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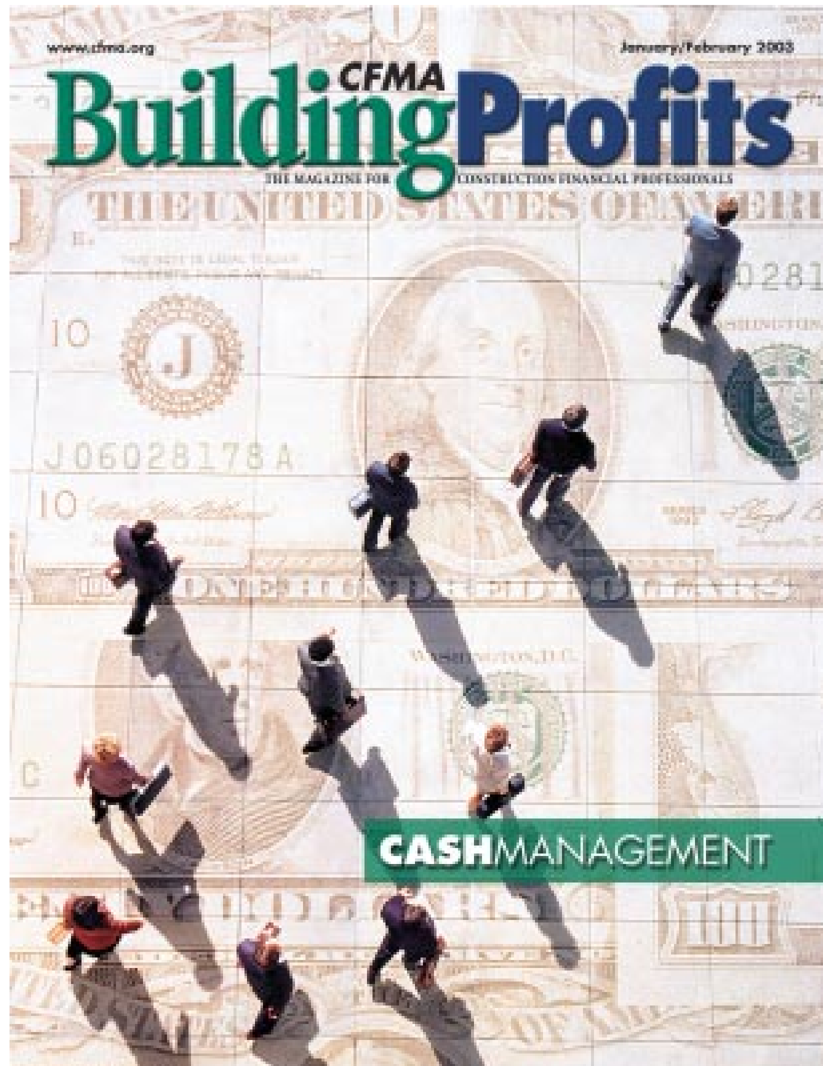


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**CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION**

*The Source and Resource for Construction Financial Professionals*

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# A Primer on Sound CASH & CREDIT Management in a Mixed Economy

PCC, a successful, old-line, family-run construction company, has been in business for 50 years, and the grandson of the founder has been groomed to take over the reins. The challenges both PCC and the family face in today's uncertain economy are shared by many construction companies – as are the solutions.

