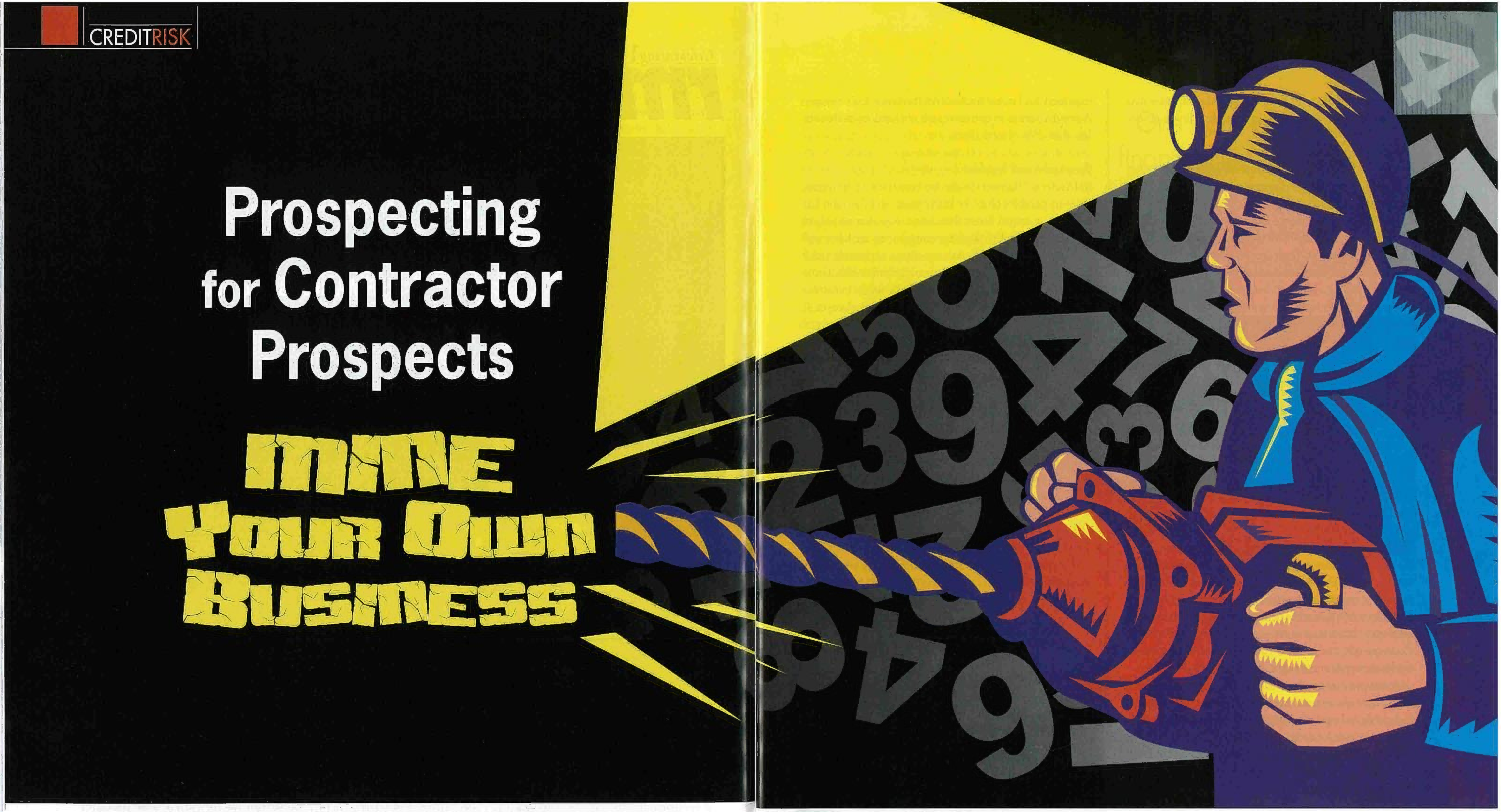
Prospecting for Contractor Prospects

Mine Your Own Business



A contractor's fortunes can rise and fall like the precious metals market. Still, there may be gold in them thar subdivisions. Here's how to judge a contractor for creditworthiness.

