CLAconnect.com/construction

The 2018 CLA Construction Benchmark Report

The 2018 CLA Construction Benchmark Report

CLA construction professionals have compiled financial data from our industry clients across the United States. The goal of this effort is to provide insight and answers to the financial and operational questions that keep construction company owners and managers up at night, such as:

1. How do I attract qualified workers to my company?
2. What employee incentives will improve profitability and decrease turnover?
3. How do we align our long-term goals with financial performance?
4. How do we effectively budget to control or minimize overhead costs?
5. In what business areas are companies investing to improve profitability?
6. Are we better off financing equipment or leasing it?

A strong benchmark analysis of financial data can provide you with answers to these questions, as well as offer insight into other areas.

The *2018 CLA Construction Benchmark Report* summarizes data from approximately 700 construction companies with operations throughout the United States. Drawing on data from their financial information, this report provides a brief summary of some of the key industry trends. Contractors who recognize and understand the changes impacting the industry will be better positioned to take advantage of future opportunities.

Construction Contractors' To-Do List

1. Review the available technology to determine what can help fill the void between qualified workers and timing of jobs.
2. Consider working with school districts to encourage building trades as an alternative to college.
3. Get your employees involved with industry associations, and use their education and training programs to help narrow the knowledge gap.
4. Evaluate your accounting system's capacity to adapt to upcoming changes, such as revenue recognition and accounting for leases. Research additional modules that could increase your efficiency.
5. Review the *Tax Cuts and Jobs Act,* and consult with your tax advisor to see how the new laws will impact your company. Consider changes needed to your entity structure to maximize tax rate savings and capitalize on new incentives.
6. Consult with your CPA or information technology advisor to understand current risks and take steps to improve internal controls.
7. Develop goals and a timeline for the implementation of technology enhancements.

Overview and executive summary

Industry challenges and opportunities

Contractors face many complex and unique challenges that are driving change throughout the construction industry. Those who recognize the impact of these changes on their business and are prepared to make the necessary adjustments will be better positioned to create opportunities in the future. Several catalysts are currently at work in the industry:

1. Tariff activity from the current administration has led to more volatility in supply prices, particularly from foreign suppliers. Cost forecasting will be increasingly difficult, and lumber and steel prices may change significantly after bids have gone out.
2. As the U.S. economic outlook presents optimistic opportunities for contractors to increase backlog, the construction industry has been experiencing labor shortages across the country. Companies have had to resort to higher labor costs or other incentives to attract and retain talent. The demand for qualified labor as well as project managers has been increasing, and a highly competitive job market continues to challenge contractors to keep a good team of employees for the long term.
3. Contractors are facing two accounting changes that will significantly impact their financial performance metrics: revenue recognition and lease accounting. Contractors should analyze the potential impact on the company's financial statements and be prepared to have a discussion with their bonding agents and bankers.
4. The recent tax reform legislation presents opportunities for contractors to re-evaluate their organization structure, capitalize on incentives for re-investment in their businesses, and make updates to their employee reward programs.
5. Cybersecurity has become an everyday problem and can impact a company's business for several days. Ongoing security and maintenance are imperative.
6. Many companies have made significant investments in technology but are not yet fully utilizing that technology. Additional training and a concrete plan for implementation are needed.

Trends in key ratios

Months in backlog — Based on the current market, we expected more active jobs circulating, and all contractors have secured more backlog in 2017 than the past two years. Further, contractors are expecting higher margins on their backlog with the median gross profit increasing to 11.9 percent in 2017 compared to 11.1 percent in 2016.

Pre-tax income as a percentage of revenue — The median pre-tax income as a percentage of revenue decreased compared to 2016 and 2015, except for electrical and mechanical contractors, which remained the same. This appears to be due to an increase in overall contract revenue volume in 2017; contractors had a good, profitable year.

Gross profit — The overall gross profit percentage for the industry has increased from 15.9 percent in 2016 to 16.8 percent in 2017. The two sub-industries contributing to this increase are civil and electrical/mechanical, which increased 0.7 percent and 0.8 percent, respectively, between 2016 and 2017. The general building and other specialty sub-industries experienced decreases in margins of 1.0 percent and 0.2 percent, respectively. Although these two sub-industries had decreased margins in 2017, the margins were higher than those in 2015 and remain strong.

