Saltmarsh
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CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

Dimensions

A CPA's Report for the Construction Industry

Summer 2014

Succession Planning

Build Value into Your Company

The construction industry is notoriously cyclical — boom-and-bust patterns seem to repeat at regular intervals. As they look back over the latest cycle, many experienced contractors are deciding they don't want to struggle through another downturn in five or 10 years, and are turning their attention to succession planning.

In many cases, however, the value of their companies shrank considerably during the recession, so rebuilding that value is now a top priority. Of course, even contractors with no intention of exiting need to rebuild their businesses' value, since a strong balance sheet is essential for increasing credit and bonding capacity.

What can you do to build the value of your business? One critical step is to build a strong management team. This group of key managers could very well be the future owners of the company. But even if you sell to an outsider, a strong management team will make the business more attractive to a prospective buyer. (See article on page 3 for more specifics on team building.)

Here are some other important principles that can help you build your company's value:

- **Run it lean.** If you survived the recession, it's likely you have already trimmed administrative expenses, disposed of unneeded equipment, and taken other basic steps to cut overhead. Now's the time to revisit those efforts to be sure fat isn't creeping back into your operations. Be sure to take a close look at owners' perks like cars and personal items to be sure your company is as lean as possible.

- **Run it clean.** Strip out any non-operating assets that might not be attractive to a prospective buyer. A common example is your company's headquarters building or other real estate. If your company owns such property, consider carving out this asset into a sister company that can be easily separated from the contracting business.

  The same principle applies to extraneous businesses or spin-offs, such as a general contractor with a land development or property management division. Often such spin-off businesses can be a drag on earnings, making the core business appear less valuable than it really is. Even if they are making a positive contribution to the bottom line, spinning these off into separate entities greatly simplifies a future sale by making it easier for prospective buyers to understand the actual value of the business.

- **Grow earnings.** Find your high success areas and focus on those niches. Analyze job histories to determine which projects produced the highest margins, and then look to the market to determine which of these niches is also growing in popularity. Many construction businesses are considerably smaller today than they were five years ago, but are nevertheless more profitable because they focused in those areas that are most likely to be profitable for them.

- **Get your house in order.** Make sure your current corporate structure is conducive to a sale. If there are multiple owners — as is the case in most S corporations, limited liability companies and partnerships — be sure the

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Contractor Dashboard

Key Indicators Track Performance

With the recovery building momentum, many contractors are beginning to pursue growth opportunities more aggressively. As this trend continues, it is important to carefully manage both the financial and operational aspects of the business.

Top performers keep a close eye on certain key financial indicators (KFIs). These function like a dashboard to give them a reading on their companies' health and performance.

Here are some of the most closely watched KFIs, grouped into five general categories. Bear in mind these KFIs should be viewed collectively — no single metric gives you the whole picture.

1) PROFITABILITY – Profits are generally derived from two sources. Operational profit is derived directly from your company's construction activities, while non-operational profit is derived from independent opportunities like improved cash management, savings from self-insurance programs, and income from other profit centers.

There are three primary KFIs for measuring profitability:

- **Gross Profit = (Revenue – Direct Cost of Work)/Revenue.** Gross profit is often used to measure individual project performance.
- **Net Profit = (Gross Profit – Indirect Costs)/Revenue.** Net profit is best used to measure performance of an entire business unit or profit center.
- **Return on Equity = Net Profit/ Owner Equity.** Return on equity provides a comprehensive formula for comparing year-to-year performance.

How much profit should a construction business generate? The answer depends on many factors, including your company's size and age, your particular trade or areas of specialty, and local economic conditions.

2) CASH FLOW – Cash is the lifeblood of your business. You need sufficient cash to meet payroll, pay for materials and supplies, reimburse subcontractors, and meet general expenses, while still meeting lenders' and sureties' liquidity requirements.

