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## Construction Quarterly by **FORVIS**

A Contractor's Pursuit of Operational Excellence

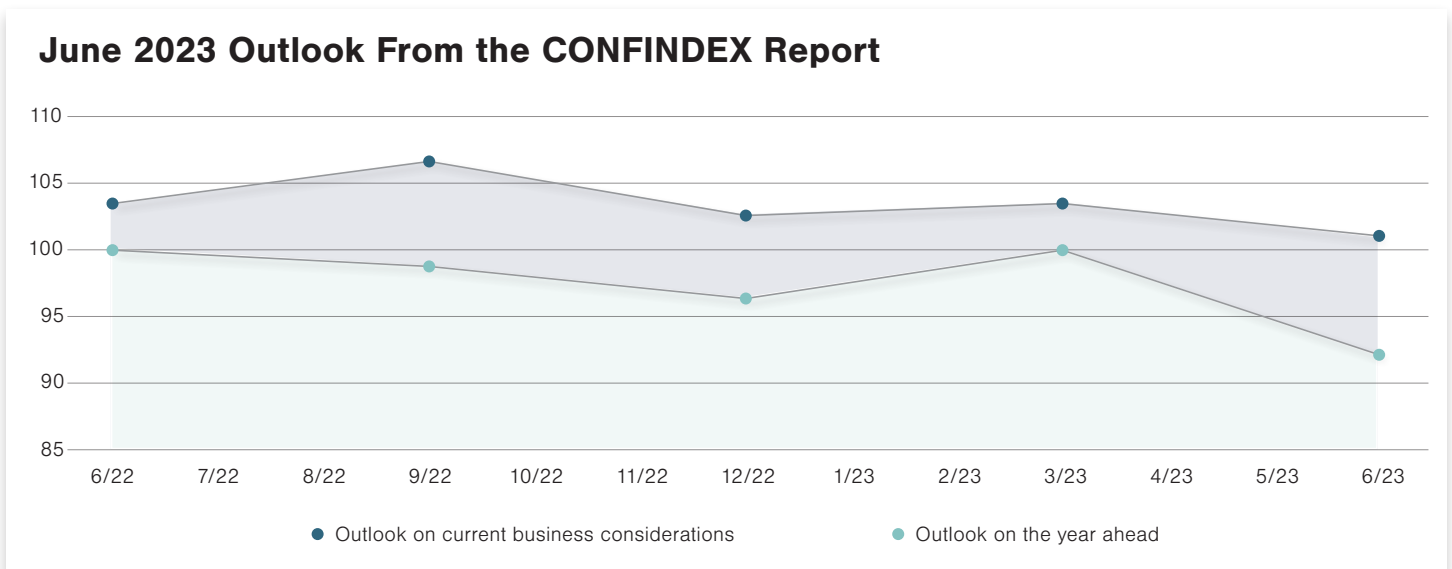
August 2023

The construction industry finds itself in an interesting position. In many ways, construction activities are holding steady. [Backlogs are strong](#); input prices are falling; and jobs are plentiful. But industry success appears tenuous. One simple slip—from interest rate volatility, to a surge in materials prices, to a project delay—can push even the most successful business into a downward spiral.

Although there is little you can do to change the market, there are plenty of ways you can mitigate the effect the market has on you and your business.

## What Is the Current Outlook for the Construction Industry?

Each quarter, the [Construction Financial Management Association \(CFMA\)](#) surveys hundreds of construction business leaders to better understand their outlook and concerns for the industry. In the June 2023 report, we can see that construction leaders feel somewhat neutral about current business conditions, but they have a much bleaker view of the year ahead.



SOURCE: CFMA, : <https://cfma.org/articles/contractor-pessimism-emerges-during-second-quarter>

### Hiring Remains Tight

Mark DeVerges, Director of Executive Search at FORVIS, confirms that jobs are especially hard to fill right now.



“Hiring remains tight for many key roles. Passive candidates are reluctant to make a job change, and the more active job seeker is continuing to receive several offers.”