Days sales outstanding — The number of days it takes to collect accounts receivable (AR) is on the rise. In an industry where the ability to pay employees and suppliers is significant, cash collection is of utmost importance. On average for all sub-industries, days sales outstanding has increased from 51.4 days in 2015 to 56.6 days in 2017. The electrical/mechanical sub-industry is the slowest collector with an increase from 62.4 days in 2015 to 71.0 days in 2017. The civil sub-industry is the best at collecting, but has also experienced an increase in days sales outstanding from 34.6 in 2015 to 47.7 in 2017.

Report methodology

Financial ratios and key performance indicators have been computed using information obtained primarily from audited and reviewed financial statements of our construction contractor clients. Participation in the study was voluntary, and data gathered have been analyzed by representatives from our construction industry practice. This report summarizes data from approximately 700 construction companies with operations throughout the United States. The companies are categorized into one of four sub-industries:

Civil contractors —This category includes contractors engaged in highway and street projects, bridges, oil and gas pipelines, railroads, underground utilities, tunnels, water resources, site work, and other general excavation. Information from 158 civil contractors was included in the report.

General building — General contractors are involved in vertical construction, including commercial, industrial, residential, and multi-family buildings. A total of 229 companies in this category participated in the report.

Electrical and mechanical — Information from 150 companies engaged in electrical, plumbing, HVAC, low-voltage, and energy efficiency trades (including both new construction and service work) contributed their information to the report.

Other specialty — This category is comprised of contractors that do not fit into the categories above. These companies are largely labor-intensive and include building subcontractors involved with work such as concrete, steel erection, roofing, and outdoor specialty trade contractors. A total of 159 companies are included in the report's other specialty.

Financial ratios and key performance indicators

Analysis of financial ratios and key performance indicators can help assess a contractor's financial health, operating efficiency, and profitability. Understanding how your company's performance compares to similar organizations can prompt you to investigate the variances and make operational changes to both improve profitability and efficiency.

Consistently monitoring key financial and operational indicators can help improve profitability, manage operations, provide key information for developing competitive bids, and maintain healthy financial statements for bonding. Some of the advantages and limitations of using comparative indicators are outlined below.

Advantages

- Benchmarks provide comparisons to contractors with similar operations.
- They identify unusual operating results and trends.
- Performance indicators highlight both areas of strength and areas for potential improvement.

Limitations

- Variances alone do not necessarily reflect an opportunity or a challenge.
- Potential for inconsistency in data collection can reduce the usefulness of comparisons.
- Benchmarks should be used in conjunction with other analysis of a contractor's operations.

Ultimately, no single ratio or financial analysis should be evaluated on its own to assess a contractor's financial condition. Variances from benchmarks should be investigated and considered in the context of the company's specific operating structure, sub-industry, and the region in which it operates. In many cases, the most useful information is a combination of benchmark data and the company's own financial trend results.

Ratio analysis and key performance indicators

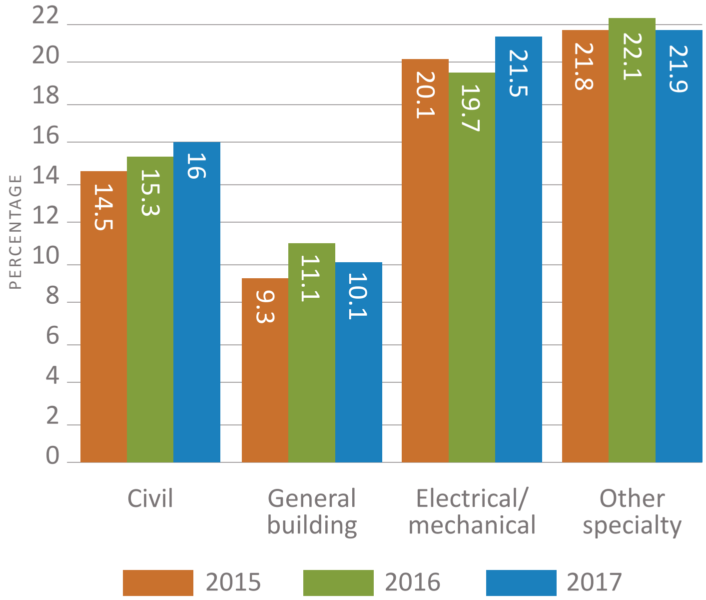
The following graphs present median data for years 2015 through 2017 for each sub-industry.