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BY DEV STRISCHEK

WALTER HUSTON PROBABLY set the cinematic standard for the grizzled prospector when he portrayed Howard in the 1948 film *The Treasure of the Sierra Madre.* Unfortunately, most bankers do not have the years to spend or the mountains to climb in their search for new business gold. As the price of the precious metal has fallen and risen over the years, so too have the prospects for the construction industry. The rediscovery of income-producing property gems and the unearthing of residential diamonds-in-the-rough have bankers staking out claims on promising construction fields in search of a mother lode of high-grade business ore.

We bankers can learn something from rock hounds like *Sierra Madre's* Howard when it comes to screening quick and picking smart among the rocks and hard places of the recession's economic tailings. In their search for treasure, prospectors routinely sift for clues in the geology—indeed, lead, copper, and zinc ore deposits often contain traces of silver and gold. Similarly, in the accounting bedrock of a contractor's balance sheet, the prospecting banker can mine data that should yield reliable trace elements of creditworthiness.

Ready Ore Not: Five Assay Pieces

Specifically, we can assay five interrelated financial ratios: cash/total assets, net fixed assets/total assets, receivables/payables, underbillings/total assets, and overbillings/total assets.[1] These ratios share the advantage of all being balance sheet measures, so none of them requires information from the income statement. Their second advantage is that only a current balance sheet is needed to perform this quick and easy screening test, which evaluates whether the contractor has invested in the right combination of cash and fixed assets to meet customers' project expectations for satisfactory work delivered on schedule.

Cash

One irony of contractor financial life is the constant need for cash despite seemingly high levels of it on the balance sheet. In fact, RMA industry statistics routinely report that, on average, contractors carry 10% to 12% of their total assets in cash, nearly double that of non-contractor businesses. So why are contractors in liquidity crises month in and month out? There are two basic reasons: the bunching of receivables toward the end of the month and the need to cover weekly payrolls.

Project billings are usually submitted toward the end of the month for processing and payment at month-end. This practice means that very little cash is flowing into the firm during the rest of the month. Meanwhile, contractors typically pay workers weekly because of trade practices, high employee turnover, and various regulatory requirements. Consequently, the prudent contractor will bankroll four weeks of payroll at the beginning of the month.

A non-construction firm with two payrolls a month and a steady flow of customer payments over the month is likely to be able to begin the month with just enough cash to cover a two-week payroll, half what the contractor needs. These facts of financial life reconcile the higher cash levels of contractors with their higher liquidity-stress levels. A positive sign is a contractor with cash balances averaging 10% or more.

Fixed Assets

Another fact of contractor life is the need for fixed assets[2]—construction equipment, tools, rolling stock, and so on. Nevertheless, net fixed assets as a percentage of total assets generally run 20% to 25%, rising above 30% only for heavy construction contractors such as those engaged in road and bridge, pipeline, cable, and related work where large amounts of material and earth must be moved. Many contractors keep their fixed-asset investment low by renting equipment for specific projects. Tools are generally expensed, and many trade's carry their own tools anyway. A positive sign is a contractor with net fixed assets that are less than 25% of total assets.

