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# BUILDING BLOCKS FOR GROWTH
## LESSONS FROM THE DOWNTURN FOR CONSTRUCTION COMPANIES

GO▶

# WHEN THE SUN IS SHINING, FIX THE ROOF

*"Construction sees near-record upturn across all sectors[1]," as the latest output indices peak at the highest rates since August 2007.*

At long last, recovery has reached the construction industry, to the great relief of all those still standing.

As contractors race to capitalise on the rises in demand, it is important to pause for a moment to reflect on the business lessons often painfully learnt during the downturn.

This is a cyclical sector – with more focus on reading the economic conditions and pipeline, could contractors have predicted and responded to the downturn more effectively? Did they have the right controls, people, data and processes in place to manage as well as could be expected in the challenging market?

Coming out of the recession will pose its own challenges too, particularly around managing supply chain risk and as firms stretch to deliver order books won at competitive rates in the context of rising prices.

Having worked closely with many of the major contractors throughout the challenging market of recent years, here we offer some observations on the key lessons from the downturn that will drive performance and reinforce resilience for construction companies going forward – the building blocks for growth.

As always, we would be very interested to hear your views. Feel free to share your feedback and reflections with your usual Deloitte contact or email us at infrastructure@deloitte.com

**Jack Kelly, Partner,** Contractors Sector Lead

1. Markit Economic Research, February 2014

# LESSONS FROM THE DOWNTURN

**SUPPLY CHAIN RISK** – FINDING THE WEAKEST LINK

**WORKING CAPITAL** – UNLOCKING CASH THROUGH COLLABORATION

**PEOPLE AND TALENT** – A BALANCING ACT

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**FINANCE TRANSFORMATION** – THINK A LA CARTE, NOT OVERHAUL

**STRATEGY** – IT'S ALL IN THE EXECUTION

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# SUPPLY CHAIN RISK

Advanced monitoring practices are essential in providing better visibility of supplier insolvency and wider contract risks.

# FINDING THE WEAKEST LINK

Many contractors found themselves exposed to the risk of sub-contractor or supplier insolvency during the challenging market conditions of recent years. Indeed, this is likely to continue to be a key consideration during the early stages of the recovery.

This risk could have been mitigated, in part, through better visibility of the relative strength, or lack thereof, of the supply chain.

### Advanced supplier risk monitoring

Credit agency scores are widely used across the sector to assess the solvency of suppliers and subcontractors. However these often do not provide sufficient information to gain an in-depth insight into financial risk, particularly where publicly available information is out of date.

Adopting more advanced supplier risk assessments which analyse a range of historical and forward-looking financial and non-financial metrics, coupled with a programme of regular inspections of high risk suppliers enables better planning and proactive management in the event of supplier failure.

### Mitigation strategies

Preparing contingency plans that address the risk of supplier insolvency, diversifying the supplier base to avoid over-reliance on a small group of subcontractors, and considering labour alternatives through increasing direct labour or multi-skilling can all help in mitigating exposure to supply chain risk, where appropriate.

### Protecting margin

Hand-in-hand with establishing better visibility of the financial health of the supply chain is the importance of monitoring supplier compliance with contract terms. With so many contractors delivering on projects won at low margins, there is very little room for error or loss. However, the incidence of contractors incurring significant additional costs due to errors in supplier charges is surprisingly prevalent across the sector.

Inadvertent supplier overcharging is perhaps a particular risk in construction due to the complex nature of contracts containing variable charges or time/cost reimbursement mechanisms, across multiple parties and a long time period.

Ensuring the teams who negotiate contract terms fully brief the contract managers responsible for the ongoing relationships with suppliers on the key areas of potential risk; setting expectations early with suppliers on the depth and frequency of reporting required, and over the longer term, implementing a supplier compliance programme focused on high risk partners will serve to protect margins on an ongoing basis.

"Your supply chain is only as strong as its weakest link. Failure to foresee and mitigate the risk of supplier failure could have serious consequences, from availability issues and revenue losses to disruption to work on site."