Gross Profit Percentage

$$\textbf{Gross Profit as a Percent of Revenue} = \frac{\textbf{Gross Profit}}{\textbf{Construction Revenue}}$$

The gross profit ratio represents the percent of total contract revenue that the company retains after incurring the direct costs associated with completing the contract.

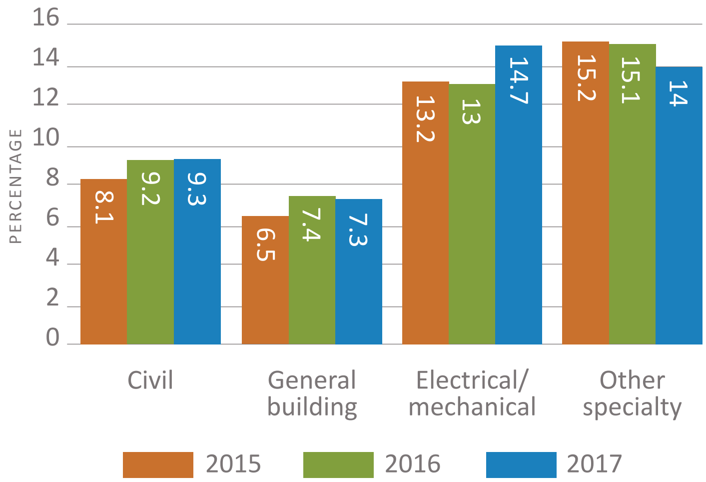
The higher the percentage, the more of each dollar the business retains, which means more money is left over for other operating expenses and net profit. Gross profit margin is impacted by the amount of work the contractor self-performs on the contract, as well as how the company allocates corporate overhead costs, such as payroll, between general and administrative expenses and contract costs.



General and Administrative (G and A) Expense as a Percentage of Revenue

$$\textbf{General and Administrative (G and A) Expense as a Percentage of Revenue} = \frac{\textbf{G and A Expense}}{\textbf{Construction Revenue}}$$

General and administrative expense includes costs associated with the day-to-day operations of the business and often include management and office salaries, rent, utilities, and insurance costs. Since general and administrative costs are independent of costs associated with construction contract activity, they are viewed as fixed. From a competitive standpoint, reducing G and A expenses as a percent of revenue can offer a company a competitive advantage over its peers and is achieved by maintaining efficiency in G and A spending relative to a company's revenue growth.



Certain expenditures are subject to discretion by management, including executive compensation, bonuses, benefit plan contributions, and charitable donations. In a rising construction market, an increase in G and A expenses is very common. These costs are often the distinguishing factor in G and A expense percentage differences among organizations.

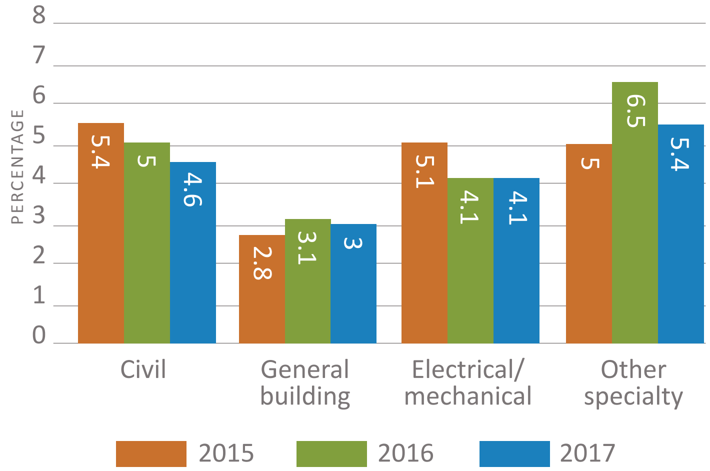
Pre-Tax Income as a Percentage of Revenue

$$\textbf{Pre-Tax Income as a Percent of Revenue} = \frac{\textbf{Pre-Tax Income}}{\textbf{Construction Revenue}}$$

This ratio represents earnings before income tax as percentage of total construction revenue.

