Construction Quarterly by FORVIS

Confidence Wanes While Backlogs Remain / January 2023

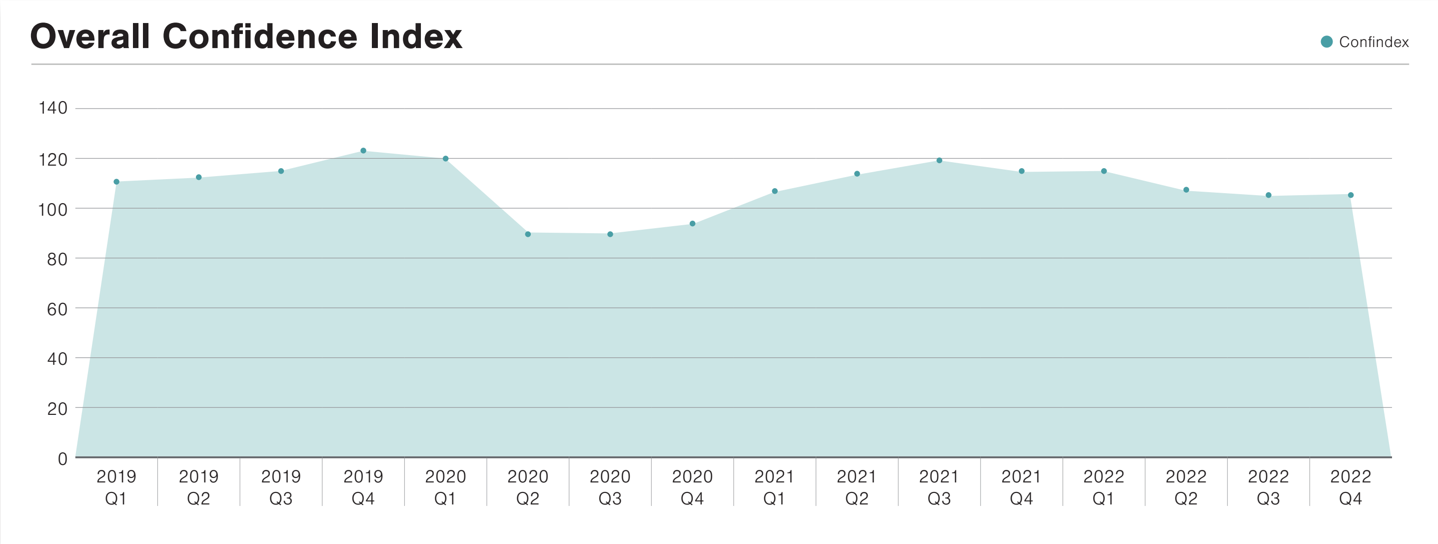
FORV/S

The construction industry came barreling out of 2021 with high hopes for what was to come. Even with supply chain uncertainties, labor shortages, and ever-changing local restrictions, 2021 was a boom for most, and this trend continued well into 2022. In fact, many contractors continued to report revenue growth through the final months of the year.

But financial performance is only one piece of the puzzle. Outlook and optimism matter, too. As we start off 2023, we need to ask ourselves: **Have industry sentiments changed?**

Confidence Is Waning

Each quarter, the [Construction Financial Management Association (CFMA)](https://cfma.org), through its CONFINDEX survey, polls leading financial professionals in the U.S. construction sector to gather both analytical data and anecdotal support to measure the confidence level of the industry. This quarter's report shows that overall confidence in the industry has dropped. Though confidence isn't at its lowest, CFOs' optimism about the year ahead has sunk to where it was at the onset of the pandemic.



SOURCE: CFMA https://cfma.org/articles/current-situation-remains-stable-outlook-deteriorates

**A score > 100 indicates that more respondents are more confident than not.*

Why is outlook falling? If demand is soaring and top-line revenues are high, why has overall confidence dropped?