**Dominic Wong**, Partner, Restructuring Services

"One of the most common areas of contract non-compliance is errors in supplier charges that go undetected, and in our experience of this sector, these can result in significant additional cost to contractors."

**Kristian Park**, Partner, Contract Risk & Compliance

**Key insights:**

- Advanced supplier risk assessments analysing a range of financial and non-financial metrics, coupled with a programme of supplier inspections, enable better planning and proactive management in the event of supplier failure.
- A robust supplier compliance programme is essential in reinforcing adherence with contract terms and eliminating errors in supplier overcharging.
- Ensuring the teams who negotiate contract terms fully brief the contract managers responsible for ongoing relationships with suppliers will help to manage risk and protect margins over the life of the contract.

**More**

Supply risk mitigation

# WORKING CAPITAL

## Getting everyone in the business thinking "CASH" drives sustainable performance improvement.

# UNLOCKING CASH THROUGH COLLABORATION

Closer management of working capital during the downturn was essential. While typical responses, such as weekly cash calls certainly helped, they required a significant amount of senior management time to sustain performance.

## Policy

Driving ongoing improvement in working capital performance requires all members of the organisation to embrace leading practices in their day-to-day activities. Creating and communicating a working capital policy helps to get everyone across the business to think "cash", and understand the impact of their actions on performance.

## Cash flow forecasts for major projects

80% of working capital value can typically be wrapped up in 20% of current projects. Building a separate cash flow forecast for each of these major projects prior to setting up, actively monitoring during the project, and agreeing contractual terms enables working capital investment to be assessed. This in turn may drive pricing and/or specification dimensions.

## A collaborative approach

Tackling working capital by delaying sub-contractor payments is clearly not the answer, risking damaging the underlying business and threatening the security of the supply chain as a whole. Taking an approach that fosters collaboration, such as bringing in supply chain finance and investing in training sub-contractors to better manage their own finances will strengthen performance and resilience across the supply chain over the long term.

## Critically assess bank facility and bonding needs

Due to the high amounts of capital often involved, banks are less likely to grant increased facilities, and in an industry with negative working capital, a downturn means an outflow of funds. Working capital forecasts need to be stringently tested, sensitised and discussed with the bank and bonding agencies in the event of a downturn.

"Getting finance and operations teams to work together to manage major project cash flows and address issues is essential in improving working capital performance."

**David Lock**, Senior Manager, Audit Advisory

**Key insights:**

- Embed responsibility for cash across the business
- Run cash flow forecasts for major projects
- Taking an approach that fosters collaboration across the supply chain, such as providing working capital advice to key sub-contractors, strengthens performance and resilience over the long term.

**More**

Making capital work – unlocking cash through cross-collaboration

# PEOPLE AND TALENT

Against the backdrop of gradual ‘de-skilling’ across the industry in recent years, a strategic approach to people and a flexible organisational model will be essential in supporting long-term growth.

# A BALANCING ACT

There have been concerns for many years that investment in workforce training and development has been inadequate across the construction industry. Cost reduction programmes during the downturn saw talent budgets reduced further still; and this, together with the fall in direct employment and apprenticeships has led to a gradual 'de-skilling' across the industry in recent years.

Therefore, as growth returns, how can contractors retain and develop their top talent and recruit, while balancing the need for workforce flexibility to maintain profits during future periods of reduced demand?

It is essential to take a strategic approach. Understanding the organisational strengths, as well as where the market and company is heading, provides a foundation to define a talent model that is based on the core capabilities the organisation and market require. This model needs to be robust, but flexible, streamlined to remove duplication, but with a clear plan for developing and retaining the talent at its core. This is at the heart of aligning people strategy with corporate strategy.