The higher the percentage, the more return can be provided to the owners or re-invested into the business. This also provides insight into a company's selling and G and A cost structure when compared to the gross profit ratio information.

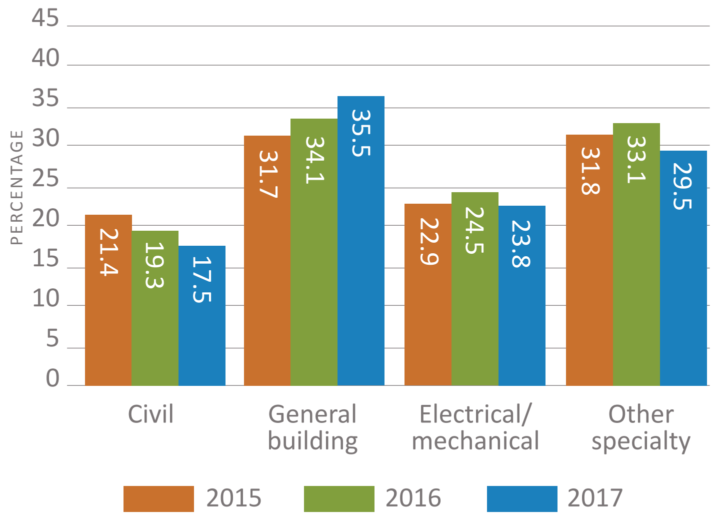
Although this ratio has declined, the percentages in general are still strong.



Pre-Tax Return on Equity

$$\textbf{Pre-Tax Return on Equity} = \frac{\textbf{Pre-Tax Income}}{\textbf{Equity}}$$

This ratio determines the rate of return on owners' capital invested or retained in the business. It measures how much profit a company generates with money the owners have invested. As an owner, this is one of the most important ratios because it shows if the business is earning a sufficient profit to compensate the owner for the risk of being in business.

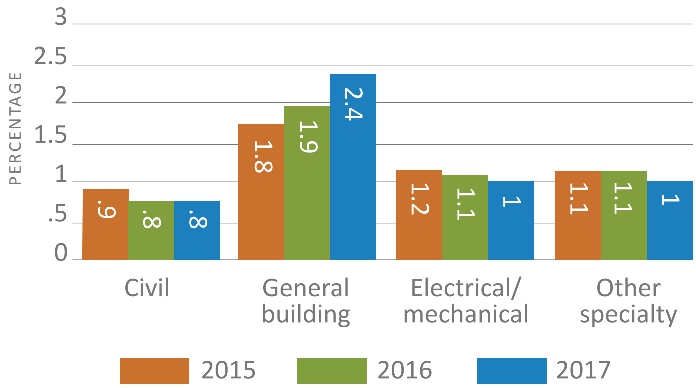


A high return on equity ratio indicates that the company is using its owners' funds effectively. Higher ratios are almost always better than lower ratios, but consideration should also be given to the significance of actual dollars invested, which can vary significantly among sub-industries.

Overall, the general building category represented the only sub-industry with an increase in return on equity in 2017. Other specialty contractors experienced the largest decline, moving from just over 33 percent in 2016 to 29.5 percent in 2017. Electrical and mechanical contractors have experienced the most consistency over the three-year period.

Debt to Equity Ratio

$$\textbf{Debt to Equity Ratio} = \frac{\textbf{Total Liabilites}}{\textbf{Equity}}$$



The debt-to-equity ratio measures a company's financial leverage. The ratio indicates how much debt (total liabilities) a company is using to finance its assets relative to the amount of investment by its owners.