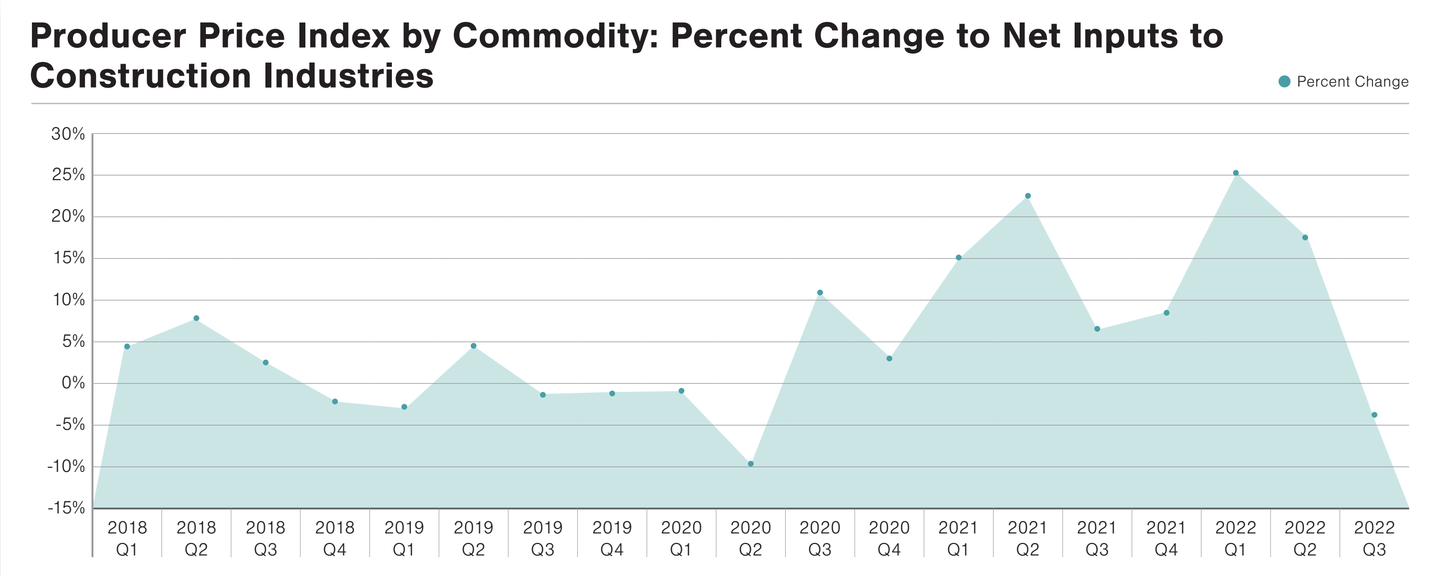
Backlogs Provide Less Comfort Than in the Past

Backlogs have historically spelled good news for construction companies, but this past year backlogs have become a double-edged sword. Of the construction leaders who responded to the CONFINDEX survey, 50% said their backlog revenue is higher than it was a year ago. Unfortunately, while the promise of work is still a great indicator of future revenues, backlogs are not necessarily great indicators of future profits, and that's for a few key reasons.

1. Cost estimates can go stale
2. Contracts aren't guaranteed
3. Clients may be looking for a way out
4. Backlog projects have become more challenging

1. Cost estimates can go stale

Construction projects are consistently being pushed back. Some businesses struggle to acquire the materials they need to complete the job; others fight to get essential tools or equipment fabricated on time; others have a limited pool of labor hours they must allocate among their open jobs. In each of these scenarios, contracts are aging, and they're aging fast. The prices quoted to customers months ago may not be enough to even cover costs today, leaving contractors with smaller and smaller margins.



SOURCE: U.S. Bureau of Labor Statistics, Producer Price Index by Commodity: Inputs to Industries: Net Inputs to Construction Industries, Goods [WPUIP2300001] https://fred.stlouisfed.org/series/WPUIP2300001

2. Contracts aren't guaranteed

Fast-rising input costs virtually guarantee that at least some contracts never cross the finish line. And when high materials prices are combined with rising interest rates, the contract becomes more problematic for both the contractor and the customer.