In instances where organisational change is required, keep a balanced focus on size as well as shape. Resizing should not simply consider headcount; rather, a holistic view of the organisation is required. The most effective organisations in the downturn ensured the right activities were delivered from the most efficient place in the structure in order to get the most out of talent assets. Any change should occur in a way that retains and develops the core capabilities to achieve long-term goals.

The best organisation and workforce decisions are based on facts, data and analytical insights. Harnessing the power of analytics to understand current organisational characteristics enables more scientific, informed decision-making.

The downturn provided a catalyst for alternative resourcing models to be adopted by many organisations. Thinking flexibly about resourcing can represent opportunities not only for efficient organisation management, but also talent development and retention. Developing secondment opportunities with partners can reduce the risk in an organisation's cost base, whilst strengthening relationships, competitive positions and developing expertise. Expanding this approach beyond the core chain to the source of talent – such as universities and technical colleges – may provide further opportunities.

A 'collaborative contractor' model has inherent benefits to clients, both in times of growth as well as market contraction. Organisations that collaborate and innovate across the value chain stand out from the pack. Resourcing projects collaboratively, reducing duplication of capability and providing more flexibility in resourcing, demonstrates a commitment to efficiency and can strengthen the chain as a whole. This not only provides a sustainable and reliable model, but one that is distinguishable from competitors.

"In many ways, the management of 'people assets' has many similarities to the management of 'infrastructure' assets. A long-term approach is required to align assets with business and market needs. But assets also need to be supported by regular maintenance and service plans."

**Julie Neuhoff**, Manager, Organisation Design & Talent

"Organisational sustainability and reliability comes from focusing on more than just size. The most effective organisations have a clear view of core capabilities required to deliver their strategy, forecasting and adopting talent models to allow the right activities to be delivered from the most efficient place. But efficiency is not the only benefit from this approach – this also provides a sustainable platform for growth."

**Jamie Herriott**, Manager, Organisation Design & Talent

**Key insights:**

- Focus on core strengths and capabilities, considering how these support the needs of clients and reinforce a position in the value chain.
- Adopt a flexible model that allows the right size and right shape, at the right time.
- Harness the power of data and analytics to make better organisation and workforce decisions.
- Embrace collaboration to strengthen a position in the value chain.

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Talent edge 2020: redrafting talent strategies for the uneven recovery

# COST CONTROL

Establishing cost control as an ongoing strategy, rather than a short-term 'event-based' tactic, will support greater efficiency and resilience going forward.

# IN YOUR DNA

Cost control was vital for contractors during the downturn, and the lessons learnt across the sector will remain critical going forward as clients continue to look for savings, and margins remain under pressure from construction cost inflation.

Indeed, cost should be seen as part of contractors' DNA – an ongoing business strategy, rather than a short-term tactic. Historically, cost control has only been used in response to market fluctuations. However, without a focus on cost from the outset of a project, it is difficult to unravel contracts, particularly on long-term engagements, to identify how and where savings can be achieved quickly. Establishing cost as an ongoing business strategy and part of daily conversations around how to improve profitability supports both ongoing efficiencies and competitive bidding, as well as providing the flexibility to adapt quickly to changes in the market.

A full appreciation of project terms and the real cost-to-serve is also vital. The sector has witnessed many examples of the challenges resulting from 'buying' contracts at unsustainable margins. Lessons from the performance on these projects should be used to educate business development teams on the importance of knowing exactly what they're signing up to when bidding, and building flexibility into contract terms that allows for savings to be made as and when required.

And while central to the prime contractors' operating model, subcontracting shouldn't be seen as a means of pushing cost downstream, particularly as it doesn't necessarily reduce cost overall and can make it more difficult to control. Agreeing on the right ways of working with suppliers from the outset allows for closer monitoring of the supply chain, and terms outlining the desired cost protocols should be a central element of any new contract. Collaboration also works both ways. Transparency in contracts with clients is critical, particularly at the estimating stage of projects when design elements may still be uncertain.

"Establishing cost as an ongoing strategy and understanding your real cost-to-serve will deliver efficiencies and support competitive bidding, as well as providing the flexibility to adapt quickly to changes in the market."