A broad cash flow dashboard reading is the cash demand period. It is driven by three balance sheet accounts: accounts receivable, accounts payable, and overbillings/underbillings:

- **Cash Demand Period = Average Days Required to Fund Operations – Average Days to Pay Creditors.** This is essentially the difference between the length of time it takes to receive payment for work and the time you take to pay your creditors.
- **Days in Accounts Receivable = 365/(Revenue/Accounts Receivable).** Top-performing contractors reduce this by managing client relationships and collections carefully.
- **Days in Accounts Payable = 365/ (Direct Cost/Accounts Payable).** Prudent use of trade credit helps maintain flexibility.
- **Overbillings/Underbillings = (Billings – Earned Revenue)/Earned Revenue.** Aggressive billing practices can help reduce underbilling for work performed, and promote prudent overbilling.

3) LIQUIDITY – Liquidity indicators measure your company's ability to meet short-term obligations. They are particularly important to your financial partners and creditors.

- **Current Ratio = Current Assets/ Current Liabilities.** This compares the availability of current assets to satisfy current liabilities. A minimum ratio of 1.0 is usually desirable.
- **Working Capital Turnover = Revenue/(Current Assets – Current Liabilities).** Working capital measures the funds available to invest in operations to generate more revenue. Working capital turnover measures how aggressively these funds are being used to generate income.

4) LEVERAGE – Financial leverage indicators directly affect your company's risk profile as well as its ability to repay debts and take advantage of new opportunities.

- **Debt to Equity = Total Liabilities/ Owner Equity.** One of the most important financial ratios, this measures how highly leveraged your company is. A higher ratio creates additional risk. A ratio of 3.0 or lower is usually desirable.
- **Revenue to Equity = Revenue/ Owner Equity.** A high ratio indicates you have less flexibility to absorb project losses.

5) FORECASTING – Top performers carefully monitor work in the pipeline, and project sales and revenue at least one year out.

- **Backlog to Equity = Backlog/ Owner Equity.** Too little backlog and your company stumbles; too much backlog and you're overwhelmed.

These KFIs should be tracked over time in order to spot trends. Monthly readings are recommended for many indicators — especially as you pursue a change in strategy — to get an early reading on whether you are gaining or losing ground. ■

We can help you compare your company's KFIs to your peers and to industry benchmarks. Call us to schedule an appointment.

Seven Essentials for Building Strong Teams

Whether you are planning for succession or long-term growth, having a strong team is essential to success in the construction industry. Building and developing such a team is one of the most important goals a company can take on — and one of the most challenging.

While there is no single formula for success, here are seven essentials that can help guide your teambuilding efforts:

1) Strong leadership – Strong teams start at the top. Try to objectively analyze your own management style as well as the strengths and weaknesses of key managers in your company. If necessary, work with management experts for a professional evaluation, but at the very least do some research to improve leadership skills at the very top of your company.

2) Investing in individuals – Project managers who have vision and the ability to motivate others are essential to success. But don't overlook the importance of skill, loyalty and a positive attitude at all levels of your company. Encourage a sense of responsibility and ownership in all members of your workforce. Don't allow carelessness, but don't be unreasonably demanding either — the trick is finding the right balance.

3) Recruitment – Strong teams need regular replenishment. Many construction businesses are struggling these days to find workers with necessary skills. Consider working with local community colleges or private trainers to develop a pipeline for future skilled workers and equipment operators, as well as future project managers.

4) Training – In addition to technical training, invest in "soft skills" or "people skills" training, especially for management-level personnel. Being able to understand and motivate various personality types is a valuable skill that doesn't come naturally to many people — most of us have to learn it.

5) Communication – Remember that communication is a two-way street — it involves listening as much as speaking or writing. The best communicators don't just bark orders, whether they are in the office or on the jobsite. Rather, they are tuned in to their audience and can tell if their messages are being heard and understood.

6) Incentives – Financial incentives should be carefully tailored to reward results that are directly related to the company's financial performance. Ideally, you should offer a mix of individual and team incentives — subject, of course, to any constraints imposed by labor contracts. Verbal, public recognition for a job well done can also be a powerful motivator, but some type of monetary incentive should be offered.

7) Consistency – Be consistent, not only in your management style and policies, but also in the business processes you use to operate the company. Consistent, effective operating procedures — both on the jobsite and in the office — can help eliminate human error and let team members know what's expected. In the end, a team is only as effective as the processes it is carrying out.

Even the best teams will encounter unexpected setbacks, but effective teams with strong leaders are flexible and nimble enough to respond to challenges. Such teams help build customer loyalty, improve financial performance, and ultimately create greater value for your company. ■

Please contact our firm to discuss ways your company can build and develop a strong team.