3. Clients may be looking for a way out

Jobs that have been in the queue for months won't always come to fruition. If contractors fall behind schedule or are unable to secure materials, the buyer may have the right to terminate the project. And because construction needs have shifted in recent years, some parties may even be looking for the chance to terminate a contract.

4. Backlog projects have become more challenging

Recent legislation has made backlogged projects more costly to construction companies than newer contracts.

- The CHIPs and Science Act incentivizes the new construction of certain manufacturing facilities.
- The Infrastructure Investment and Jobs Act provides grants to state, local, and tribal governments that invest in new infrastructure improvement projects.
- The Inflation Reduction Act (IRA) expands deductions and credits that reward investment in clean energy.

Many projects in the backlog don't take advantage of these incentives, which makes newer projects more tempting to contractors and more enticing to their customers.

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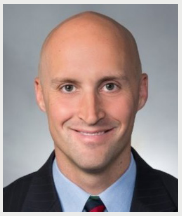


"There are some real fundamental backlog challenges that contractors are dealing with that go beyond just the numbers. Construction leaders whose companies have strong backlogs know to be wary; they aren't as strong of an indicator of high performance as they used to be."

-Jason Myers, Partner & National Industry Leader, Construction & Real Estate

Employees Are Migrating Away from the Industry

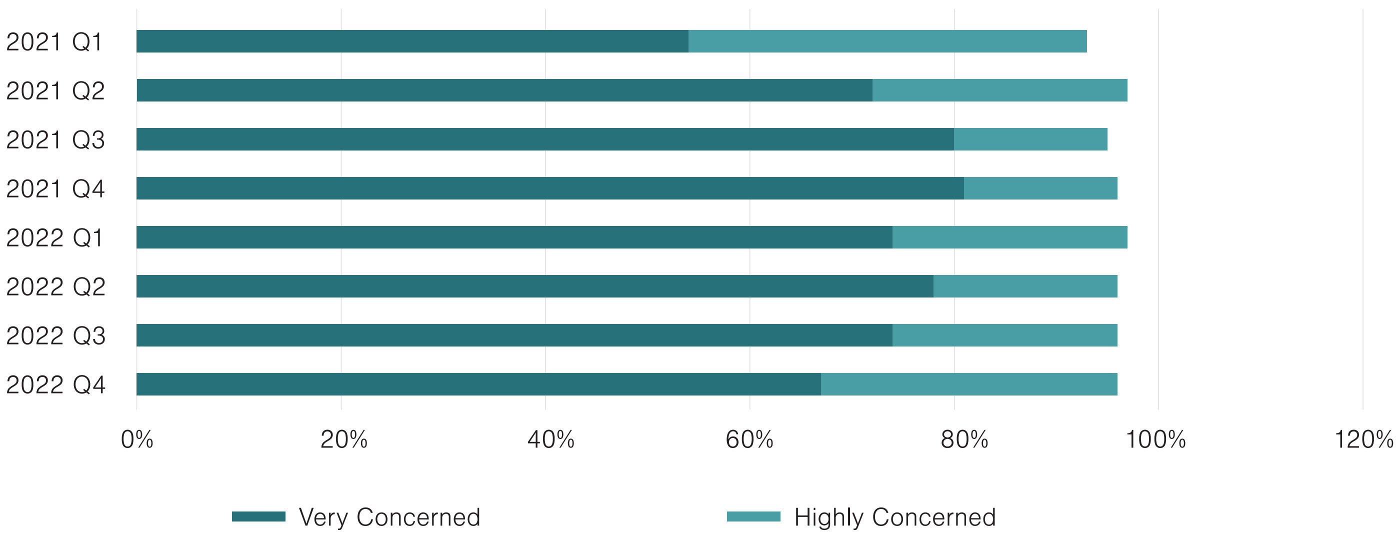
In the past year, we have seen an exodus from the construction industry workforce.

In 2020 and 2021, almost all industries saw a shift in their workforce. There was more interest in remote work, and public fears pushed many workers to re-evaluate how they spent their working hours, some even choosing to leave the labor force altogether. The construction industry was no different.

