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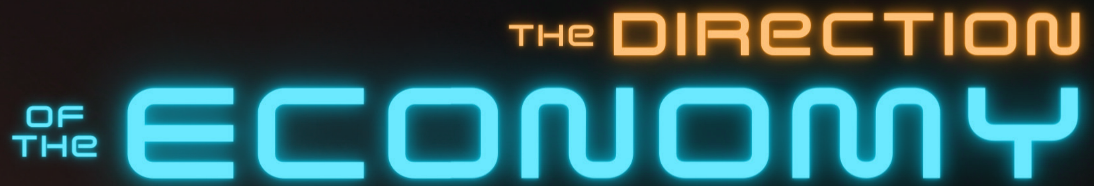


The Direction of the Economy

Impacts & Considerations for Contractors

By Kevin Hamernik

CONSTRUCTION HAS HAD A GOOD RUN; BUT DEPENDING ON WHERE YOU SIT, YOU MAY HAVE STARTED TO SEE CHANGES OVER THE PAST FEW MONTHS. EVEN THOUGH SOME MAY NOT BE POSITIVE, OTHER NICHES REMAIN RELATIVELY STRONG.

Construction is often at the forefront of economic downturns and upswings, which means construction business managers do not have other data sets or long lead times to consider when determining how to change their operations – whether that means pulling back on the reins or stepping on the gas.

This article explores the current state of the construction industry, as well as several areas of which contractors should be aware to ensure stability during potential future downturns.

THE CURRENT STATE OF CONSTRUCTION

So, where is construction now? Good question, and the answer is *no one's sure.* Over the past few years, the market has been very good. Many, if not most, companies benefitted from government stimulus money related to COVID-19, which offset losses or camouflaged management inefficiencies, propelling contractors to increase business revenues as well as margins.

The need for reliable contractors that could timely perform allowed companies, especially trade contractors, to increase pricing. Banks have been very lenient and access to capital has been (relatively) easy. And until recently, cost of funds has been at all-time lows.

Whether or not we're in a recession depends on whether or not you accept the historically applied definition of two consecutive quarters of negative GDP growth.[1] And isn't it true that historically the U.S. has seen a recession an estimated 80% of the time after yield curves have inverted (2/10-Year Yield Curve)?[2] The answer is *yes.* And haven't we been in an inverted yield curve since summer 2022? Again, *yes.* So, now what?

HEDGING YOUR BETS

Have a Plan

Take time to assemble key management and develop a plan that is not only financial (a budget) but also strategic. Define what makes your company unique and then seek to exploit it.

RULE OF THUMB FOR DEFINING A RECESSION

In 1974, economist Julius Shiskin came up with a few rules of thumb to define a recession. The most popular rule was two consecutive quarters of declining GDP.

A healthy economy expands over time, so two quarters in a row of contracting output suggests there are serious underlying problems. This definition of a recession became a common standard over the years.

An annual plan may suffice in good times, but in times of uncertainty, revisit your plan frequently – more often than once a year. This will provide the opportunity to analyze and discuss how things are trending vs. initial expectations and ascertain why and what corrective action(s) may be necessary, if any.

For your financial budget, incorporate a balance sheet (if you do not already) – it speaks to liquidity and forces considerations around leverage models, capital expenditure spending, and working capital management.

In addition, set a few critical metrics or covenants. Especially if you do not have lender covenants on your line of credit or term debt, it is appropriate to calculate them for yourself, as they serve as early warning signs that something is off track. If you begin to approach or fail these metrics, then take them seriously – just as your lender would – and assess the reasons they've been triggered and identify corrective actions.

Understand & Manage Your Costs

When times get difficult, it's not only more rational to look at your expenses, but imperative; and there is no reason to wait.

Expense alignment and management often lose appropriate attention during good times, and the influx of stimulus money has allowed businesses to not have to operate as lean as they might otherwise. Complicating matters, the past several years have exposed construction to wildly changing input costs – supply chain issues have meaningfully influenced costs of materials, and labor costs have greatly increased due to labor shortages and the Silent Resignation.

While supply chain issues appear to be abating – ultimately reducing supply premiums – inflation appears to want to have its own say, with real costs increasing significantly.

