If you don't handle success carefully, it can become your biggest failure

ILLUSTRATIONS BY DAN DRABEK

Going Belly Up: A Builder Looks Back

— Anonymous

Like many builders, I started my contracting business with an old van, a small assortment of tools, and an unflinching desire to be my own boss. Through constant hard work, what started as a part-time business grew into a corporation grossing over $2 million, with 15 full-time employees. An excellent reputation allowed my company to focus solely on the design and construction of high-end custom homes.

To even out the peaks and valleys of our construction cycles, we decided to build a few spec homes each year. Work had never been so plentiful. In fact, the volume soon started to become unmanageable. I found myself spending less time developing new projects and more time chasing money and putting out fires with customers, suppliers, and subs. Because I had survived rapid growth in the past, it all just seemed like more of the whirlwind of a busy construction company.

The extended winter of 1993 set production way behind, and by the following summer, the writing was on the wall: Big trouble ahead. The realtors and bankers who had been buying me dinner were nowhere to be found. We lost several key employees, and our customer service went from bad to worse. Lawyers who used to call about real estate closings were now serving me with papers from disgruntled buyers. And just when it seemed things couldn't get worse, the IRS chose our company for a two-year federal tax audit.

During the years I was in business, I saw dozens of contractors come and go. New trucks one day, bankrupt the next. I was always confident that there was no way anything like that could happen to me. But it did, and after sorting through the wreckage, I've come up with a number of red flags that should have tipped me off.

Hiring in a Hurry

By not planning for growth, a large portion of my time was spent running from crisis to crisis. In an effort to catch up, I hastily delegated important tasks to anybody who appeared willing and able. When hiring employees, I signed people up as quickly as possible instead of running ads and interviewing applicants. This resulted in some "bad hires" and added to the list of problems.

Given another chance, I would be much more careful about what outside help I brought in on projects. I would conduct detailed interviews for important "in-house" positions, and I would *always* call the references listed by serious job candidates. One employee who lasted less than a week had listed as a reference the name of a respected businessperson I knew. When I later mentioned my experience to the businessman, he said, "That guy's a waste of time. If you had called me, I'd have set you straight."

Breaking Up the Team

As our volume increased, we were putting pressure on our subs to grow with us. Some kept up with our growth, but many wouldn't admit that we were biting off more than *they* could chew. As subs dropped the ball, we found ourselves scrambling for last-minute replacements, often hiring the competitors of our long-time subs. As a result, many of our subs now viewed us as "sleeping with the enemy." Employee morale began to suffer, and we were losing the teamwork atmosphere that was so instrumental in our successful building projects.

We could have avoided these problems by planning for increased growth. By cultivating relationships with a number of subcontractors *before* our growth spurts, we would have developed a stable of subs and been prepared as subs reached their individual volume limits. I would also have held frank discussions with all of the subs and explained why we felt it was important to spread the work among a group of subs.

Minor League Suppliers

Our increased volume, coupled with the "high end" nature of our homes, meant our suppliers were now being called on to provide more upscale and unique products. The "special order" nature of these products required close attention to detail, and during the busy building season, our suppliers often made mistakes that weren't discovered until the orders arrived at the job site. Given the lead times involved, the delays were substantial.

I always felt that my "hometown" suppliers provided the personal service that was missing at the larger chains. I realized too late that the larger suppliers had more frequent contact with the companies that provided the special-order items we were using in our homes. In retrospect, I would have worked with a couple of the larger suppliers and established a "point person" within each company who followed the special orders that were so critical to our work schedule.

Wallets Springing Leaks

Growth and overhead go hand in hand, and as our volume increased, so did our overhead. We went from one cellular phone to three and had job trailers for every project. Previously "hands-on" foremen seemed to always need an extra helper or two. I was as guilty as the rest, purchasing more powerful computers, a new truck, and taking more vacation time. When business was brisk, the company could easily handle the increased overhead, but when business slacked off a bit, the overhead costs kept roaring along.

My Real Problem With Realtors

Spec homes offered a refreshing break from building custom homes. There were no change orders to deal with, and substitutions could be made without customer involvement, streamlining the entire building process. But three problems surfaced that turned this builder's dream into a recurring nightmare.