**Bill Kane**, Partner, Operations Consulting

**Key insights:**

- Don't buy tomorrow's problem today – fully understand contract terms and the real cost-to-serve up front, particularly on long-term contracts.
- Use lessons from the performance on 'bought' projects to educate business development teams on a more sustainable pricing strategy.
- Don't abdicate responsibility of cost efficiencies to subcontractors – a collaborative approach will be more effective in the long term.
- Establish a culture of cost as an ongoing focus for the business, rather than a tactic in response to market developments.

# GOVERNANCE

Governance arrangements that drive robust reporting, sustainable tendering and supply chain resilience are fundamental to the performance of a contracting business and should be areas for particular focus following business consolidation.

# ALL TOGETHER NOW

### Reporting

Self-reporting or ambiguous overlays between site, regional and board-level reporting can dilute the impact or severity of messages. This can generate increased risk, or a lag in addressing key issues on contracts. Centralised governance and controls can help mitigate the risk and, if rigorously applied, can help align different business practices and cultures, with best practice.

### Tendering and estimating

With many contractors now stretched to service projects won on low rates, having a set of tendering and estimating controls that are tightened as a recession looms and released when growth returns is vital to ensure the pipeline is sustainable. Scenario testing in advance which performance metrics the Board is willing, or able, to flex at tender stage and how this impacts wider business strategy will allow prudent and informed decisions to be taken during the tender process.

Furthermore, today's global supply chain structures expose companies to exchange rate fluctuations – hedging the downside risk through contractually aligning all supply chain elements at the outset of a project is essential in mitigating this, particularly on long-term contracts where prices are not fixed at the outset.

### Supply chain management

During difficult economic conditions, supply chain performance can often be overlooked and yet can expose an organisation to significant un-reported risk. By establishing appropriate supply chain resilience testing, contractors can ensure they partner with appropriate and financially robust suppliers. This can also be supplemented by strict controls to minimise key supplier risk. **Read more on managing supply chain risk**.

### Post-merger integration

Examples of mergers and acquisitions where detailed business-wide integration has not taken place are surprisingly widespread across the sector. Full operational and commercial integration is necessary to ensure a common and coherent approach to the management of contracts on a consistent basis. Without this key control, divisional or regional operations continue to operate as they had done previously, leading to potential errors, omissions or financial mis-reporting.

"Having seen contractors and house builders consolidate through the downturn, post-merger integration of cultures and ways of working are key to ensuring a successful outcome. Failing to robustly address post-merger integration will only store up problems for the future."

**Nigel Shilton**, Partner, Real Estate Consulting

**Key insights:**

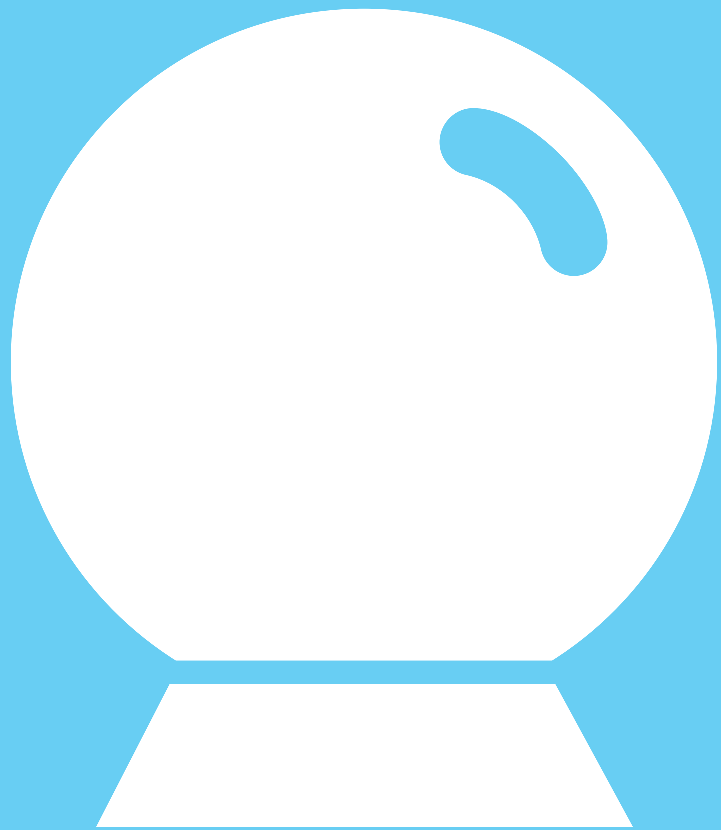
- Centralised governance and controls offer the best approach to ensuring consistency across projects and the application of best practice throughout the business.
- Having a set of tendering and estimating controls that are tightened as a recession looms and released when growth returns is vital to ensure the pipeline is sustainable.
- A supply chain is only as strong as the weakest link – test resilience to ensure you are not overly exposed to key supplier risk.
- Post-merger integration requires continued, on-going effort to ensure success.

