CASH FLOW

BEST PRACTICES

to Help Subcontractors

By Daniel Gaston
While most businesses appreciate and understand the need to manage cash inflows and outflows, this concept is more complex than just ensuring that the cash collected is more than the cash paid out.

In *CFMA’s 2018 Construction Financial Benchmarker*, the average number of days in accounts receivable (A/R) was 54 for the 2017 fiscal year. The Benchmark’s Specialty Trade participants (into which most subcontractors typically fall) projected 15.1 days of cash on hand, which is about five days fewer than the ratio for all companies surveyed. Similarly, the average number of days in A/R for Specialty Trade contractors was about five days greater than the ratio for all companies surveyed. This makes sense – when it takes five more days to collect on receivables, the days of cash will be about five days fewer due to the delay in collections.

Generally, subcontractors are one of the furthest down the payment chain on a project and typically aren’t paid until the GC is paid by the owner. This creates working capital challenges in a robust construction market; as volumes increase, more cash stress is placed on subcontractors. The delay of cash receipts can be exacerbated by disputes between the owner and GC as well, which is why it is important to have a good understanding of the contract terms and the various parties involved.

Subcontractors can be the most sensitive to changes in the market or on a specific job because they’re furthest away from the payment cycle. However, there are multiple areas subcontractors should address to help improve their cash flow such as a robust forecasting model, understanding the payment terms of the contract and the parties involved, identifying KPIs relevant to cash management, and leveraging your existing relationships.

**Implement Forecasting**

When the economy is robust and there’s available work, many contractors put their heads down and focus on the tasks at hand. It can be difficult to devote time and resources to longer-term planning and have the courage to walk away from higher-risk, low-margin jobs. However, there is a need to develop a more robust forecasting methodology along with an account review.

Forecasting provides subcontractors with the information needed to make decisions about the future of the business. It also allows them the opportunity to analyze and evaluate expected revenues and costs over time which will assist in better planning.
Forecasting can be done at the global company level and at a more microlevel, such as by division or project. The forecast should consider multiple factors such as:

- Current work-in-progress (WIP) and projected work remaining
- Awarded work not yet started
- Projects currently being bid or expected to be bid
- Geography of WIP and work being bid
- Projected labor and project management available throughout the forecast
- Projected overhead based on volume and head counts
- Projected capital expenditures
- Projected financing needs

A good forecasting model will help identify potential cash flow shortages, allowing them to be addressed before it’s too late related to current work, work bid but not awarded, and general overhead.

Some contractors with a robust forecasting model may begin stress testing, looking at how different variables affect their business so they can put a plan in place early and react appropriately. Most forecasting models are derived from a company’s historical financial results.

Stress testing the forecasting model involves making changes to the historical numbers to project different scenarios. These scenarios could include best and worst case. Some variables to consider while stress testing include changes to interest rates, price escalation of materials, cost and availability of labor, entrance into a new line of work, significant changes in volume, and a change in timing of large projects.

This process allows for time to make judgments on the proper course of action and is a more proactive approach to planning. For more information on forecasting, see page 26 of the May/June 2019 issue of Building Profits, or check out CFMA’s Advanced Cash Forecasting course (www.cfma.org/education).

**Understand the Contract & Players Involved**

As a general rule, subcontractors should have an understanding of the various parties involved in a project:

- What’s their experience with the GC?
- Who is the owner?
- How is the project being financed?
- What have past payment experiences been?
- Who are the other subcontractors involved?
- How should your company interact with them during the project?

Knowing the history and information of all parties involved upfront can be beneficial when making the decision to bid and price the work.

Subcontractors (and GCs) often don’t understand the specifics of the construction lending process, which can lead to additional risk and uncertainty. The loan agreement with the owner may limit the loan to a set amount or value, so there may not be funds available for change orders.

Moreover, the lender could insert additional provisions in the contract such as a bonding requirement or more restrictive retainage requirements. The loan agreements may also contain language to stop funding if the provisions of the loan aren’t in compliance.

Contractors will need to adjust for, and be aware of, this risk, as the lender and owner likely won’t notify the contractors if there’s noncompliance with a provision of the loan.

In addition, subcontractors must have an adequate contract review process and understand the key terms of the contract, including how they’ll affect the cash management of the project. Subcontractors should take time to thoroughly understand the provisions in their contracts and how those provisions can affect payment terms, the change order process, indemnification clauses, and other aspects.

The contract between the GC and subcontractor often references back to the GC’s contract with the owner. The contract between the subcontractor and GC may not always spell out these clauses clearly, which makes it difficult to fully understand all of the terms to which the subcontractor is agreeing in its contract with the GC.

As the subcontractor, if you’re agreeing to terms outlined in a different contract, then you should obtain and review that contract to understand to what you’re agreeing. Most subcontractors aren’t going to have the same internal legal resources as a GC, and some subcontractors may feel they have little leverage with negotiating provisions in the contract.