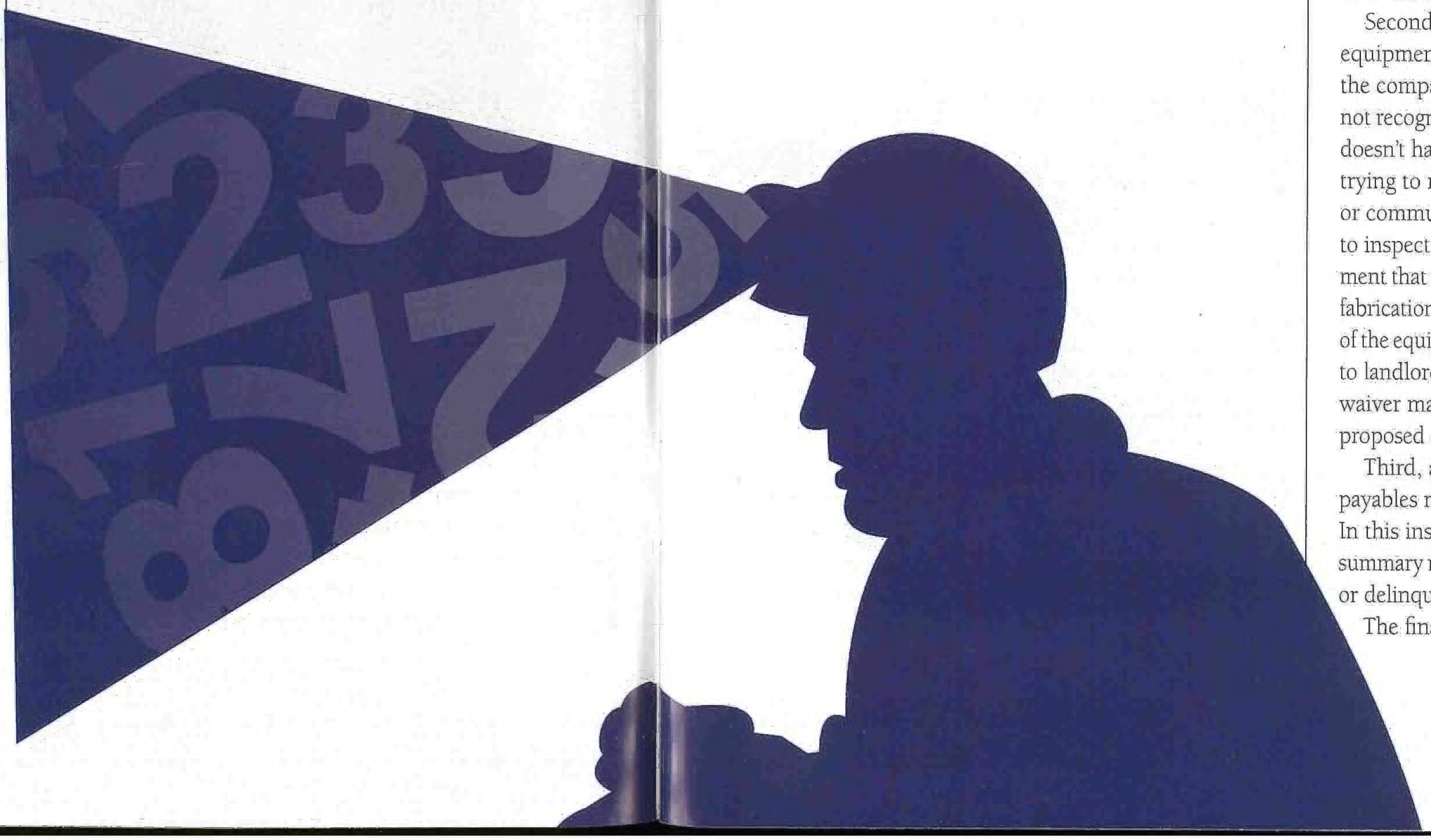
Receivables and Payables

RMA's *Annual Statement Studies* has been tracking the receivables-to-payables ratio[3] for many years, and this ratio has generally averaged better than 2-to-1 over that period. In a typical project, the two large components are labor and materials, although materials constitute a relatively small percentage of the total bill—often only a third to 40%. Gross profit margins have averaged around 20% for the construction industry, so that leaves 80% to cover total costs. If receivables reflect billings and payables consist mostly of trade payables, the receivables-to-payables ratio will usually run 2.0x and higher.

There is no good reason why payables should ever exceed receivables. In such instances, the contractor is usually seriously past due or has been relegated to C.O.D. status by suppliers. Likewise, because of the close interrelationship between the company and its owners, the firm's principals often are generating low credit scores. Anyway, a positive sign is a contractor with the aforementioned receivables-to-payables ratio of 2.0x or better.

Underbillings and Overbillings

Two unique items in contractor accounting, underbillings and overbillings are shorthand for the current asset "costs and estimated earnings in excess of billings" and the current liability "billings in excess of costs and estimated earnings," respectively. Because no contractor likes to underbill and none of the contractor's clients wants to be overbilled, these two accounts tend to be very small, usually no more than 5% of total assets. A positive sign is a contractor with both underbillings and overbillings that are less than 5% of total assets.



Easy to Assemble: Instructions Included

The next time you are prospecting for contractors, mine a little financial data and assay your claim's prospects with a "creditworthy contractor" checklist. The example shown here is for Georgia Ornamental Landscaping Design (GOLD), a site preparation and landscaping contractor (see table at right).