### More

Managing supply chain risk

# DATA ANALYTICS

Contractors that put analytics at the heart of their operations can create significant value. Those that master the use of analytics to become truly predictive will stay one step ahead.



# STAYING ONE STEP AHEAD

During the downturn, Boards looked for greater insight around risk, operations and pipeline to help navigate the turbulent market. Did contractors have access to the right kind of information and systems to manage as effectively as could be expected under such challenging conditions?

And in the context of today's recovery, could data be working harder to assist in demand planning, or identifying contracts with profitability challenges and eliminating wastage to support those delivering order books on thin margins?

Many contractors erroneously see data as separate from their day-to-day operations. There is construction, and then there is data.

Data is in fact a window into your business operations, through which new insights can be identified that will enable you to identify cost savings, serve your customers better, and keep your staff safe.

There is much talk of "big data" and how it can revolutionise your world. But for most businesses, whilst they should think big, they should start small:

- Have a clear strategy for what you want to achieve with data.
- Identify a pilot project that will enable you to prove the value (e.g. for a division or a process).
- Seek to consolidate and cleanse data where possible, but do not use poor data quality as an excuse to stand still – without proving the value, funds will never be available to address this.
- Be careful not to believe the hype. Technology and tools are just one part of the equation.

"There is a huge amount of value trapped inside many organisations' data which never sees the light of day. Many contractors may have found it easy to do nothing, faced with poor quality data or lots of disparate systems. In reality, there is not one organisation on the planet that has perfect data, but many nonetheless extract value when they start to scrape the surface of the information at their disposal."

**David Blackwell**, Partner, Deloitte Analytics

**Key insights:**

- Get your strategy right: Work out what you want to achieve with your data, everything starts here.
- Get moving: Your data won't be perfect, but that is not a reason to do nothing. No organisation has perfect data, but lots still generate value from what they have.
- Think big, start small: Don't try and do everything at once, pick some pilot projects, prove the value – and expand from there.