### A Family Saga . . .

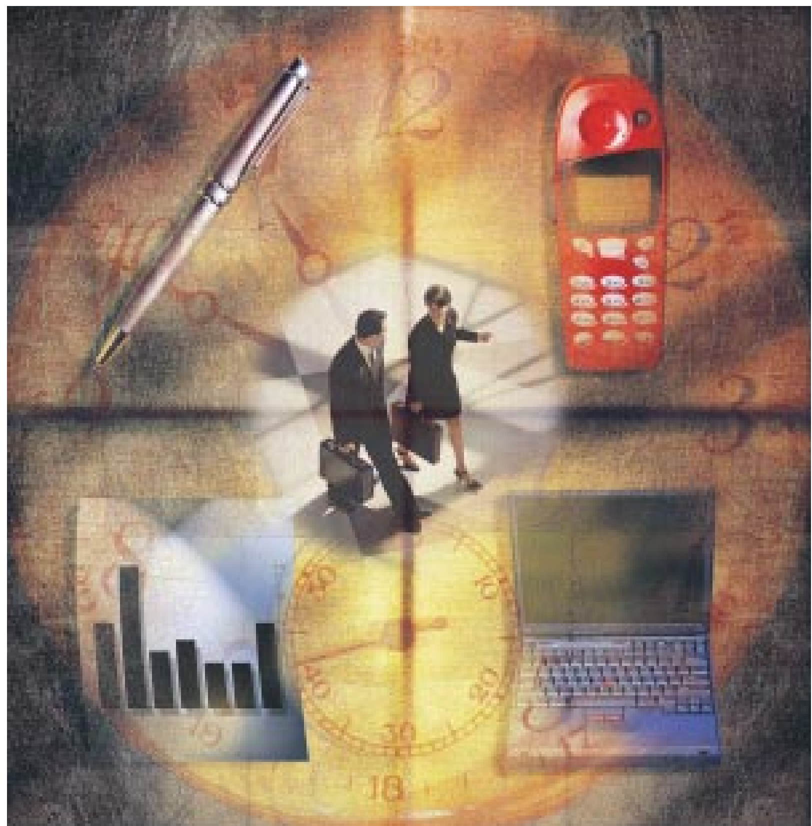
Tom, Sr. started PCC from scratch. He carefully monitored both the volume of work and the cash flow while growing the business. His approach was simple: Manage the cash (as opposed to debt or other credit facilities).

Tom, Sr. didn't believe in debt; he felt growth should be self-funded. His view of cash flow management was simple and linear:

*Bid the work → Secure the job → Send out bills → Collect payments → Pay workers, suppliers, and subs → Net the cash flow.*

Tom, Sr. turned the business over to Tom, Jr. 25 years ago. Tom, Jr.'s approach to business growth and cash management was somewhat different that his father's, as was the business environment in which he found himself.

Tom, Jr. was lucky enough to inherit many well-established clients from his father, and he relied



heavily on this stable of existing customers for cash flow and steady work.

However, Jr. was much more growth-oriented than his father. In keeping with his goal of growth, Jr. took on new clients and more risk in terms of project types and payment terms. However, over time this approach was less profitable and Jr. often had to borrow to make payroll.

The last few years have seen a mixed economy, further exacerbating PCC's troubles. Tom, Jr. is now in the process of transferring the business to his son, Tom, III.

This transition has not been easy. The economy is trying to bounce back from a downturn; however, the construction industry in PCC's area has not yet recovered. Cash is very tight and Jr. insists that more volume is the key to restoring cash flow.

Tom III had been a CPA in public practice for several years before joining the family business. He knows that the only way to restore cash flow is to follow the principles of sound cash and credit management.

## The Moment of Truth

Tom III also knows that he must sit down with his dad and outline what constitutes sound cash management in this mixed economy. Tom, Jr. may know construction and his customers, but it is Tom III who has the financial sense and business acumen that will see the company through the current transition and re-energize its growth.

### What Tom III Told His Dad

Unless there was a dramatic shift in the way PCC conducts its business, it would soon be out of business:

- Its line of credit was borrowed out fully and continuously.
- Its vendors were becoming increasingly less tolerant of slow payments.
- Its bonding company was reluctant to provide any additional suretyship.
- Its employees were getting nervous.

Tom III returned to the basics of proper cash and credit management. First, he identified the factors that have a positive or negative effect on cash flow. These include:

- Markups on bid work,
- Taking jobs at cost to keep cash "flowing,"
- Capturing changes,
- Billing for change orders, and
- Collecting receivables.

### Bad Jobs or Bad Management?

After reviewing his findings, Tom III still needed to determine what was hurting PCC – unprofitable jobs or poor cash and credit management?

From his analysis, he found the problem was some of both. Tom III knew that if PCC took some practical steps to *improve liquidity management* – coupled with *bidding work with proper markups* – cash flow would improve.

### What Else Tom Knew

Managing cash balances in the bank does not constitute cash management. It is impossible to effectively manage cash without considering the other sources of credit and liquidity that a contractor relies on (either consciously or unconsciously) each day.

So, Tom faced a two-fold challenge:

1) To make an effective case to his dad showing the need for a new strategy.

2) To implement new cash and credit management procedures to effectively manage PCC's liquidity.

## Liquidity Management

Effective cash and credit management requires the full use of all available resources. Liquidity management can help contractors work through the ebbs and flows in the business cycle.

