FOUR STEPS TO PREPARE
Your Company for the Next Downturn

While the current economic expansion is the longest in our nation’s history, there’s been much talk of a recession in the near future and warning signs are already appearing.

Historically, a recession occurs about 14 months after an inversion, which occurred on March 22, 2019. Slowdowns in housing starts and market segments have also begun; material cost increases have also continued to rise.

Higher wages coupled with a shortage of skilled labor only complicates workforce issues. All of this along with decreases in interest rates are indicators that an economic downturn may be on the horizon.

Since recessions are a normal event in our economy, being prepared for the next one should be a top priority. A great deal of time and effort has been invested in building your company, so be proactive in protecting it during a recession.

Develop a Plan Before You Need It

Companies with a contingency plan in place before a downturn occurs are not only more likely to survive, but are also better positioned for growth when the economy turns around.

By developing a plan that allows your company to act fast, the odds of survival dramatically increase.

And, planning in a calm state is much easier than coming up with creative options in the middle of a crisis:

- A stable economy allows time for thorough consideration of difficult topics without the stress of external economic pressure.
- Bringing your team together in a calm period will allow them to develop a broad plan of action that aligns with your long-term strategies.
- With little pressure because of time, your team can explore your company’s priorities and allow them to determine the sequences of events that will trigger actions.
• Assignments and execution can be thoroughly discussed and planned.
• A clear communication plan for all stakeholders can be prepared in advance to inspire confidence and calmness even in the midst of difficult news.

FOUR STEPS IN CONTINGENCY PLANNING

While there’s a lot of upfront work – especially in the beginning stages – having these safeguards in place before a recession hits helps protect your company from being blindsided.

Step One: Research & Analysis

Before you can create a plan, you must spend significant time on research and analysis. Your research should focus on why, how, and when action plans will be deployed. Your analysis should address the following questions:

• Why are we doing this (i.e., preserve cash)?
• How are we doing this (i.e., identifying the steps to be executed in sequential order)?
• When are we doing this (i.e., an economic indicator or key performance indicator (KPI) like 15% decrease in backlog)?

The analysis should consider cash, accounts receivable (A/R), accounts payable (A/P), sales, covenants ratios, KPIs, gross profits, and net profits. It may also include operational costs, discretionary spending, employee benefits, and contract obligations.

The following areas of your business should be scrutinized.

Operational Costs

Strategic goals and sustainability should always guide your contingency plan decisions. Often, the impact of a single action may be minor by itself, but the cumulative effect may be greater when added to other actions.

For example, contingency planning should include a methodical questioning of how costs are connected and how their effects will be felt by asking:

• Which line item expenses can be canceled, reduced, or deferred? Prioritize those expenses as they relate to sales, gross margins, and cash reserves.
• What would happen to sales and cash flow if spending for marketing was reduced or eliminated?
• Can spending for advertising be reduced or eliminated?
• Can car expenses be shifted in whole or in part to employees?

Discretionary Spending

Nonessential spending takes on a new meaning when developing a plan to weather a recession. Although cutting back on discretionary spending may seem obvious from an owner’s perspective, these changes can affect operations and employee morale and must also be considered carefully:

• Can you minimize or defer payments to the profit-sharing plan?
• What is the minimum contribution to the profit-sharing plan?
• Can you defer payments for bonus or commission plans?
• Can you stop, minimize, or defer donations, research, or promotions?

Employees

How do you determine the right path when it comes to your workforce? Guided by the goal of sustaining your operation into the future, your options may include workforce reduction, pay cuts, reduced work weeks, outsourcing work, and hiring consultants.

Contract Obligations

Each contract should be reviewed for risk mitigation and identified as high-, medium-, or low-probability. Your assessment should include the following considerations:

• Are the indemnity provisions reasonable?
• Do you have adequate insurance coverage?
• Do your subcontractors carry adequate protection?
• Do you have processes in place to mitigate damages?
• Do you have processes to monitor earn outs, incentives, and bonuses?

Asset Divestitures

During an economic downturn, the goal is not only to reduce your debt, but also to generate liquidity and enhance your working capital. This can be accomplished by selling non-strategic assets or shutting down underperforming divisions. Review your balance sheet and identify assets that could be sold, leased back, or exchanged.

Evaluating underperforming divisions requires more analysis and raises questions such as:

• Is poor performance temporary?
• Is the location strategic?
• How can the location be maintained and for how long?
Could its footprint be shrunk?
Can the division be sold or would it be more strategic to wind it down?

**Capital Expenditures**

Prioritize your expenditures and analyze the effect of purchasing, leasing, or renting capital equipment. Be certain to understand the change in accounting for leases under the new rules. Consider used vs. new equipment, and evaluate the timing and benefits of the expenditures on cash, output, and gross profit margins. Explore auctions or buy equipment from other contractors. Meet with your bank to discuss the possibility of wrapping all existing equipment into a new credit line.

**Credit Sources**

Every stage of your plan should have this common thread: **Cash is king.** All actions to safeguard your assets and stabilize your operations require cash.