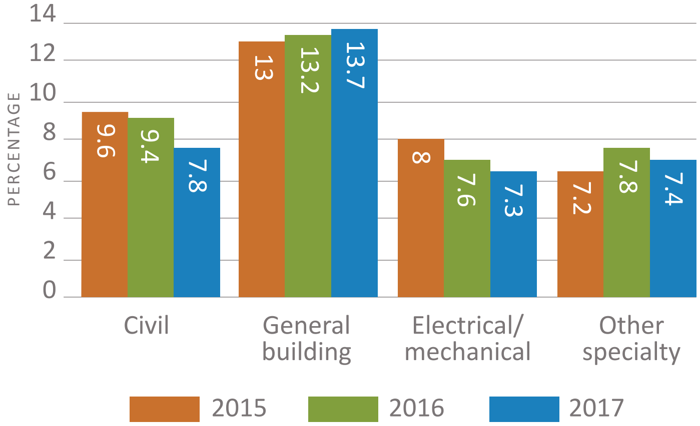
The higher the ratio, the more debt a company is using to leverage its operations. To improve your debt-to-equity ratio (decrease the number), you generally must increase your equity levels through net income retained or through additional capital investment by the owners. Debt-to-equity can be significantly impacted by the amount of pass-through costs, such as material and subcontract costs that are incurred throughout the contract, so the ratio varies significantly among the sub-industries represented.

Because the construction industry is a seasonal business, accounts payable and lines of credit balances can fluctuate significantly throughout the year, which can impact the debt-to-equity ratio.

Due to another year of strong profitability, many contractors have minimized debt financing and financed purchases with internal funds. Financing costs have been on the rise the past few years, and strong job performance has allowed contractors to use less outside financing. This has lowered the debt-to-equity ratio for many companies and allowed them to maintain bonding capacity to support their revenue goals.

Working Capital Turnover

$$\textbf{Working Capital Turnover} = \frac{\textbf{Construction Revenue}}{\textbf{Current Assets - Current Liabilities}}$$



Working capital turnover indicates the amount of construction revenue generated by each dollar of working capital.

The higher the ratio, the more efficient a company is in using working capital to generate revenue. However, a very high working capital turnover (ratios approaching 20) may indicate a business does not have enough capital to support its revenue goals. Sureties and lending institutions often look at working capital as an important metric in their credit granting decisions.

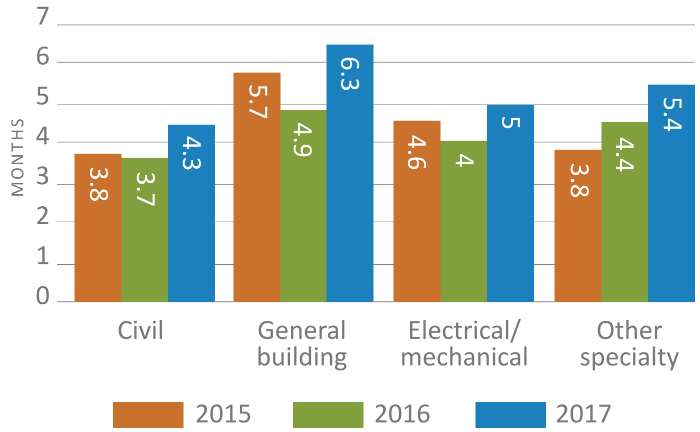
Working capital turnover for general building contractors has been trending up, which indicates revenue growth has exceeded the growth in working capital over that time frame. However, the opposite is true when looking at the trend for civil, electrical, mechanical, and other specialty contractors.

Months in Backlog

Months in Backlog $= \dfrac{\textbf{Backlog Dollars}}{\textbf{Construction Revenue / 12}}$

This ratio indicates the number of months it will take to complete all signed contracts or committed work based on the revenue volume of the previous year. A ratio of less than 12 indicates a need to secure new contracts in the next year to maintain a constant level of annual revenue.

General contractors, including those classified within the civil and general building sub-industries, typically have a larger number of months in backlog due to the nature and length of their contracts.

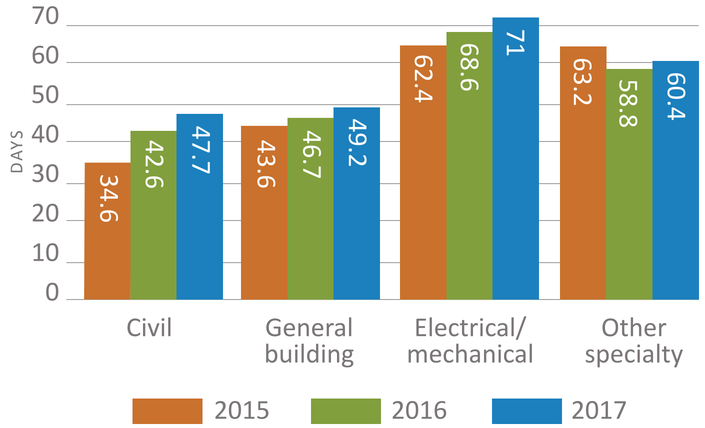


Industry-wide backlog has improved considerably over 2016 levels, which is consistent with the overall trend in construction spending forecasts. Most companies in the sub-industries have enough backlog at year-end to operate through the first quarter without obtaining any new work, with most general builders having half the year already covered.