– Mark DeVerges, Director of [Executive Search](#) at FORVIS

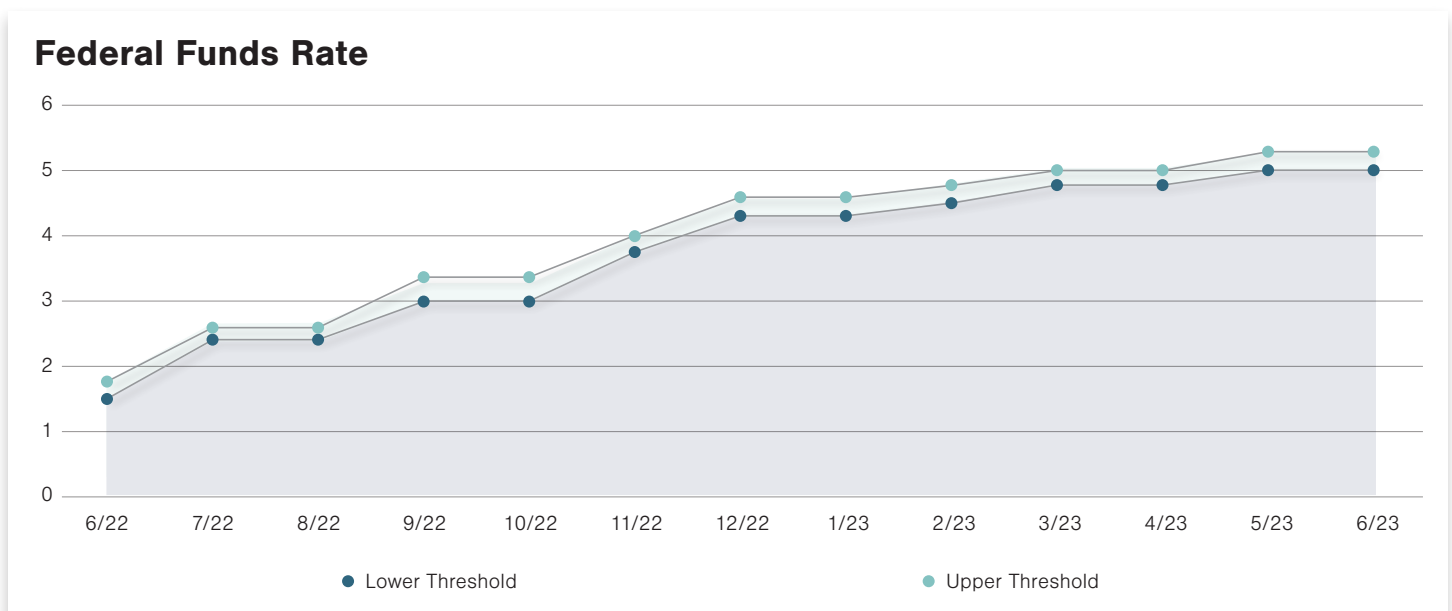
Respondents in the CONFINDEX survey agreed. A few of the survey comments we saw were:

- “There aren’t any people left to employ.”
- “We continue to struggle to find qualified workers.”
- “The supply of labor is short and experienced labor is being diluted due to retirements.”

Labor has been an issue for years, and construction leaders don’t expect it to get better anytime soon.

## Interest Rates Are Challenging Projects

Interest rates have soared this past year. The federal funds borrowing rate is at 5% today when a year ago it was only 1.5%.



SOURCE: Forbes Advisor, <https://www.forbes.com/advisor/investing/fed-funds-rate-history/>

High interest rates are tough for a few reasons. First, in older contracts, the agreed-upon prices almost certainly didn’t account for such high costs of borrowing. Second, when securing newer projects, contractors may struggle to pass all those additional costs on to the buyer. Third, banks are less likely to extend financing for riskier projects, and even if they do, you may not be happy with the terms. Until interest rates plateau, construction companies are going to worry about borrowing costs.

## Competition Is Changing

Although there are many projects available for the taking, the competition has shifted. Local contractors now often have to compete against larger, national GCs for the work as contractors want to keep backlog strong.

For illustrative purposes, let’s see how competition has changed with the passage of the CHIPS Act.

The *Creating Helpful Incentives to Produce Semiconductors (CHIPS) and Science Act* is a tax credit that rewards contractors who help build semiconductor fabrication plants. The tax credit is so generous that many states have been encouraging contractors from across the nation to bid on local projects. When larger contractors and contractors from out of state join in the bidding war, local contractors often miss out on these incentives.



“ Numerous planning opportunities exist at the state and local levels including the Pass-Through Entity (PTE) elections now available in many states. It’s important for construction companies to align with tax advisors skilled in multiple areas of state and local tax so that they can consider new opportunities when they become available.”