Historically, some level of negotiation is expected between the GC and the subcontractor. If it’s impractical or unfeasible to negotiate the contract terms, then the subcontractor should take those terms into consideration as they evaluate risk. For example, some GCs are offering to fast pay their subcontractors for a fee or percentage discount.
Subcontractors should ensure that their PMs understand the key provisions of the contract. One risk to consider is change order disconnect. The final contract price can differ by 15-20% from the initial price. There’s a significant amount of profit that can be won or lost during this process.

**Identify KPIs Relevant to Cash Management**

A key performance indicator (KPI) is a measurable value that demonstrates how effectively a company is achieving key business objectives. Companies can use KPIs at multiple levels to evaluate their progress in meeting those key business objectives.

Companies need to determine which KPIs are most relevant to their business and, specifically, the company’s liquidity. There are many possible KPIs, but it’s important to narrow the focus to those most significant to your company.

While KPIs at the global or company-wide level can be helpful, they’re often at such a high level that emerging trends may be missed. Having accountability tied to the measurement of KPIs at the project level, as well as keeping them relevant and meaningful to project managers (PMs), can help with enhancing cash flow. Some examples of liquidity KPIs at the project level include:

- **Cash conversion cycle by contract.** This is a measure of days in A/R, less days in accounts payable (A/P), plus inventory days (ID) (AR - AP + ID). This metric illustrates how long it takes a company or project to turn its resources into cash.

- **Rolling two-week billings on contracts and daily cash collection on a rolling two-week basis by contract** are two KPIs that can assist in identifying issues that can lead to cash shortages. By knowing how the billings and collections by contract are currently trending, action can be taken when these start to show a slowdown.

- **Change order requests overdue by contract** is a KPI that will help the project teams track and identify changes to the contract so disputes can be addressed in a timely and proactive manner.

In some cases, the work has already been performed with respect to the change order requests, so the subcontractor is already out of pocket for those expenses. The sooner those change orders are resolved, the sooner the subcontractor can bill and collect on those change orders.

Once you’ve identified relevant KPIs and established an appropriate baseline, then continued involvement, monitoring, and accountability are key. Developing and tracking KPIs is just the start; actively using the information to drive appropriate change and enhanced results is the most important part of the process.

**Leverage Your Relationships**

As a CFM, it’s important to proactively leverage your relationships with external service providers since they can provide unique insight and solutions. These service providers will most likely work with several other companies and have a depth of knowledge about the industry that CFMs can leverage. It is also helpful to get an outsider’s opinion or view from a different perspective when working through identifying and implementing ways to improve cash flow.

Your CPA likely works with other contractors facing similar challenges. Use your CPA as a resource as you work through these issues, and get other thoughts on your forecasting model. See if they’re aware of any best practices and what ideas they may have. Utilize your CPA as a resource to assist with the development, monitoring, and revisions to maximize the use of your KPIs and forecasting models.

Engage in discussions with your banker on current and future financing needs. Should you be converting short-term debt into long-term debt to lock in a lower rate? Do they have advice on short-term investment strategies to generate a higher return on excess cash? Do they offer services such as automated payments, rebates through credit card purchases, or others that could save money, reduce risk, and improve your cash conversion cycle?

It’s also important to maintain good relationships with your surety. Do they have best practices or offer products that can help with your cash metrics? In some states, contractors can purchase a bond to effectively release the retainage that would have otherwise been withheld, which can have a significant effect on cash flow.

Finally, leverage your CFMA relationships. Get involved with your local chapters and network with your peers to develop those relationships. Others could be struggling with similar issues, or maybe they’ve already accomplished what you’re just beginning to tackle.

**Conclusion**

Enhancing cash flow is important for subcontractors in a growing and competitive construction market. A subcontractor that fails to monitor and employ best practices related to cash flow management runs the risk of a cash shortfall.
In a robust market, cash shortfalls can sneak up on subcontractors as there may be plenty of work to be done, but the business may become stressed due to a delay in the payment cycle. A delay could arise in such ways as not understanding the terms of the contract, poor billing and collection practices, poor change order management practices, contract disputes, etc.

Implementing forecasting, understanding the terms and the parties involved in the contract, identifying and utilizing KPIs relevant to cash management, and leveraging existing relationships are all important processes to employ to enhance cash flow for subcontractors. These concepts will help CFMs improve their ability to proactively identify and manage a potential cash shortfall.

According to a popular Chinese proverb, “The best time to plant a tree was 20 years ago. The second-best time is now.” If you’re already employing some or all of these strategies in your company, then you’re ahead of the curve.

It’s easy to get too busy and focused on the day-to-day operations and defer the additional time and resources needed to secure the future. Challenge yourself to think about these ideas and then leverage your relationships, get feedback and implement the right mix for your company so you’ll be better prepared for the future.