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CAN LENDERS AFFORD NOT TO LEND TO CONSTRUCTION COMPANIES?

by W. David Brown

What does a person call a $450-billion industry that few people, including bankers, really understand? If you guessed "construction industry" (not too hard a guess given the title of this article), then you were correct. This industry is truly national and global in scope. Yet, the economic performance of the industry may vary widely by city or even within a given market.

Even though the construction industry is the world's largest, it is a difficult industry to lend to. What can a banker and his team do to successfully lend to borrowers? And what can a lender do to reduce his risk?

Here are three lessons lenders must learn:

- *Lesson 1*: The contracting business is really a job business.
- *Lesson 2:* The lender must monitor jobs constantly, analyzing its position relative to the bonding companies (if involved), and have a well-conceived crisis plan.
- *Lesson 3:* The relationship between the lender and the construction company can be very prosperous for each if certain critical actions are taken. If not, watch out.

Important background

While the construction industry is huge, little attention seems to be paid to it by the business press and investment analysts. The primary reasons: the industry has a relatively low market capitalization (outstanding shares multiplied by share price) and is thinly traded. Since investment bankers and brokers are compensated on the number of transactions they complete, they look at other industries to follow. This lack of public information is one of the challenges a lender must overcome. It is difficult to establish meaningful financial comparisons between construction companies. In addition, the key financial indicators for construction borrowers lie in performance on jobs.

The cash flows of the companies in this industry are dynamic. For example, in one sizable contracting business, profitability has improved from an annual loss of $7 million to break-even in 15 months. However, in a recent month the contractor had one job which had a negative profit variance of $1 million, blowing its financial plan for the quarter and putting the entire business under pressure. This example illustrates what can happen even with the most careful and professional management of a construction business and is a lesson for all concerned. The lender needs to be prepared for the latest "disaster" and have his contingency plans available.

Lesson 1: The construction industry is different

The size and scale of a construction job is usually much larger than, say, one undertaken by a manufacturing job shop. For example, a mid-sized construction firm may at any one time have two or three jobs each, usually located hundreds of miles from its main office, with total projected billings in excess of $10 million, hundreds of personnel involved (many of them new to the company because they were recruited from the local union hall), numerous vendors and a project length of many months. By comparison, a mid-sized machine tool maker may have several contracts for a $1 million machine, but each is produced in its main factory, under controlled conditions, with the same workforce used on other similar machines and a process time of two months.

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Construction receivables have little or no value if the business is no longer operating. This difference is frequently difficult for inexperienced asset-based lenders to understand. A recent example: an insolvent construction firm, with its consultant, was preparing a liquidation plan and setting up negotiations with its lenders. The primary focus of the plan was to avoid losing collections of receivables due to setoffs and chargebacks from customers who suffer as a result of the contractor ceasing operations. The borrower requested in its plan that the lenders provide minimal working capital while certain jobs were completed and the associated receivables collected. By this time in the negotiations, the banks involved had assigned the credit to their respective workout groups who