Customized Spec Houses

When our local housing market heated up, the realty company we worked with began to "pre-sell" our spec houses. The realtor would agree to "special requests" made by the customer, and we ended up building a semicustom home for the price of a spec home. To further complicate matters, the realtors routinely committed our company to unrealistic time frames and included penalty clauses for failure to bring the job in on schedule. The unspoken threat: There were a lot of builders who would jump at a chance to build in these subdivisions. If we didn't cooperate, there was a list of builders who would.

Looking back, I never should have allowed an unfinished house to be listed unless there was an ironclad system in place that would have compensated our company for honoring any "special requests." And I would never again let the realtor set the terms and conditions for the construction of a home.

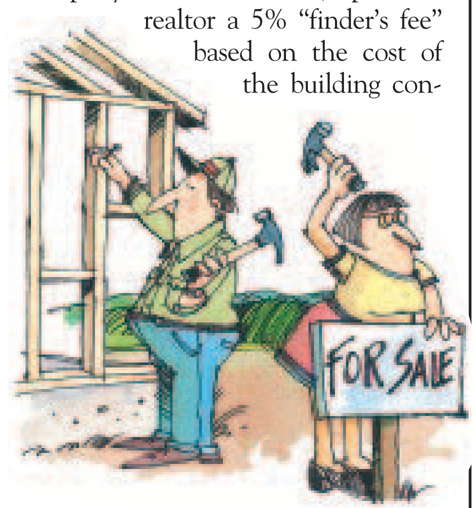
Avoid Exclusive Listing Agreements

If a realtor asks you to sign an exclusive listing agreement, my advice is to turn around and run away. An exclusive listing agreement requires that you list all your homes with one particular realty company. What would entice a builder to restrict himself to one realty company? If the realty company is large enough, they may instruct their salespeople to "overlook" your spec homes, or neglect to include you in a list of builders given to good custom home prospects. Since the realty company in my case controlled 70% of the market, signing the exclusive listing agreement was akin to selling out to the devil.

If I had it to do over again, I would have stayed a one-truck operation before falling prey to this scheme. If an exclusive listing relationship deteriorates, it's the builder who ends up losing.

Finder's Fees

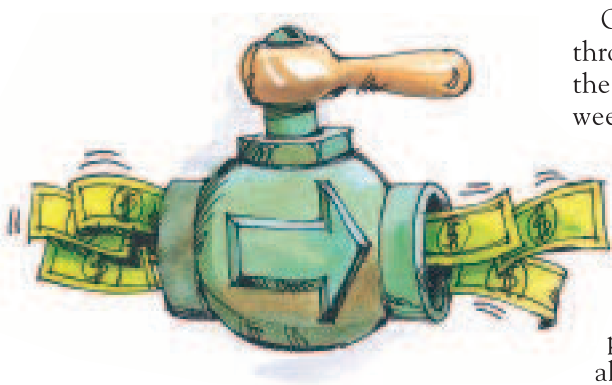
When someone from out of town purchased a lot in a subdivision, the controlling realtor would "steer" the potential customer my way. If my company won the contract, I paid the realtor a 5% "finder's fee" based on the cost of the building contract. The problem was that the fee was never disclosed to the buyer, and when the 5% fee was added to the bid, we often ended up being the high bidder. After losing a few of these jobs due to high bids, the realtor stopped pushing our other spec houses as well and started favoring builders who bid low, generating quick sales. To regain favor, we started paying a portion of the finder's fee from our profit, maintaining our volume by weakening our bottom line.



In hindsight, I would have informed potential customers of the finder's fee. I doubt that the realtor would have continued to work with us, but our profit would have remained intact. One of our customers, when he became aware of the finders fee, told me he would have called us regardless of the realtor. He had written down our number from a job sign.

Some overhead increases came as a surprise. When we were "small time," no one paid much attention to our company. As our public profile grew, we encountered all types of intrusions that left us with a lighter wallet. Code enforcement officers were suddenly enforcing local "porta-potty" rules, and we were being billed for "street maintenance." Increased builder's risk insurance was required by certain building departments, and we were maintaining drainage systems that were the developer's responsibility.

Most of these unexpected expenses were valid. Our mistake was not knowing our true overhead costs and not budgeting for them. We were still marking up 10% to cover costs that were closer to 17%. It takes more than a $100 software package to keep track of millions of dollars. I learned that there is one overhead expense you can't afford to be without — a Certified Public Accountant. Had I hired one, 90% of our money problems could have been eliminated.