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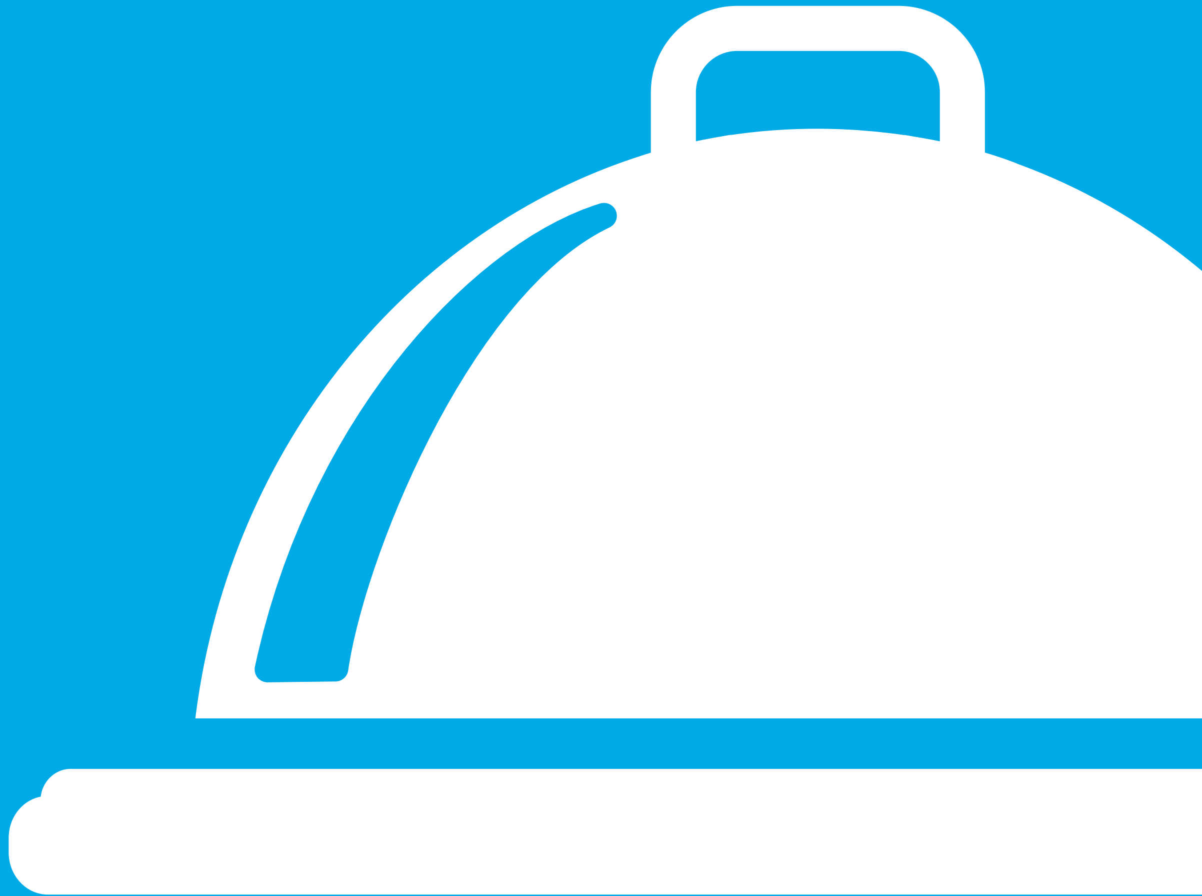
Foresight to navigate the turbulent construction market

Get ahead of the game: What business can learn from the use of analytics in sport

# FINANCE TRANSFORMATION

Although the economic crisis has passed, cost pressures remain and finance transformation is still high on the CFO agenda. However, transformation is not a 'one size fits all' solution.



# THINK A LA CARTE, NOT OVERHAUL

During the financial crisis, companies have been well served by being fiscally prudent. Finance functions have led enterprise cost-cutting initiatives, and many were asked to "do more with less" themselves. In addition, Boards looked to Finance to go beyond a traditional reporting role to provide greater insight around risk and pipeline to help steer the business through the challenging market conditions.

Although the moment of economic crisis has passed, cost pressures remain and finance transformation remains high on the CFO agenda. However, transformation is not a 'one size fits all' solution. The downturn has shown that successful transformations can be achieved by taking a more 'a la carte' approach – providing shorter-term initiatives covering organisation, process, technology and people, that remain true to the longer-term vision of Finance and the organisation as a whole.

The use of analytics and Business Partnering to support better business decisions is an important part of supporting growth.

- Business Partnering represents both Finance and the Business's desire to work together to drive improved operational performance. To be effective, it must be perceived as more than a role description; it often requires a significant shift in the way Finance interacts with the business. If Finance can understand its role in defining strategy and supporting the business to create value, it can organise itself to deliver.

