Risks and Trends for Middle Market Contractors As the Economy Improves

THOMAS FINN, Territory Manager for Zurich Surety

Partnering with a professional surety agent and a construction-oriented CPA firm will help identify risk and minimize downside.

The construction industry is experiencing an upward trend since it bottomed out in 2011, and the mood within the industry is generally optimistic as trends indicate growth. The degree of market improvement varies by region and market segment. In Florida, for example, there are more than 100 condominium towers under construction in southeast portion of the state. In contrast to the private construction market, public construction spending still has not rebounded to pre-crisis levels.

Growth in construction spending is resulting in more opportunities for contractors, but margins are slow to improve and contractors are facing challenges with staffing from both craft and management resources. Legacy low margin work acquired within the past 24 months lingers in backlogs and impacts profit and cash flow.

The National Bureau of Economics Research reports 14 recessionary periods from 1929 to 2014. Interestingly, the longest and most severe recession in the last 70 years occurred between December 2007 and June 2009. Unlike any other recession, construction spending declined for three straight years after the recession officially ended. Construction spending improved in 2012, yet by 2014, spending still was 17 percent less than the peak in 2007. The surety industry historically has suffered increased contractor failures as the general economy and construction market migrate out of a downturn. If history repeats itself, higher loss ratios and contractor failures are lurking as the construction market heats up.

It is imperative to evaluate your business structure and make necessary adjustments to be prepared as the economy recovers. How did your organization change as a result of the five-year construction market retraction? If your organization had generated your top revenue five or six years ago, are you staffed today with the right people to take on that amount of work again? Is your financial base sufficient to support your desired revenue level? How is your debt load, higher than before? Are the same subcontractors and suppliers still in business and capable of operating at a higher level? As labor shifted into areas with more work, is there a sufficient qualified labor pool in your local market? Are your subcontractors bondable? As private work increases, how well do you know the owners for whom you are working? Are they sophisticated? Do they have a successful track record and history of prompt payment?

Brian Kirwin, partner of Kirwin Norris law firm in Orlando recently stated, “As construction picks up, we are seeing more issues on projects that are staffed by unqualified project management and superintendents. Contractors need to have the right manpower in place at all levels before expanding. You are only as good as your weakest project management team.”

Contractors who have succeeded in the up and down cycles comment that there is a shift in the way business is done now. In years past, a job was agreed upon with a handshake, but now successful contractors are diligent about reviewing contract terms before starting a job. Today, owners continue to push risk down to the prime contractor and then to the subcontractor. Understanding the details of your contractual obligations is critical and use of an attorney well-versed in construction law is an important risk-prevention strategy. Likewise, partnering with a professional surety agent and a construction-oriented CPA firm will help identify risk and minimize downside. “Avoid accepting risk-shifting provisions,” says Kirwin. “It’s time to push back on onerous contract terms.”

There is a saying in the surety world that “contractors don’t go broke from too little work but from too much work.” Extreme and rapid backlog growth, geographic over-expansion, and entering new fields of work can overextend human and financial resources, creating greater risk to the organization. Construction firms need to be disciplined in order to succeed in a growing construction economy. ■

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