominator of success or failure of a contractor is the person leading the charge. During the transition from one generation of leaders to the next is when many firms falter.

Downturns in construction tend to be sudden and severe and can catch the unprepared firm with too much overhead.

POOR FIELD PERFORMANCE

Money is made and lost in the field. It is often said that great execution can overcome poor strategy. However, the wrong project manager or superintendent, or turnover at those positions can spell trouble. Adequate project control systems are critical to identifying problems early and making mid-course corrections.

PROBLEM OWNERS

A difficult owner is frequently the downfall of a contractor. A poorly financed owner may lead to slow pay or no pay, creating liquidity problems. Disputes resulting in claims, litigation, and unsigned change orders leave the contractor in a poor negotiating position with substantial cash tied up in the project. That situation can spell bankruptcy. Customer selection is key.

UNCONTROLLABLE ISSUES ECONOMIC VOLATILITY

The construction market is currently very strong, which can lead to good times, overexpansion, and failure. Downturns in construction tend to be sudden and severe and can catch the unprepared firm with too much overhead or precipitate taking very low margin work. Vigilance is necessary to avoid crashing aimlessly on the waves of economic cycles.

CREDIT MARKET CHANGES

Surety and banking credit are the lifeblood of the contractor. Changes in the underwriting standards, such as those that occurred

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after 2001, can create serious difficulties for contractors who are pressing the outer limits of their credit availability.

Several firms have had to sell or seriously downsize in the past few years due to unforeseen changes in the credit markets. This list is only the beginning of the story. For every risk factor or cause of contractor failure there is a "cause behind the cause." For instance, a chain of failure could look like the chart on page 9.

FMI's ongoing research will evaluate 30 to 40 major contractor failures to determine the underlying causes and common themes. Our objective is to help other firms be more successful by studying past failures.

In the meantime, the best advice is to keep some "dry powder." Bad things happen to good contractors. Make sure the financial position of your firm is adequate to withstand the inevitable negative event so you can live to tell about it. Future success is predicated on being in business to take advantage of opportunities.

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OSHA Partnership Signing



*Occupational Safety and Health Administration Area Director Diane Turek (left), The Levy Company Safety Director Bob Smith (center) and Builders Association President Al Leitschuh sign the Builders Association/OSHA Partnership March 2nd at OSHA's Des Plaines office. The new accord will be in effect until Dec. 31, 2009 and replaces the original agreement signed in 2003. Look for more information on the OSHA Partnership and what it can do for your company from a safety standpoint in future issues of *The Builder*.*

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