While expense management is always important, are you timely reviewing your standard costs or estimated costs to reflect current and real-time changes in input costs of labor and materials? Have you updated these costs in your enterprise resource planning system and your proposal process? If you have acquired new equipment because times have been good (again, possibly because of the stimulus funding), have you updated your costing model to reflect these new equipment rates, which are likely higher? How is your utilization on that new equipment?

Bill Timely & Manage Cash

Innovatively work to improve billing terms in the contract so as to allow your company to operate in an overbilled position relative to the costs incurred and revenue recognized on its jobs. Be diligent about sending invoices on time, proactively following up on payment, documenting "promises for payment" dates, and calendaring time for follow-up. Establish a pattern of intolerance for late payments, holding work performance when necessary and as warranted.

On the other side of the ledger, if you have the liquidity to do so, then ask your trade or subcontractors for discounts on early payment. An analysis should be conducted to evaluate your overall cost benefit of parting early with cash in pursuit of payment discounts.

Defend Your Core Business

Good times mask inefficiencies and poor management and create cash to invest in new services or markets – it's a good thing, but do so wisely, carefully, and thoughtfully. Structure growth and new business in such a way that if the winds change, then you can readily pull back and be prepared to quickly protect the core business.

Project Costs, Bidding & Work-in-Progress Reporting

Now more than ever, slow down and dial in estimated costs on new bids. Discuss, consider, and negotiate escalators, and aggressively identify and bill change orders.

Once the project has commenced, engage others across functional departments in assessing the status of the jobs in monthly intervals at the least, and perhaps have project managers (PMs) occasionally review each other's work (e.g., quarterly).

Work-in-progress (WIP) meetings should happen face to face, allowing for questions to be asked and answers to be provided. Don't just circulate updates by email without appropriate discussion and context.

Preparing the jobs-in-process schedule is not just a finance/accounting function but should also include field operations people. Consider getting out of the office, as C-suite personnel can learn a lot by periodically visiting jobsites.

When preparing the WIP schedule, consider cash exposures. Job schedules most commonly do not include open accounts receivables (A/R) and open accounts payable (A/P) on the job. When included, you gain a better understanding of the cash remaining in the job and the overall exposure. Analyze relationships across common customers and vendors, not just at the specific job level itself.

Budgeting

Experience has revealed that most companies do an income statement budget but far fewer do project balance sheets (and statements of cash flow). Forecast cash so that you understand your liquidity, and if you utilize a revolving line of credit, then forecast the borrowings and needs on the line, especially where your business has seasonality or cyclicality.

Budgets are encouraged to be built up rather than top down, and it is easy to just "spreadsheet forecast" by rolling the prior year forward. As mentioned, if you have credit facilities, then model those as well and run some sensitivities on the assumptions to determine the operating ranges before you begin to trigger defaults, go out of borrowing formula, or have liquidity concerns.

Communicate With Your Primary Constituents

The budget – if shared with your lender – conveys management strength, leadership, awareness, and proactivity. It aligns your company with its financial partner and assists them in preparing for your (potential) future needs.

Situations have occurred in which the lender wanted to respond to a client's request for help on short notice but could not, only to the company's peril. Banks are institutions and most are governed by and through committees, and they need time to be responsive, take action, and prepare documentation. Help them help you.

2/10-YEAR YIELD CURVE

The 2/10-year yield curve has inverted 6-24 months before each recession since 1955, according to a 2018 report by researchers at the San Francisco Fed. It offered a false signal just once in that time.[1] That research focused on the part of the curve between one- and 10-year yields.

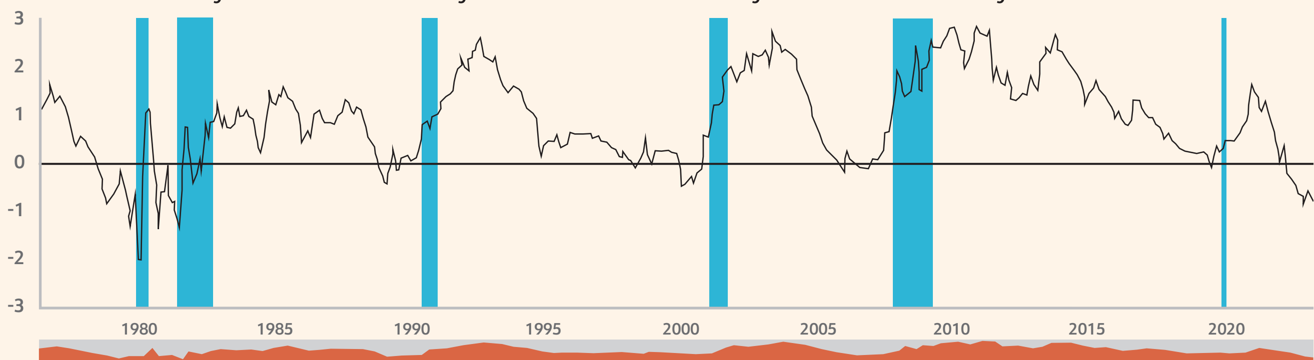
Anu Gaggar, global investment strategist for Commonwealth Financial Network, found that the 2/10 spread has inverted 28 times since 1900.[2] In 22 of these instances, a recession followed, she said in June. In comparison, for the last six recessions, a recession on average began six to 36 months after the curve inverted.