Review your current cash reserve and forecast to determine if you are or will be within your planned baseline.

If your forecast shows that you are out of compliance, look for actions that can remediate the problem. One source of credit may be to roll up all current equipment into a short-term loan. Another option may be to modify existing lines of credit that would free additional financing. Discuss alternative credit with your current creditor and identify secondary sources for credit.

**Materials & Vendors**

In the construction industry, vendors and materials are essential to operations, and disruptions can have significant consequences in an economic downturn. How you respond to the following questions will influence your contingency plan:

- Who are your critical resources?
- What are the critical materials for specific jobs?
- How are critical materials connected in the supply chain?
- Who are your alternative material suppliers if your vendors cannot perform?
- Are there materials you could hedge to attain better pricing (i.e., sand, drywall, lumber)?
- Can you project how tariffs will affect your costs?
- What are your contractual risks if material delivery is delayed or cannot be procured?

Ultimately, your research should contribute to a comprehensive plan that provides a wide range of available options for decision-makers. Later, when a forecast model is developed, leaders will be able to more easily consider a range of scenarios.

**Step Two: Build a Realistic Financial Forecasting Model**

Once you’ve completed the necessary research and analysis, you can start working on your financial forecasting model. Your forecasting model should be based on normal business activity in a normal business environment.

At a minimum, the model should report a rolling 12 months and include a balance sheet, income statement, statement of cash, and headcount, as well as sales, general, and administrative expenses.

The model should be flexible enough to create “what-if” scenarios. It should allow for immediate feedback to specific predetermined metrics whenever data for some or all of your “what-ifs” have been inputted based on your action plans.

Your research and analysis stage should outline the sequence of events according to your plan and define optimistic, realistic, or worst-case scenarios. Your forecasting model should provide concrete options for decision-makers in each case.

**Step Three: Determine Sequential Actions**

A contingency plan requires project teams that will communicate and implement the plan. Each initiative should be prioritized and take into consideration how certain actions at certain points in time will affect not only cash, but also sales, job performance, profitability, and metrics or covenants required by creditors and sureties.

Taking action without thoroughly vetting the effects across operations may have undesirable consequences. For example, eliminating marketing or advertising will enhance your cash situation, but how will that affect your sales pipeline? Delaying material vendor payments will maintain cash, but will it also lead to delays in material shipments to jobsites and affect job performance, billings, completion, and trigger escalation clauses?

Consider creating a workflow that methodically phases in your action plans. The workflow should identify who has been assigned which actions and who is responsible for communicating to others.
Step Four: Review, Adjust & Monitor

Contingency planning is an ongoing process, but your strategic objectives and the goal of sustainability are your unchanging guides.

Upon completion of your contingency plan, spend time reviewing and adjusting it. As your business evolves and your strategies change, your plan should too.

Changes, such as adding new debt and related covenants or new contracts and their related risks, will require adjustments. Strategic changes may include downsizing or adding new locations or divisions. Whatever the changes, your teams should revise their action plans to keep them current.

Most companies monitor certain KPIs on a regular basis. For a sample of both financial and nonfinancial KPIs, visit www.cfma.org/SO19KPIs.pdf. Once you have reviewed your own financial and nonfinancial KPIs, use them as a benchmark and compare them to actual activity regularly.

When there is slippage from your baseline, identify the cause and if necessary, execute your action plans in the sequence you previously developed to address the problem.

Don’t Wait for a Crisis

The best time to develop a contingency plan is during a stable economic environment. Following these steps can help position your company well for when the next downturn arrives. And if your competition failed to plan ahead, you may find unique opportunities to expand market share, acquire needed assets, and find available skilled workers.

Your plan will increase the chances of your company coming out of the downturn better positioned for expansion and profitability when the economy returns to a growth cycle. And though preparing for a downturn may be a lot of work, one of the most important benefits it will provide is peace of mind.

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In January 2007, a company’s owner and executive team discussed cash flow at the monthly management meeting. Based on the forecast, the first quarter was going to be difficult from a cash perspective. They discussed, in detail, the current jobs in progress, billings, and backlog. They began preplanning “what-if” scenarios if the situation continued and discussed a reduction in force, a reduced work week, and a reduction in salary for office and administrative personnel.

They decided against a reduction in force (since they did not want to lose employees) and a reduced work week (due to its effect on jobs-in-progress). In the end, the action plan was to defer salary by 10% across all office employees (executive, clerical, accounting, PMs, project engineers, and superintendents) beginning the next quarter, unless there were improvements in the cash position.

The company continued to struggle with cash through the first quarter. They executed their action plan and communicated it to the staff. Happily, by the fourth quarter, they were back on budget and reinstated the employees’ full salaries. During the next year, they were able to pay back the deferred 10%.

In the following years of the Great Recession, they continued to adjust their action plans to meet the current environment. Those adjustments included working with their creditors, banks, vendors, and personnel in a completely transparent manner. At the end of the downturn, the company had key personnel intact, had doubled its sales, and had maintained its reputation in the market.