### The Difference

Cash management and liquidity management are not the same thing. Cash management is a subset of liquidity management because liquidity is more than just cash you can physically count; it also includes available credit.

Liquidity ratios and working capital are important parts of a contractor's balance sheet – and not just because they are available to meet the current and short-term operating needs of the company. They are the assurance that outside credit providers, such as banks and sureties, rely on when making their credit decisions.

## PCC's Problem

In the current uncertain economy, owners and developers are less likely to undertake new projects. As backlogs shrink, contractors are more apt to bid jobs with tighter margins. This is exactly what Tom III saw happening at PCC.

He also saw something else that contractors typically do when faced with poor cash flow: They take another job, paying the debts of one job with cash from the next.

This process has a snowball effect. Sureties respond to the inevitable slippage in a contractor's liquidity by tightening credit, further restricting the contractor's ability to bid new work and, ultimately, affecting cash flow.

## The Factors Affecting Cash Flow

In order to present his father with a well-articulated plan, Tom III needed to

understand all the factors that could affect cash flow, including:

- Contract terms and retainage
- Cash reserves and balances
- Banking facilities
- Credit facilities
- Suretyship and bonding
- Fixed asset utilization
- Suppliers and subcontractors
- Debt
- Legal factors

Let's look at each separately.

## Contract Terms and Retainage

In a mixed or down economy, an owner or upstream contractor may hold the payments that a contractor is legally entitled to receive. This creates a serious drain on cash flow since the contractor has probably paid out a significant amount of money for the draw that is being held.

### Contract Terms

It is difficult to manage cash flow and liquidity when payments for services rendered are tied to another's ability to collect, as in the "pay when paid" or "pay if paid" clauses in many contracts.

Each state enforces and adjudicates these clauses differently. At a minimum, however, they represent additional hurdles to getting paid for labor and material that have been poured into a project.

When negotiating a contract, consider adding language that calls for payments to be made at regular intervals and in a reasonable time frame after performance of that billing cycle's work.

### Retainage

The retainage clause is another often-overlooked source of liquidity. This clause should be monitored to ensure that no more retainage is being held than originally agreed upon.

For example: A sub participated in a government project that required the 8% retainage to stop being withheld after the project was 50% complete; however, the upstream contractor continued to withhold retention, enhancing its cash flow at the sub's expense.

It's also important to include a clause that reduces the amount of your downstream retainage that will be held when upstream retainage is reduced.

## Cash Reserves and Balances

Cash reserves are obviously a major component of a contractor's liquidity program. The more cash, the greater the ability to weather a storm. Prudent investment guidelines should be followed when accumulating and investing excess cash. An analysis should be performed to determine if the excess should be used to pay down debt prior to investing.

## Banking Facilities

Banking facilities can provide a wide variety of options for effective cash management. One example: the utilization of a lockbox to speed up collections, increasing cash flow and improving liquidity.

Other options are sweep accounts and zero-balance accounts (to effectively manage short-term cash flows and line of credit pay-downs), as well as short-term or overnight (repo) investing.

## Credit Facilities

Credit facilities are of the utmost importance to a contractor's long-term financial well-being. The more credit a contractor has, the greater its ability to make better business decisions. Treating the credit facility as an insurance policy allows for sound long-term liquidity decisions, instead of short-term, stop-gap reactions.

Credit is critical to the long-term health of a construction company. Lack of available credit is a prime indicator that a contractor may be having difficulty or is not creditworthy, and can also be a hurdle for securing work.

Tom III knew that banks and sureties are often on the same page when it comes to extending credit; both have a substantial interest in the assets that are being used as security.

Consequently, if one facility tightens credit, the other is likely to follow suit, especially in the case where either or both believe the contractor is in financial difficulty.

### No Way Out

A liquidity crisis can be directly related to a cut-off of available credit from banks or other traditional lending sources. And, while a contractor may look to the owners of the business or other third parties for cash infusions, that is not always a viable option.

The reason? Most owners are reluctant to throw good money after bad. An owner may not be willing to keep infusing cash into a business without getting to the root of the reasons why there is a liquidity crunch.

### Building More Credit

How does a contractor accumulate more credit? It's simple: When times are good, stockpile. Ask for additional credit from the bank or surety, even if it may not be needed immediately.

