Construction Quarterly by FORVIS

How Is the Industry Faring? It All Comes Back to Backlog

April 2023

While there has been much coverage on economic indicators hinting at a recession, the construction industry remains strong as we head into the next quarter of 2023. Not only is demand the highest it's been in years, but government funding is flowing, and infrastructure projects are plentiful. Activity in adjacent industries hints at continued opportunity in the near term. Consider multifamily housing.

"There is still strong demand for multifamily housing, but occupancy rates seem to be returning to normal levels and concessions are increasing. While this is partly due to an influx of new units, the supply side is currently facing challenges due to rising financing costs and construction delays. Despite these concerns, many forecasters are still anticipating strong growth in the multifamily housing market for 2023."

– Leslie Hedrick Bates, Multifamily Housing Industry Leader

Architecture firms are also likely to keep demand steady for contractors. The Architecture Billings Index (ABI), which is an indicator of nonresidential construction activity, is declining, but at a slower pace than last quarter. While architecture firm billings declined for the fourth consecutive month in January 2023, the pace of the decline continued to slow, and the ABI score of 49.3 indicates that fewer firms reported softening conditions this month. This shows that client interest remains positive.

"Given the uneven outlook for different sectors in the industry, it is critical to understand your core competencies, markets and clients. Knowing your opportunities and challenges and having a plan for tackling them will help your company continue to be successful."

– Dustin Haywood, Architecture & Engineering Industry Leader

These developments have driven growth in the construction industry, **but one concern remains top of mind for nearly every contractor: backlog.**

Backlog has historically been a net benefit, and that's because backlog represents:

Predictability in revenue	Freedom to invest in the future	A competitive advantage
Contracts in the queue are future revenues, so backlog puts your mind at ease about cash flow and going concern.	If you know that revenue is on the way, you can make new capital investments, negotiate better terms with lenders and suppliers, or expand into new marketplaces.	Buyers who see contractors with high backlogs assume they are well-vetted and reliable, and customers may be willing to pay a bit more or wait a little longer to work with someone trustworthy.

But backlog is tricky. Backlog can make a business … but it can also break a business.

Backlog is not only an indicator of the actions of your production team, but the entire revenue stream. From marketing to customer service to sales to scheduling and production, all departments must be in alignment in understanding production goals and what actions need to be taken to achieve them. Having profitable project pursuits in the pipeline is a great goal, but only beneficial with a strong bid, effective management, and efficient execution.

"A growing backlog left unmanaged can lead to a myriad of issues both internal and external to your organization. Unmanaged backlog can lead to added stress, employee burnout, lower profitability, loss of future business revenues, and a damaged reputation. As such, backlog is a metric that must be tracked and must be a continual point of focus organization-wide."

– Julie Nesbitt, CPA, CCIFP, Senior Managing Consultant, Construction & Real Estate (and former CFO of a mechanical contractor)

What's Going On With Backlog?

Each quarter, the Construction Financial Management Association (CFMA) surveys CFOs from businesses across the construction sector. This survey gathers information to help us better understand how industry leaders are feeling. One of the survey respondents in March 2023's survey reported that their backlog is stronger than it has ever been but that it could all go up in smoke if the projects in their queue don't pan out as expected.

Confidence in Backlog Revenue

SOURCE: CFMA https://cfma.org/articles/cfo-confidence-expands-in-early-2-23

Most contractors we talk to feel the same. They are reporting strong backlogs and anticipate they will turn a profit, but they're finding that project completion is taking longer and those projects appear more at risk of profit fade than in years past. Here are a few reasons why backlog is so tenuous.

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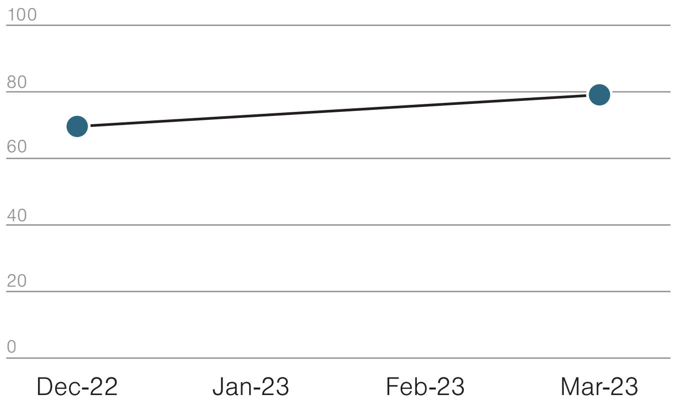
Labor

