Evolution and Revolution:

Three Stages of Growth for Construction Companies

by Judith Miller

Builders new to the business imagine that success lies just around the corner. They believe that a few years of hard work, combined with an honest approach and a continuous stream of jobs bid at 10% overhead and 5% profit, will turn their dreams into reality. More experienced builders know, however, that the road to success is full of potholes big enough to sink the company, together with the builder and his or her dreams.

After ten years as a business consultant working exclusively with builders, remodelers, and their subs, I have begun to see patterns common to both successful and unsuccessful companies. Not long ago, I reread an article from the *Harvard Business Review* called "The Five Stages of Small Business Growth" (May/June 1983), and it inspired me to define the stages of growth for small construction companies. In the process, I identified those patterns and qualities most likely to predict success or failure.

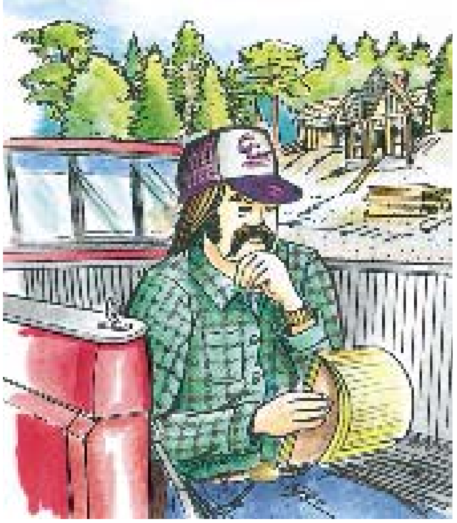
Evolution vs. Revolution

My hypothesis is this: Just as a baby first crawls, then walks, and finally runs, a typical building company passes through three distinct stages of growth. The stages are predictable, and while circumstances may vary from company to company, the problems encountered along the way are of the same type. Success at any stage depends on mastery of critical issues and careful navigation through the danger zones between one stage and the next.

I think of the movement through the stages of growth as a process of *evolution* followed by *revolution*. A company "evolves" as it learns to manage the critical issues of one stage. At first, everything runs more smoothly; efficiency and productivity rise and business improves.

Continued evolution, however, usually propels the company to the next stage. I call this a "revolution," because it is dangerous, terrifying, and often happens suddenly. During a revolution, old systems no longer work as planned, cash flow is always tight, crisis management rules the day, and the company owner works harder with less success.

Luckily, with a little planning and foresight, evolution and revolution can be controlled and predicted. The result is a successful company operating at optimum levels.



Stage One: One-Man Band

Although hybrids exist, most stage-one construction companies follow a predictable growth path. Stage-one companies usually have only one job in progress at a time, and stage-one owners do it all — bid the job, order the materials, produce the work, pay the bills, and keep the books. Typical stage-one owners work out of a home office and the back of a truck; their hours are long and their vacations infrequent.

To be successful, stage-one companies must overcome the five obstacles that most commonly lead the revolution to stage two:

1. Technical expertise. If you do nothing else to prepare for running your own company, learn as much as you can about your trade and about the proper use of all commonly used tools. Learn to read blueprints and calculate takeoff quantities, and become knowledgeable about contracts and specifications. Watch companies you respect closely to see how they run their job sites and their offices. Evaluate the quality of their work, and begin to track how long it takes you to produce to the same level.

2. Time management. Stage-one owners commonly work 60- to 70-hour weeks, so they must learn to schedule critical tasks for times when they are most alert. Maintain a weekly time card to track how you spend your time. When you decide to hire your first employee, this record will tell you where you need the most help.

Schedule time each week for those tasks you don't enjoy, such as filing or bookkeeping. Don't skip that time — you must understand the basic administrative functions at stage one before you can safely delegate them at stage two. Otherwise, you will have no way to judge your employees' performance.

3. Basic bookkeeping. Owners of successful companies of any size know and understand their numbers. As your company grows, an employee will eventually handle the bookkeeping, but unless you understand the process, you will leave an essential part of your business at the mercy of another. Practice simple cash accounting, balance your checkbook every month, and learn how to read an income statement. Learn the difference between direct costs and overhead, and track them separately.