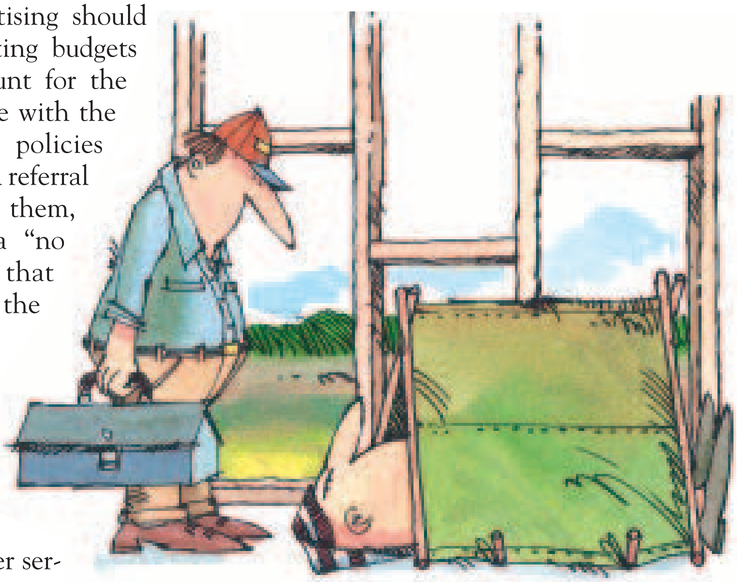


Bottom line: Install a check valve in your cash-flow pipeline, making sure that the arrows point in the right direction.

Budget for Word of Mouth

It's no secret that word of mouth is one of the best forms of advertisement. Because we had developed such good referrals, I cut our marketing budget substantially. This reduced marketing costs, but created problems. Word-of-mouth clients expected a much higher standard than we could consistently deliver (after all, their expectations were based on the glowing reports of former customers). I also discovered that former clients who have "passed on" a lead for a $350,000 house will often consider themselves eligible for substantial "freebies" — a little backhoe work, a patio from "leftover" concrete. These unspoken commissions started adding up to real time and money — costs we didn't budget for.

Word-of-mouth advertising doesn't eliminate marketing costs, it simply redirects them. Builders who rely on this form of advertising should revise their marketing budgets to accurately account for the "freebies" that come with the territory. Establish policies that quantify what a referral is worth, stick to them, and *always* send a "no charge" invoice that notes the value of the work performed.



Never-Ending Punchlists

Few things hastened our demise more than the collapse of our customer service. Our failure to pay attention to details undid in a few months what it had taken years to build.

Our contracts called for a walk-through with customers 30 days before the scheduled closing, and again the week before the closing date. Omissions and defects were to be noted and initialed by all and taken care of before closing. We had a good policy and procedure set up; we just didn't follow our own rules. To avoid penalties for being late, we would allow buyers to move into uncompleted houses. Once they moved in, there was little incentive for the buyer to "sign off" on the punchlist and make the final payment. To further postpone final payment, buyers would continue to add items to the punchlist, creating a vicious cycle that crippled our cash flow and undermined moral.

Looking back, I would have *never* let a customer move into a house until it was complete, with the punchlist initialed and a check written for the balance due — no matter how much trouble it might have caused.

Loose Lips Sink Ships

I've never been afraid of talking. This trait was an asset when it came to sales, but often a hindrance in other business dealings. I readily talked to subs, employees, and customers about a broad range of the company's business issues. When these people "rebroadcast" this information, it would often do more harm than good.

For example, as our volume grew, we were able to negotiate deeper discounts from suppliers. My loose tongue often made these discounts public knowledge, and when well-informed acquaintances started using these numbers to haggle for better pricing, suppliers became less willing to offer our company volume discounts.

If there is important business information that a person should know about, tell them. But don't use aspects of your business to fill gaps in a conversation. It just isn't worth the potential trouble it can cause.

Be Careful Out There

Even though it's been two years since our last project, the ordeal is far from over. There are several judgments pending against the corporation, and there are still a few irate customers with axes to grind. It will most likely take years to resolve the mess, with legal fees running in the tens of thousands of dollars.

Even though the names are withheld in this article, the message is easy to identify: If your business is roaring along and things couldn't look any better, get a second opinion. You may be surprised to learn that to a knowledgeable eye, the grass doesn't look greener on your side of the fence. ■

The author of this story chose to remain anonymous because of ongoing litigation related to the closing of his business.