Building Company Value

Continued from page 1

corporate documents include clear provisions for a smooth dissolution of the business.

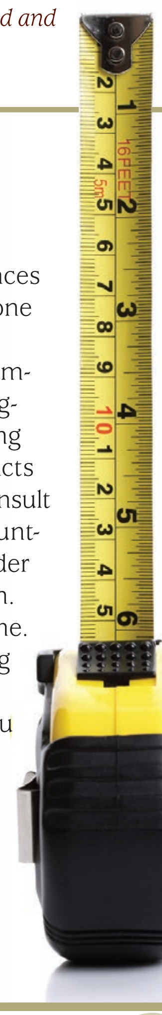
Review buy-sell agreements and other relevant documents with your legal counsel to clarify the roles and rights of minority owners in the event of a sale. Clarifying these issues now can help make the business more attractive to a buyer, and also help avoid last-minute snags or complications.

- **Plan your exit strategy.** Before you begin marketing the business, determine your best-case and worst-case scenarios. Will you insist on a stock sale, in which the new buyer simply takes over the company intact? Or would you be willing to consider an asset sale, in which the company is liquidated and its assets and liabilities are sold to the new buyer? There are significant tax consequences in this decision for everyone concerned.

The decision will also impact your company's long-term obligations, including ongoing customer contracts and warranties. Again, consult with your legal and accounting professionals to consider all aspects of this decision.

All these steps take time. Even if you aren't planning to exit soon, you should start planning now as you continue building your company's value. ■

To learn more about business value and succession planning, please call us for an appointment.



IN 1944, Thomas Saltmarsh, Harold Cleaveland and Charles Gund pooled their talents and modest resources to form a partnership for the practice of accounting. The three founding partners soon established a client base that included large and small businesses, as well as commercial and governmental accounts. Their success was attributed to their guiding principles of honesty and integrity, accuracy and thoroughness, quality client service and, most importantly, the belief that service to the community is an individual as well as a corporate, responsibility.

TODAY, Saltmarsh offers a variety of services — from accounting and taxation to consulting — all based on the Firm's mission statement and core values. It is this philosophy, based on the principles of yesterday, that has helped the Firm grow to one of the largest locally-owned certified public accounting firms in the Southeast.

SALTMARSH CONSTRUCTION ADVISORS are here to meet the specific needs of contractors, home builders and related trades within the construction, real estate and development industries. Because we truly understand construction accounting and financial management, contractors and developers of all sizes and different trades rely upon our experience. **Need assistance?** Contact the construction advisors at Saltmarsh or call us today at **800.477.7458**.

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There's an App for That

Smart phones and tablets are everywhere, including on the jobsite. Mobile software applications have long passed the phase when they were primarily used for playing Solitaire in the doctor's waiting room.

In 2013, Sage Software, a leading supplier of business software, surveyed several hundred construction industry executives about their companies' use of mobile devices. Almost nine out of 10 (89 percent) said the use of smart phones for remote access to work-related information had increased during the previous year. Nearly as many (79 percent) said tablet usage had increased.

General business applications like contact management, calendar and planning apps are widely used by contractors, just as they are in other businesses. Beyond these almost universal workhorses, however, there are thousands of specialized apps designed specifically to meet the needs of construction industry professionals. One construction industry website estimates there are already 13,000 construction, development and design-related apps for mobile devices.

These include popular apps for estimating, onsite calculations and organizing plans such as ConstructionHelper, Architect's Formulator, BuildCalc and iBlueprint. Not surprisingly, building information modeling (BIM), a 3D model-based project planning process, is especially popular with app developers. Programs such as BIMx, GoBIM and PlanGrid are gaining prominence.

Many specialized apps deal with subcontractor specialties like HVAC, roofing, concrete, electrical, drywall and plumbing. Most manufacturers also offer specialized applications for estimating, specifying and ordering their products.

Other, more general applications such as iBooks let you replace bulky, hardbound reference manuals and charts. This puts the equivalent of an entire reference shelf in your pocket.

With thousands of apps and the number growing every day, the challenge is not finding an app you can use. It's keeping up with the array of choices now available. ■