The skills shortage is—by far—the chief concern among contractors, as it has been for years. But this quarter, those sentiments grew stronger. In the CFMA survey, respondents expressing concern about their labor force rose from 67% to 78% from Q4 2022 to Q1 2023. Right now, construction businesses don't have the skilled labor they need to complete backlogs. Jobs are being delayed as they try to source labor—and the longer projects sit in queue, the higher the risk of bids going stale. Interest rates are changing, materials can't be easily or quickly sourced, equipment prices change, projects get delayed, and suddenly, a backlogged project that was predicted to be a money maker begins to eat into the business's annual profits.

Very Highly or Highly Concerned Over Skills Shortages



SOURCE: CFMA https://cfma.org/articles/cfo-confidence-expands-in-early-2-23

Input Costs

In a Bureau of Labor Statistics report, construction input costs outpaced bid prices in February 2023. The producer price index for nonresidential construction inputs (cement, building products, labor, etc.) rose 0.4% from January to February, and rose 2.7% from this time last year. Clearly, costs are more difficult to predict, and **unfortunately, backlogs are only strong if pricing estimates hold true. The further a backlog is pushed back, the less accurate the cost estimates will be.**

Change Orders

Owners and general contractors are seeing more and more requests for change orders, and that's for a handful of reasons. Contractors will often request a change order when:

- Input costs change
- Projects are delayed
- Materials are difficult to source
- Local regulations slow down the permitting process

When contractors have these difficulties, options for relief can include requesting contract modifications, escalation clauses, or change orders. If owners, designers, or construction managers do not respond and resolve requests quickly and equitably, further delays can compound the risk of success for the overall project.

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Retainage Fees

Delayed projects can hold retainage fees hostage for months longer than expected. Not all contracts have retainage fees, but many do—and when a percentage of the contract price is held until every aspect of the project is completed, cash flow suffers. With constricted cash flows, deterioration of efficiencies can extend the timeline even more, which kicks off a cycle that slowly strangles cash flow. In these scenarios, backlog can be more of a hindrance than a benefit.

Lure of Large Projects

The so-called "infrastructure boom" arising from the Infrastructure Investment and Jobs Act makes large government projects more appealing to contractors. But loading your backlog with larger infrastructure projects can be risky. If you tie your workforce up on one large job, you have a lot to lose if it goes south. Additionally, these government projects often have compliance challenges that contractors aren't used to seeing.

"It's important for contractors to understand the compliance challenges and regulatory requirements embedded into federal contracts and subcontracts. Understanding the complex aspects of a government contract will help contractors walk away making a profit worthy of their time and resource investment."

– Bill Walter, Managing Director, Government Contracting

Subcontractor Risk

Right now, many contractors are oversubscribed. As jobs are being delayed, construction deadlines are stacking up, and contractors may be forced to hire unfamiliar subcontractors to complete jobs that are in the queue. Unfortunately, this type of subcontracting adds another layer of risk. **Subcontractors are feeling the same economic pressures that you're feeling, so whether you exchange a subcontractor with another subcontractor, or seek to supplement them with your own workforce, you'll never eliminate those market risks.** And because you're on the hook for paying both your subcontractors and meeting the needs of your customer, relying on overburdened subcontractors could be to your detriment.