Securing labor has always been a struggle for the industry, but the pandemic exacerbated that challenge. Initially, when the rest of the world was on lockdown, construction workers continued to travel to job sites. But after some time, these workers realized they could seek out different work. They found jobs in other sectors that were less stressful, paid a similar wage, and let them build a more flexible work schedule that met their family's needs.

It's not just construction laborers who have been leaving; contractors are also struggling to maintain a full roster of highly skilled workers. 67% of survey respondents said they were either very concerned or highly concerned with securing skilled labor this upcoming year.

Concern Over Labor Shortages



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"The labor shortage issue we've seen in the past few years could reverberate for five to ten years. A lot of experienced people left the industry: at the superintendent level, at the project management level, and even at the craft level. That hands-on experience—iron workers, brick masons, pipe fitters—is next to impossible to replace. I don't see that pipeline being refilled in the short run."

-Mike Trammell, Partner & Advisory Service Leader, Construction & Real Estate

The skilled workers who have stuck around have their pick of jobs, which means that the highest paying gigs often win out. Contractors who are already fighting to keep pace with rising materials costs struggle to find space in their budgets to pay these higher wages. Equilibrium is on the horizon, but the industry isn't there quite yet, and contractors likely have a few more years of struggle ahead of them.

Costs Aren't Going Down

Estimating project costs has always been a bit of a gamble, but it has been nearly impossible to provide accurate quotes in the recent months, and that's in large part to borrowing rates. In 2022 alone, the Federal Reserve raised interest rates seven times, starting out the year at 0% to 0.25% and ending the year at 4.25% to 4.50%. Daniel Gaston, Construction leader at FORVIS, said that he's seeing projects get shelved or canceled altogether because his clients' pricing structure doesn't work with current interest rates. The cap rate that worked a year and a half ago doesn't work now. Such high-cost inputs require leaders to look elsewhere to make up the difference, and many are turning to credits and incentives.

Credits and incentives have always played a role in construction business models, but they have become even more important this year. The federal government created new credits under the CHIPS Act and expanded existing credits under the IRA, but they also made changes to certain credits that could reduce their effectiveness. The Research and Development (R&D) Tax Credit has been popular with contractors since its inception in the 1980s, but the credit has undergone a few changes that could make the R&D credit riskier to pursue.

First, in 2022 a provision from the 2017 *Tax Cuts and Jobs Act* went into effect that required R&D costs to be amortized over five or 15 years rather than deducted in the current year. Contractors who historically relied on R&D expense deductions to lower their tax bills could be in for a disappointment.

Second, though the amortization requirement is currently in effect, there is a chance Congress will repeal it. The business community has urged Congress to remove this requirement from the statutes, and so far their request has received strong bipartisan support. But until Congress passes new legislation, contractors may choose to pass up the diluted R&D credit in favor of other federal or local credits and deductions.

Third, for tax years beginning in 2023, the IRA increased the potential payroll tax credit election by $250,000. The catch? This additional $250,000 can only offset the 1.45% Medicare tax. Of course, contractors are always free to use the R&D credit to offset income taxes, but if they (1) are reporting a tax loss, or (2) have insufficient payroll, they may not see a benefit from the R&D credit for years.

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"While the Inflation Reduction Act has greatly improved the accessibility of the R&D Tax Credit to startup and early-stage businesses, the requirement to now capitalize and amortize R&D expenditures has created compliance challenges. To the extent Congress allows these rules requiring capitalization of research and development costs to stay in place, I fear it will have a reverberating impact on R&D investment, overall job creation, and the economy in the U.S."

-Mike Boenzi, Managing Director & R&D Tax Credit Services Leader, R&D Tax Credit Services

Business Succession Is More Appealing Than Ever

Even though revenues have held strong this year, many contractors are struggling to maintain healthy operations. The demand is there, but the materials and labor necessary to meet the demand are not as easy to come by. CFOs and other leaders consistently find themselves one step behind of where they want to be, fighting to keep up.

Jason Myers notes that construction leaders "… are working harder than they have ever worked to maintain the same level of revenue and have still lost profit margin. And it has taken a toll on their people, their resources, their equipment, and their psyche." More than ever, construction leaders are looking for a way out.