4. Sales and marketing. Your current clients are the source of a strong referral base. Make only promises you can keep, then keep them — there is no better marketing technique. Be honest, and discuss difficult issues in a forthright and timely manner. Ask for letters of reference, and put them in a presentation folder together with photographs of good examples of your work. Keep a simple list of everyone you've worked for, the type of project, and the lead source. Evaluate what types of projects you do best and most profitably, and what types of clients you prefer to work with. Learn to say "no" to the others.

5. Save money. Spend no dime before its time. Hoard your money, your tools and vehicles, and your time, then evaluate each demand on these resources to determine if it meets your long-term goals.

When the great recession of 1991 hit California, builders who were flush in the '80s couldn't unload their ski boats and jet skis fast enough. Many went under because they failed to preserve their capital. To avoid this fate, put aside a small percentage of each dollar you receive until you have a savings account equal to about 10% of your annual volume. If you plan to grow to stage two, increase cash reserves to about 15%.

Stage-One Pitfalls

If your savings account has grown from profits of well-run jobs, if your phone is still ringing with new and returning clients, and if you still don't have enough time to handle all the demands on you, you're on the way to stage two. But there are still a couple of obstacles that can trip you up.

Underestimating labor productivity. This is the greatest danger between stage one and two. Stage-one builders often estimate employee labor at the same rate of productivity that they themselves work at on site. No matter how experienced the carpenters you hire are, no one will ever approach your speed and efficiency. To allow for this, you must increase labor estimates by 33% to 50%, depending on your circumstances.

Crisis mentality. The overworked stage-one builder never has time enough to plan properly, and runs around constantly putting out fires caused by lack of foresight. Working "under siege" like this results in late and over-budget projects, which can delay moving onward to stage two; worse, it can put you out of business. To break this pattern, set aside a certain part of your week, perhaps Saturday morning, to plan for the next week. Make planning a priority, and never miss a scheduled planning session.

Stage Two: Letting Go

If you perform well in stage one, revolution will propel you to stage two. During stage two, the company office is usually moved out of the owner's home and the company begins to take on more than one job at a time. Stage-two company owners begin to delegate certain tasks, often hiring a part-time bookkeeper to work in the office and a laborer or helper to work on site. All of this increases both overhead and risk.

For continued success, stage-two builders should focus on the following systems:

1. Computerized job-costing and accounting. Regardless of volume, companies that choose to grow must eventually invest in a computer and computerized bookkeeping system. Simple software, such as QuickBooks Pro, is a good place to start, because it enables the owner to track both accounting and job-cost data. Builders who are comfortable with computers and who intend to grow to stage three might want to invest in a more sophisticated integrated construction accounting and estimating program now, and cut their conversion costs in half.

2. Written job descriptions. The owner who begins to delegate at stage two must decide which work is to be done by employees, what the standard of quality is for that work, how long it takes to do, and when it should be done. This information should be incorporated into written job descriptions appropriate to the functions to be performed, not to the person currently performing them.

3. Sound contracts. As your company grows, risk also increases, especially around common misunderstandings with clients, architects, subs, and employees. Prepare simple, clear contracts for the work you do, and review them with an attorney. Also write simple guidelines for employee hiring, firing, and review, and make them part of the employee file.

4. Standardized estimating. Because a larger company requires a larger volume, estimating must be more efficient. Preparing standard forms is a good first step. These can be as simple as photocopied checklists, so that no phase of work is forgotten; or as sophisticated as integrated computer programs, which itemize the work in great detail. By comparing actual and estimated costs, you can continually refine the accuracy of your labor estimates. Again, put in the best system you can afford at this stage if you intend to grow.

Stage-Two Dangers

By the time a company reaches stage two, profitability is predictable, work is backlogged for a few months, the work force is stable, and the phone is still ringing. Successful evolution at stage two leads to the inevitable revolution and progression to stage three, but greater dangers lie in the transition. As a stage-two company adds employees, overhead goes up; this increases the pressure on the owner to sell and produce more jobs while protecting the bottom line.

Here are some of the greatest obstacles to the natural progression to stage three:

Inefficient delegation. A stage-three company must run like a well-oiled machine. If one cog fails, the entire company is put at risk. To succeed at stage three, a stage-two owner must be careful to delegate work without duplicating effort. The flow of information must be smooth and efficient.