- Finance functions now have an inordinate amount of data available for analysis, they just need the tools and technologies necessary to extract and manipulate the data. Analytics projects should be hypothesis-driven, aimed at improving measurable business objectives and the results of any analysis must be incorporated into business practice in order to derive any value from it. Finance needs to be both the owner of information consistency and the engine room to produce timely, insightful and forward-looking information. **Read more about data analytics**.

Process and technology change act as important enablers to support finance transformation initiatives. However, addressing Finance's prime capability – its people – is critical to successfully transforming how Finance supports business decisions and outcomes. One in three organisations state a lack of people capability, combined with a lack of resource capacity, as the greatest barrier to effective Business Partnering[3].

"Many organisations have already started to invest and develop Finance Business Partnering capabilities, but must embrace the challenge of translating capability into tangible benefits for the organisation."

**Simon Kerton-Johnson**, Partner, UK Finance Lead

**Key insights:**

- Finance transformation isn't a 'one size fits all' solution – successful transformations can be achieved by taking a more 'a la carte' approach.
- Analytics and Business Partnering are central to realising the Finance function's role in supporting growth. 83% of Finance leaders look to increase Business Partnering activity over the next three years[2].
- Process and technology change are important enablers, but developing 'people' is critical in successfully supporting how Finance supports business decisions.

**More**

Finance Transformation: Think a la carte, not overhaul

Changing the focus: Finance Business Partnering

Save the date: September 2014 – the Deloitte Finance Conference in London, exploring key challenges of CFOs and finance functions

2 & 3 Deloitte UK Business Partnering Survey, 2012

# STRATEGY

Business decision-making is increasingly moving from tactical responses to taking strategic decisions on where to play and how to win.

# IT'S ALL IN THE EXECUTION

Contractors have increasingly sharp strategies, but it is the discipline in executing them which really differentiates the best.

Clarity on where to play and how to win, even if it did exist, is lost when volumes of work drop. There is a challenge in 'sticking to your knitting' and resisting the need to chase unprofitable and cash-absorbing turnover by unwittingly entering new markets; geographies and sectors. In the past, some contractors have stretched geographic boundaries to such an extent that on occasion their existing supply chain is unwilling to service them.

A close understanding of the drivers of profit, customer needs and supply chain is critical. Avoiding scope creep to maintain utilisation of the workforce is key – new pursuits should be aligned to corporate positioning, rather than diversifying into sectors or services that might have been divested during downturn.

New models are emerging:

- There is potential to transition to the "intelligent contractor" model, where contractors more actively take propositions to clients rather than wait for work to find them (particularly in the public sector).
- Contractors are taking advantage of their skillsets, as demonstrated by one firm which now provides low-cost legal advice to clients.

"Demanding revenue, profitability and growth pressures exist for all in the sector; contractors need to have a clear strategy and supporting metrics to make the required resource and investment prioritisation decisions. Without that clarity, management decisions will be at best sub-optimal and resources will be misallocated. The resulting lack of sharp execution leads to confused clients, external stakeholders, employees and ultimately missed opportunity.

The best optimise their investment and prioritisation decisions; building on core capabilities delivering strong market-leading franchises."

**Oliver Hemming**, Partner, Strategy Consulting

**Key insights:**

- Playing to win: get clarity on where to play and how to win.
- Execution is everything.
- Have an open mind to new business models.

# THE RIGHT MIX FOR THE CHALLENGES OF THE CONSTRUCTION MARKET

Deloitte works with many of the world's leading construction firms to address these and many other business challenges.

We offer a truly comprehensive range of business advisory services for contractors – from strategic and financial advisory to PPP bid support and operations consulting, as well as specialist contract and commercial risk management expertise.

With a deep understanding of the sector and extensive industry experience, our dedicated Contractors network brings together the very best of Deloitte's leading expertise into practical, integrated solutions to address the challenges and opportunities across the construction market.

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