Why? Because it's much easier (and cheaper) to get credit when it's not needed than when a financial crisis

develops and times are desperate. However, remember to weigh the associated fees, covenants, and required debt guarantees against any additional liquidity provided by the credit facility.

## Suretyship and Bonding

There are also several other sources of liquidity that should not be overlooked.

### Sureties

Sureties provide liquidity. While they may not be thought of as a traditional liquidity source and do not factor into the formal working capital calculation, they are still a valuable source of liquidity that allows a contractor to continue to pursue work.

Without the ability to bid work requiring bonds, many contractors would be faced with the unhappy choice of either only bidding work that doesn't require bonding or finding risky alternatives to secure bonds (such as putting up cash or choosing substandard surety companies that charge higher premiums).

### Back-Bonding

Back-bonding lower-tier subs may also have an incremental effect on a contractor's ability to secure additional bonding capacity. The theory is that if one has subs back-bonded, then the part of credit that is back-bonded should still be available for bidding.

Although there is seldom a straight dollar-for-dollar benefit of back-bonding, it can provide an intangible that is considered by a surety when evaluating bid/performance bond requests.

## Fixed Asset Utilization

One of the largest items on the balance sheets of many heavy/highway, excavation, and other equipment-intensive contractors is their investment in fixed assets. For that reason, contractors should periodically review their fixed asset investments, regardless of the state of the economy.

Examine break-even analyses and projections of future work to determine if (in terms of liquidity management) it makes more sense to rent equipment on an as-needed basis, to lease it, or to purchase it outright.

This decision affects more than just the bottom line; it may also affect the ability to secure additional credit from lending institutions. Equipment that is encumbered with a mortgage or similar pledge may be difficult (if not impossible) to use as security for a bank line of credit.

## Suppliers and Subcontractors

Suppliers and subs can be an excellent source of liquidity.

### Suppliers

Suppliers that offer discounts are a good source of liquidity. For instance, a standard supplier discount of 2/10 net 30 can translate into an annualized discount of roughly 36%!

So, it makes economic (as well as cash flow) sense to borrow to take the discounts being offered.

Additionally, a contractor who manages its liquidity properly can take advantage of a supplier looking to enhance its short-term liquidity.

For example, if a struggling supplier is willing to trade short-term cash infusions for long-term liquidity, this could be an opportunity for a discounted debt buy-down.

### Subcontractors

As I mentioned earlier, subs should try to eliminate "pay when paid" or "pay if paid" clauses. However, tension will always exist between subs and GCs in this area. GCs will want to incorporate these clauses into their contracts to allow for legal flexibility in the event bills are not paid on a particular project, and subs will want to avoid these clauses whenever possible.

## Debt

A mixed economy can have a ripple effect, creating both opportunities and problems at all levels of the construction "food chain."

### An Opportunity

Being able to pay less and still receive full value can contribute to cash flow.

For instance, a sub in financial difficulty may ask for pre-payment or settlement of its outstanding invoices and extra work orders; it might settle for less than "full value," thus enhancing your company's long-term liquidity.

### A Problem

On the other hand, if an owner or upstream contractor is in trouble, it may be in your best interest to settle for less than full value on some invoices.

This decision must be made with a great deal of thought and analysis, however. While on the surface it may seem to enhance cash flow, taking too little for a settlement can have the opposite effect in the long run.

## Legal Factors

There are a number of legal (or quasi-legal) factors or processes that can affect a contractor's liquidity. These include:

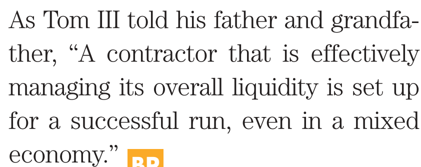
- Obtaining lien waivers from all suppliers and subcontractors,
- Ensuring that mechanics lien rights are kept in place by following the specific state statutes for liens,
- Filing of a lien itself,
- Collection actions, and
- Outright suing for non-payment.

Some or all of these factors may come into play during a project and as part of the liquidity management process.

## A Happy Ending?

In order to be successful in the ebb and flow that is a contractor's existence, it is crucial that liquidity management – not just managing the cash balances in the bank – be the focus of a contractor's cash and credit management strategy.

As Tom III told his father and grandfather, "A contractor that is effectively managing its overall liquidity is set up for a successful run, even in a mixed economy." BP



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