To ensure that delegated tasks work the way you intend, track each step in the performance of each task. (Flow-charting software makes this easy.) When you have completely defined the task, give the procedure to the person responsible for its completion for a "test drive." After revisions, use this procedure unchanged for at least three months so that an efficient routine develops. (Alternatively, ask the person responsible to define each step in the process, review and revise it yourself, then publish it for testing.)

Low net profit. As their companies grow, many builders imagine that they will be able to make up in volume what they lack in profitability. To be sure, increased volume solves the problem of under-used overhead, but often it creates other, greater problems.

The most important number on the income statement is net profit, not volume. Gross profit margin must be sufficient to cover the increased overhead required by stage-two and stage-three companies, and still leave sufficient net profit to compensate for the greater degree of risk.

Stage Three: Focus on Planning

Stage-three builders delegate all functions, except for a small portion of sales. Typical stage-three builders maintain a large network of job sources and often negotiate the final contract, while employees estimate the job and define the scope of work. An office manager oversees all administrative tasks, while project managers act as liaisons between the estimators and job-site foremen.

To remain successful, stage-three builders should focus on the following:

1. Business plan. At this point in the company's development, planning takes center stage. The organization, heavier with increased overhead, must follow a road map to maintain profitability. Beginning stage-three companies might develop a two-year plan; more sophisticated companies plan five years ahead. A well-conceived business plan defines sources of income, gross profit margin, fixed versus variable overhead, and break-even volume (see *Business Forum*, 4/94). Such strategies, when defined in a plan, have a better chance of achieving the desired net profit.

2. Financial analysis. After developing a clear understanding of the relationship between gross volume, gross profit margin, net profit, and owner's draw, the stage-three company owner turns to an analysis of the balance sheet. Instead of monitoring the business directly, the owner uses standard ratios and evaluates trends to determine the health of the business (see "Making Sense of Your Balance Sheet," 4/95).

3. Organizational chart. To maintain a stable work force, successful stage-three companies need a written organizational chart that illustrates the hierarchy of decision-making in the company. The chart serves to promote an understanding of the roles played by each employee as well as a sense of shared commitment.

4. Policy and procedures manual. Policies define the goals in all vital areas of the company; procedures are the steps required to implement any given policy. Written policies ensure that the company's goals and objectives are known and understood by all employees; written procedures define clear steps for meeting policy goals. Stage-three business owners should develop policies and let those responsible for implementing them write the procedures. For example, a policy might state that "cash reserves shall be equal to 10% of projected annual gross volume." The controller would then develop procedures that implement this policy through accounts receivable, accounts payable, and payroll processing.

5. Line of credit. A stage-three business needs a line of credit above and beyond the 10% or 15% liquid cash reserves. This allows the business owner to develop the business by investing in personnel, training, and equipment as strategic planning dictates. In addition, a line of credit enables the company to ride out unforeseen economic downturns. Until the profitability of the company is predictable, however, and actual job costs come within 1% of the estimated costs, lines of credit should not be used to finance additional business growth.

The Final Barriers

The greatest obstacles to the success of a stage-three company are old age and lack of an exit strategy.

Old age. Often, ten or fifteen years of hard work passes before an owner can bask in the fruits of his or her labors. If the owner has failed to put money aside for retirement during his or her 20s and 30s, when "the miracle of compound interest" can work its magic, even a healthy net profit may not accumulate capital quickly enough to provide for retirement at age 60 or 65. It is essential to provide for your future in your youth.

Exit strategy. Busy owners of stage-three companies typically fail to plan for a way to get out of the business. No matter how much he or she loves the work, at some point even the most satisfied company owner looks for relief from the responsibility of managing a large company. The truly successful owner plans for such a possibility well in advance.

Some rely on successful middle managers, whose salaries are tied to company profitability, to run the company while the owner gradually withdraws from management. In other cases, the company can be run by a younger sibling or child. Or, as is the case of some of my far-sighted clients, the owners will put enough of the profits of the business into secure investments, such as real estate or mutual funds, that they can live happily on the resulting dividends.

Whichever stage you find your company at currently, future progress and success depends on you as owner. Your vision brought the company into being; your clear and continued attention to the systems necessary for success at each stage will propel the company onward. ■

Judith Miller consults with local builders in Oakland, Calif., about accounting, financial management, computerization, and office procedures.