Before this year, the last time the 2/10 part of the curve inverted was in 2019. The following year, the U.S. entered a recession, albeit one caused by the pandemic.

Endnotes

1. *reuters.com/markets/us/us-2yr10yr-yield-curve-hits-deepest-inversion-42-years-2023-07-03.*
2. *blog.commonwealth.com/independent-market-observer/if-the-yield-curve-inverts-will-recession-follow.*

10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity



Know Your Customer(s), Diversify & Align

In softening times, it is increasingly important to know your customers. Meet face to face and attempt to gain insights, not only into their business and strengths, but also to flush out any concerns they may have with you or others. Sometimes third-party interviewers can provide candid insights regarding customer experience and project performance.

These conversations can allow you to gain intelligence into the market, which also may identify risks or opportunities. Work to build your brand and reputation as a strong and ethical corporate citizen that adequately prepares for challenging times and can be relied upon to fulfill its obligations.

Exploit this reputation and work toward customer and supplier diversification. Diversification is not only a natural hedge to larger losses or business impacts should a customer or vendor fail, but accordingly, it increases your credit profile to lenders and other capital sources.

Similarly, align with strong and reputable financial and operating customers or vendors as your partners. There may be others with whom you can squeeze just a little more margin, but management of a business is, like many things, a marathon rather than a sprint. There will be good times and bad times, and alignment with strong partners will push you through the valleys when they come.

Invest In & Utilize Technology

Technology is moving *fast.* As a preliminary matter, get educated on what technology is available for your use, whether you ultimately opt to implement it or not.

There are powerful technology tools that allow businesses to track job costs, assets, and track and input labor. Not only can the use of technology allow

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for faster and more timely recording of information, but it can create efficiencies and reduce other overhead to manage, input, report, and track the same information – often with fewer errors.

Secure Capital in Advance

Having your capital arranged in advance and when times are good is much easier than trying to secure it while in a downslide. Not only will there be more alternatives, structures, and options, but pricing is much more likely to be better.

In addition, as addressed previously, should the need arise abruptly, many financial institutions cannot act as readily as might be necessary. If the relationship has been established and documents negotiated and executed, then you're ahead.

DEALING WITH FINANCIAL DISTRESS

Sometimes there are major events that cause undue financial distress. So, then what?

Communicate With Your Financial Partner(s)

Partners do not like surprises, and they may have helpful recommendations or solutions. And, as we already established, they may not be able to otherwise respond quickly enough. Be on the offense; it most often mitigates the aforementioned issues.

Expect Tension & New Parties to Come to the Table & Potentially a Series of Triggered Events

When your credit becomes riskier to your lender, the loan may very well transfer to a new relationship manager or department. Their primary job is to help ensure against loss and maximize lender recovery, and the actions they take may not be intuitive to you for the circumstances. They may be inclined to:

- Reduce your overall credit amount
- Reduce availability on your revolver
- Decrease advance rates on your borrowing base certificate
- Require significantly more timely financial information
- Ask for additional collateral
- Request or demand affiliated corporate or personal guarantees
- Impose additional covenants

In my experience, clients have expressed surprise by the actions of their bank partners, conveying bewilderment by the bank's reactions because no note payment was late or missed or questioning why the bank would cause the company to incur additional expenses (e.g., having to hire professionals, increased bank fees, increased/higher interest, etc.).