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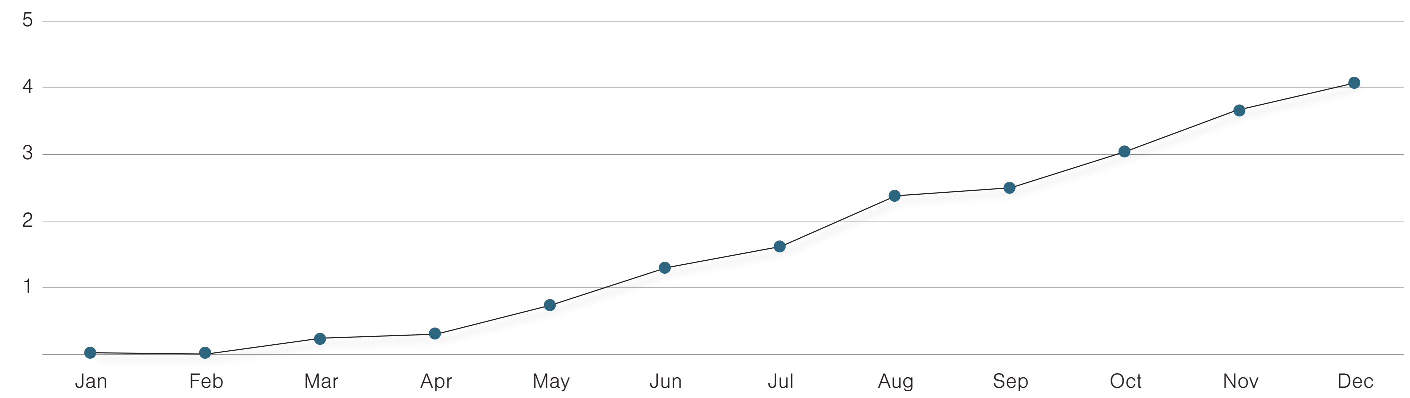
Interest Rates

Inflation has been on the minds of nearly every contractor this past year. **In 2022, 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 4.5%**, and just this past quarter raised interest rates another quarter point. Interest rates are changing so fast that overall carrying costs of a project could be much higher than the owner or developer budgeted by the time work begins. When this additional risk is present, staying ahead on the cash flow of a project is even more paramount.

Change in Federal Fund Rate in 2022



SOURCE: Board of Governors of the Federal Reserve System (US), Federal Funds Effective Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FEDFUNDS, March 21, 2023.

Overhead

It's important for contractors to update their internal cost rates, especially when it comes to heavy equipment and payroll. When was the last time you revised your bid sheets? Updating equipment rates is key, especially for companies that treat their equipment division as a profit center.

"As the cost of new equipment, repair parts, and fuel rise in the current economic environment, so does the need to evaluate how much of that cost can be passed along to the owner without pricing yourself out of the market."

– Jamie Tancos, Senior Managing Consultant, Construction & Real Estate

$ The overhead costs that you factored into projects prior to the pandemic simply may not work in today's economy, and when contracts in the queue are only profitable when using those outdated costs, margins begin to shrink.

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What Is the Solution to the Backlog Dilemma?

It's tempting to believe that strong backlog can save us, but we learned during the 2008/2009 economic downturn in an unpredictable market, backlogs may not be a saving grace. Here are just a few things you and your team can be thinking about.

Backlog Checklist for Contractors:

Don't focus only on revenues; revenues from backlogs will only be beneficial if margins accompany those revenues.

Understand your contracts so that they account for change orders, rate adjustments, and price increases. You don't want your margin to be so tight that any change in pricing or timing would bankrupt the project.

Although it can be tempting to bid at your lowest predicted cost, businesses that carefully **build price escalations and delay contingencies into their contracts** will fare the best.

Chasing after mega projects can be risky. Signing on for a large project isn't necessarily a bad thing; you just need to ensure you offset the inherent risks with the appropriate margin.

Consider opportunity costs. Yes, those large government infrastructure projects may make you eligible for tax credits and you may not have to worry about retainage fees, but are you giving up flexibility and maneuverability? Could multiple smaller projects be more profitable? It's possible that smaller projects could free up bonding capacity and make you more resistant to pricing and market uncertainties.

Look at your contracts closely to see when retainage will be released. If that timeline doesn't seem reasonable, see if you can negotiate to a lower percentage or different terms.

Put your resources into your money-making sectors.

Manage your backlog thoughtfully so you don't oversubscribe yourself. Subcontractors could be struggling as well, and taking on their risks in addition to your own may be too much.

Set overhead and profits based on the knowledge that backlogged projects are getting delayed.

There are no simple solutions or silver bullets to backlog management. **Being aware that the market is more dynamic than recent history, and that labor availability, material and labor pricing, and subcontractor stress are all at work in the marketplace is a great start.** Being able to bend to the changing market rather than fight against the current will help keep your margins strong and your business successful for years to come.

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