– Jack Small, National Practice Leader in [State & Local Tax](#) at FORVIS

## Subcontracting Is Risky

All industry players—not just general contractors—are navigating volatile market conditions. Unfortunately, that means that businesses with a large subcontractor base are taking on more risk. Not only must these businesses manage the effects of the market on their own financial statements, but they also must consider how their subcontractors will fare. As market conditions tighten, more subcontractors are expected to fail, and those general contractors who have heavily subscribed will feel the effects.

## The Solution? Pursue Operational Excellence

Our clients often tell us that the success of their projects feels largely out of their control; that they feel tethered to the whims of the market. While we agree that the market is unpredictable, it’s simply not true that it’s impossible to manage.



The best way for businesses to mitigate the effects of the market is to pursue operational excellence.

Operational excellence is the continued improvement across all aspects of your business, from operations, to philosophies, to business goals. If all leaders and key employees take time to pursue operational excellence, the business becomes more agile, workers become more efficient, and project outcomes are more predictable.

Mike Trammell, partner and consulting services leader of the Construction & Real Estate Industry at FORVIS, describes operational excellence as follows.



“ Best-in-class contractors adopt a philosophy of constant improvement. How to “be a better contractor tomorrow than we are today” is a time-honored self-reflection mantra.”

– Mike Trammell, Partner & Consulting Services Leader of the [Construction & Real Estate](#) Industry at FORVIS

So ... what does operational excellence look like? Operational excellence can be thought of as implementing a series of “best practices” for your business. Consider some of the following best practices.

## Contractor Best Practices for Operational Excellence



### Engage with high-performing employees

- You and dozens of other contractors are competing for talent from the same small pool of workers. Raising salaries can help place you above the rest, but if salary is your only draw, your workers will leave the moment they find someone offering more.
- Making a personal connection with your employees, especially high-value ones, can help reduce turnover. If your workers know that the company supports them, that they have a well-defined career path, and that they are appreciated and respected, they will be less likely to leave, even if they find a job that pays better elsewhere.



### Revamp your subcontractor qualification process

- Subcontractor failure is a risk you can mitigate by only engaging with well-vetted subcontractors. Before you accept work from a subcontractor, review your qualification process. What financial reports do you request? How detailed of a work history do you ask for? And when subcontractors answer your questions, do you truly have a better understanding of how they operate?
- If you've worked with subcontractors in the past who have failed or been a drain on your resources, ask yourselves how you could have foreseen this outcome. Is there a question you could have asked or a report you could have requested that would have shown them to be a less-than-ideal business partner? If so, adjust your qualification checklist accordingly.



### Develop a backlog philosophy

- Backlog can be a positive indicator of a company's financial health, but it also can pose risks. Contractors with heavily stacked backlogs can easily become overextended if a project is delayed or labor is hard to secure. Finding balance is key.
- When establishing your backlog philosophy, you first need to measure it accurately. Construction-specific project management software can help with this. Once your measurements are accurate, assess your operational capacity regarding people, equipment, infrastructure, and financial capacity. Then assess remaining capacity, based on these capacities and the timing of upcoming contracting opportunities. As economic conditions or your tolerance for risk changes, you can tweak the type or amount of projects you take on so that backlog is a benefit rather than a hindrance.



### Understand your costs

- Many businesses overlook how important it is to understand your costs. It may sound simple, but if you know what your costs are, you will be much better at estimating them in contract negotiations.
- Not only do you need to know your costs, but you also need to have access to them at a moment's notice. As you are considering new projects, you want to have accurate and up-to-date information about current projects so you can determine if that new project is feasible.



### Regularly consider new tax strategies

- When was the last time you evaluated your tax strategy? The IRS offers many different tax credits and deductions that contractors can use to improve their bottom lines, but it's important you look to your state government for opportunities, as well.



“Remember to update your WIP schedules for change orders and project fade/gain. This will allow you to be sure your percentage of completion calculations are up to date for tax planning and you are not paying tax sooner than required. Also remember as you plan for new debt and higher interest rates, new rules that may limit interest deductions for some taxpayers changed in 2022.”

– Sarah Windham, Partner, Construction & Real Estate

## What Are Your Business's Best Practices?

The best practices you choose to implement will likely look a bit different from the ones listed above, and that's OK. Each business will have its own set of solutions. The pursuit of operational excellence is an ongoing journey, but if you dedicate yourself to focusing on those best practices, your business will see the reward.

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