As your loan moves closer to apparent default, the bank grades and regrades your loan, and with each movement down, the bank is required to make additional reserves or capital allocations. These reserves negatively impact the bank's earnings (even if you are making your payments), which *motivates the bank* to increase its rates to higher default rates to offset the increasing expense or loss and *motivates the borrower* to fix the negative financial trends or find a new lender.

Consider Engaging Professionals

Financial advisors can assist by helping management navigate the challenges that come with distress and lack of liquidity. They can help with:

- Anticipating pitfalls based on prior experiences in similar situations.
- Aiding in avoiding decisions that might create greater concerns when in the zone of insolvency, including those actions that management may or may not take that begin to shift liability to themselves individually.
- Providing objectivity with the independence to speak candidly to owners and management.
- Aiding in communications with your constituents, such as evaluating in advance materials to be shared, assisting in anticipating how they will be received, and what actions may be taken by such parties as a result. Sometimes they can do this on your behalf – outside of your presence – to remove emotions, when appropriate.
- Understanding what concerns your counterparties have and what they need to continue working with you.

Consultants also bring a resource that is likely not already at the company. When times are difficult, it is not uncommon for key financial staff to leave out of concern. Consultants backfill and augment staff at a time when there will be increasingly more demands made of them and assist in preparing information on short demand using tools, templates, and approaches developed over the years and in prior engagements.

While we acknowledge that management may be concerned that employees will become nervous with consultants on location, it has actually been found that the opposite is often the case. Employees frequently know more than believed and are commonly relieved to see that management has finally taken action to start addressing the issues they have identified.

KEY TAKEAWAYS FOR THE REST OF 2023

- Anticipate a slowdown/downturn.
- Develop a plan for the future, assuming a market slowdown.
- Identify what makes your organization unique and how to exploit it.
- Secure credit as early as possible (or now if you have not already).
- Take measured and calculated risks, but shifting to a more conservative point of view is encouraged.
- Know your core business, defend it, and do not be afraid to rescale/downsize back to it. Downsizing creates liquidity whereas growth consumes capital.
- Proactively manage your customer, supplier, and lender relationships.
- Increase focus on working capital management, including collections of open accounts and appropriate use of trade credit.
- Tighten up reporting, spend more time challenging assumptions, and make sure estimates are accurate.
- Incorporate and embrace technology.
- Seek outside assistance appropriately.
- Establish a dashboard of key metrics.
- When change is necessary, act quickly and with conviction.

It's also well advised to engage qualified legal counsel who should review credit agreements and other ancillary agreements to look for opportunities where there may be improper perfections of security agreements or defenses on guarantees, for example, that can be leveraged. They also can review customer and supplier agreements similarly evaluating risks and, like the consultant, assist management from exposing themselves to personal liabilities. Counsel also can assist in filing any mechanics liens or send appropriate collection letters on cold and old receivables.

KNOW YOUR DOWNSIDES

Contractors are truly unique when compared to other businesses, such as manufacturers, that are more likely to have liquidation values upon closure realized not only from inventory and equipment but A/R. In those situations, while there can be asserted set-offs for things such as breach of contract from failure to perform, lack of merchantability, warranty, or failure of delivery as a defense to making payment, this is much more likely with contractors and even more or less so depending if you are the GC or subcontractor.

Accordingly, the value of the A/R quickly approaches zero if the contractor cannot complete the project. Moreover, customers and GCs may move to joint check arrangements downstream, meaning there is no longer any ability to control funds or work off others' money. These two factors, compounded with the filing of mechanics liens as subcontractors are not paid, make the filing of bankruptcy more often than not an ineffective solution.

As we navigate the challenges and uncertainties ahead, it's crucial for contractors to be proactive, adaptive, and strategic in their approach to ensure financial stability and resilience in the ever-changing construction landscape. **BP**

This article is for general information purposes only and is not to be considered as legal advice. Consult a professional or your legal counsel before acting on any matter covered in this article.

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Endnotes

1. *Rodeck, David. "What Is A Recession?" Forbes. July 12, 2022. forbes.com/advisor/investing/what-is-a-recession.*
2. *Randall, David & Barbuscia, Davide. "US yield curve hits deepest inversion since 1981: What is it telling us?" Reuters. July 7, 2023. reuters.com/markets/us/several-parts-us-yield-curve-are-inverted-what-does-it-tell-us-2022-11-01/?taid=6408026be84f3b0001d8d696.*