Mergers and acquisitions have been one solution. We've seen several contractors merge with (or have considered merging with) a competitor to consolidate resources and improve buying power. Others have considered selling to a venture capitalist or private equity firm. These options can help owners leave the business, but because buyouts can disrupt business or damage relationships with surety companies, customers, suppliers, and employees, they're not always the first routes CFOs consider. Another common succession plan is to use an employee stock ownership plan (ESOP). ESOPs can make great succession plans for contractors because:

ESOPs give current owners a reliable way to exit the business.

To initially fund the ESOP, the company's current owners sell their corporate shares to the ESOP trust, either all at once or over time. The ESOP is allowed to pay market value for those shares. By creating a market for company shares, owners can easily walk away when the time feels right.

ESOPs keep company ownership close & provide management continuity.

An ESOP allocates company shares to employees' retirement accounts, but those shares' voting rights don't typically transfer to employees. Instead, employees are seen as the "beneficial owners" of those stock shares. In most cases, the ESOP's trustee is the one who votes on ESOP shares. Current owners hold some form of influence over the business even after selling their shares to the ESOP through board membership.

ESOPs help the next generation of owners take over.

Business owners don't always have a family member or trusted employee who can afford to buy them out of the business. An ESOP makes that transition possible. Shares are allocated to current employees as retirement benefits, which means they don't even need to front any funds of their own to become the company's new owners.

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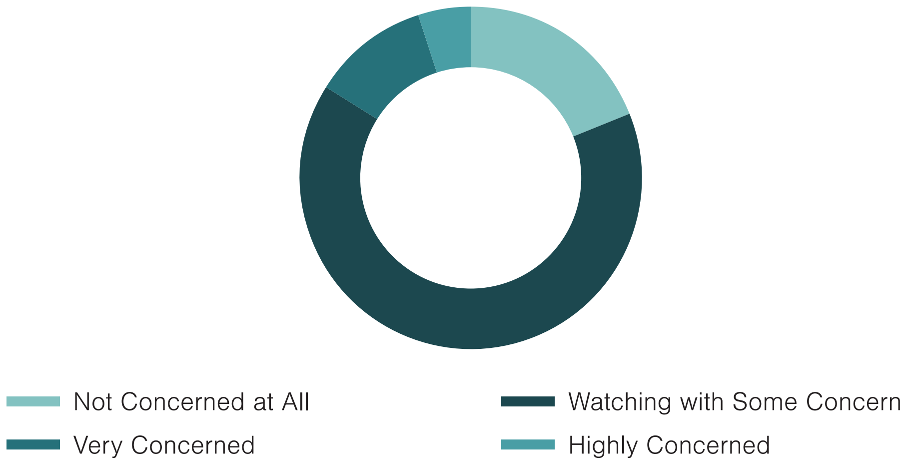
"We're seeing a lot more private equity activity in construction. These contractors are looking for an exit, and often, family members and key employees don't have the wherewithal to buy out the owners. So, we're seeing ESOPs and private equity acquisitions driving a lot of the transitions."

-Daniel Gaston, Partner & Construction Leader, Construction & Real Estate

It Isn't All Bad News

Despite the less than stellar confidence rating, there are plenty of positive trends to note within the construction sector. Demand has been extremely high the past two years and CFOs expect it to remain high in 2023. Only 16% of survey respondents said they were very or highly concerned that demand would fall in the coming year. This all-but-guaranteed list of future jobs can encourage contractors to be more selective about the types of contracts they're willing to accept. It could also encourage them to take the risk to expand their business model, merge with a similar business, or seek new lenders. Increased demand can also encourage contractors to put recruiting and retention at the forefront.

Concern for Demand for Construction



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"While some groups are holding off on new hires, we are seeing others jump at the opportunity to land high-value candidates who are looking to make a change. And because mortgage interest rates and higher living costs have slowed workers' interests in relocating, I believe that contractors may see experienced project managers and superintendents willing to consider options in their own backyard with companies showing stability and backlog rather than relocating for a slightly higher salary."

-Mark DeVerges, Senior Manager, Executive Search

Contacts

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