Days in Sales Outstanding

Days in Sales Outstanding = Accounts Receivable $\dfrac{\textbf{360}}{\textbf{Revenue}}$

Days sales outstanding represents the average number of days it takes to collect payment for construction services performed. Generally, the greater the number of days, the greater the likelihood of delinquent payments and cash flow problems. A ratio of 60 days or less is generally considered acceptable.



Electrical and mechanical and other specialty sub-industries take longer to collect payment because they are frequently used as subcontractors and are typically paid after the general contractors are paid. The days in AR for these two sub-industries are slower than the normally acceptable range of 60 days or less. The civil and general building sub-industries, although increasing in number of days, are still collecting at an acceptable rate.

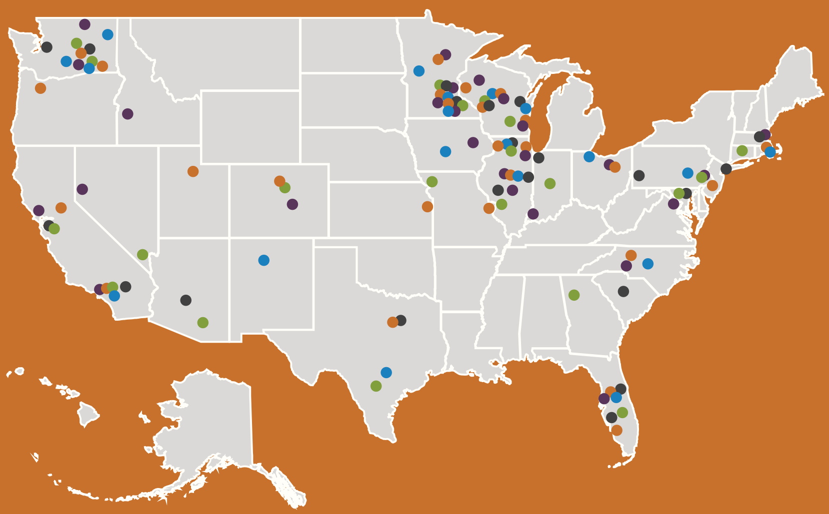
Benchmark Analysis

A more detailed comparison of your financial results is available with CLA's benchmark analysis service. The benchmark analysis provides a comprehensive comparison of your financial results to a defined group of similar contractors that are selected using a number of factors, including geographic operating region, company size, union or non-union labor force, and public or private work focus, along with many other considerations. The analysis provides for easy comparison between different-sized companies and combines balance sheet and income statement analysis and graphical comparisons of approximately 40 key performance indicators.

The information presented in the benchmark analysis has assisted many construction companies in identifying areas for improvement and highlighting aspects of their business that need further attention. Your company's decisions-makers can use the analysis on an ongoing basis for strategic planning, risk mitigation, and internal budgeting, and to help define and track financial and operating goals.

About CLA

CLA exists to create opportunities — for our clients, our people, and our communities. We help clients succeed professionally and personally by providing integrated wealth advisory, outsourcing, audit, tax, and consulting services. We get to know you as a person, so we can understand how to help you. Then we combine our knowledge with yours to make you stronger. With more than 5,400 people, 110 U.S. locations, and a global affiliation, one firm is all you need. *Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC, an SEC-registered investment advisor.*



Our construction professionals

Our teams include construction professionals, CPAs, engineers, and people who know the industry because they have worked in it. We participate in the construction industry at local and national levels through the Construction Financial Management Association (CFMA), Associated General Contractors of America (AGC), and Associated Builders and Contractors (ABC).

For a more detailed analysis and comparison of your company's results to the benchmark, contact Jon Weston, Principal, Construction and Real Estate, at jon.weston@CLAconnect.com or 218-825-2913.