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Creditworthy Contractor Checklist					
Financial Measures	Creditworthy if:	Prospect	Yes	No	Comments
1. Cash/Total Assets	≥ 10%	11.5%	X		$500 cash on hand, remainder in bank account
2. Net Fixed Assets/ Total Assets	≤ 25%	21.8%	X		Equipment, no real estate, probably leased premises
3. Receivables/Payables	≥ 2.0x	2.3x	X		D&B shows prospect current in trade
4. Underbillings/ Total Assets	≤ 5%	3.2%	X		Next step: Review CSR to identify UB'd jobs
5. Overbillings/ Total Assets	≤ 5%	3.4%	X		Next step: Review CSR to identify OB'd jobs
Summary and Final Comment/Decision			5	0	Good to go to next level

All five measures in the GOLD example meet or exceed the standards, so the banker will be moving on to the next level—evaluating the income statement, analyzing the contract status report (CSR), and calculating a downside cash flow. The next step lies beyond the horizon of this article, but the "Comments" column in the checklist offers some additional observations at this stage.

First, most contractors have cash on hand to deal with day-to-day petty cash requirements, such as travel and expense reimbursements, office supplies, and postage. Company credit cards obviate most of the need for cash on hand—an important consideration since cash raises the risk of internal theft, necessitates daily accounting of transactions, and requires physical security of the cash itself. Petty cash balances should be minimal—say, under $1,000.

Second, GOLD's net fixed assets consist entirely of equipment, so the absence of real property implies that the company operates out of leased premises. GOLD has not recognized any leasehold improvements, so the banker doesn't have to worry about the dubious value or effort of trying to reclaim and liquidate carpeting, wall coverings, or communication wiring. A prudent next step would be to inspect the premises for any non-transportation equipment that might be attached to the premises, such as metal-fabrication or materials-processing equipment. Ideally, none of the equipment is attached and therefore will not be subject to landlord liens. If it is attached, however, a landlord lien waiver may be a necessary next step in underwriting any proposed credit offering.

Third, a parallel step in calculating the receivables-to-payables ratio is to order a credit agency report on GOLD. In this instance, the Dun & Bradstreet report's trade debt summary reports GOLD as current—no accounts on C.O.D. or delinquent.

The final step in evaluating underbillings and overbill-

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ings is to identify which jobs are underbilled and overbilled and to find out what the contractor is doing to manage the underbillings and overbillings within the standards. Likely causes of underbillings are cost overruns due to *force majeure* events such as floods or other weather-related delays. Overbillings may result from customer deposits, a common practice in landscaping, fine carpentry work, and interior design projects.

Remember, the purpose of the checklist is not to fully analyze the prospective borrower, but to quickly separate the high-grade and low-grade prospects and invest the extra time and effort in processing viable candidates. Each bank will have to decide how tight to set its screen, whether at five out of five ratios or some lesser number out of five, depending on its risk-reward appetite. Nevertheless, the interrelated nature of these five measures becomes more apparent if the screen is set at five out of five.

These measures are chosen for two reasons: 1) they are balance sheet based and therefore do not require an income statement, and 2) RMA industry statistics are available for all five of them, offering more granular analysis with the addition of the most recent industry averages for the contractor's specific line of business. Just the application of this financial checklist should help sort out the waste from a potential strike. The next step would be a downside cash flow projection, but for that you need the income statement, and that is beyond the scope of this checklist.[4]

Conclusion: Make Mine Day

Mark Twain once defined a mine as a hole in the ground owned by a liar. Truth be told, prospecting for prospects has its pitfalls, but digging up some creditworthy contractors may not require a banker to move heaven and earth. Identifying five ratios available to screen prospective contactors, this article demonstrates how to score a quick win by fast-tracking promising nuggets and dumping unpromising prospects.

More analysis will be necessary to underwrite the contractor, but at least a bank's analytical resources can be applied to viable candidates so they can hit the ground running. As the prospector Howard advised his gold-hunting partners, "Once on the ground, all we gotta do is open our eyes and look around." So look around. "There's gold in them thar hills"[5]—and bankable contractors breaking ground everywhere. ❖

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Notes

1. Dev Strischek, *Analyzing Construction Contractors, Third Edition*, Risk Management Association, Philadelphia, 2004.
2. Ibid.
3. Dev Strischek, "Looking for a Vital Sign in Contractor Accounts: The Receivables/Payables Ratio," *The RMA Journal*, July-August 2001.
4. For more information, see *Analyzing Construction Contractors*.
5. In 1828, Dahlonega, Georgia, was the site of the first major gold rush in the United States. When the gold rush in Georgia was believed to be over, many miners headed west to join the California Gold Rush. Dahlonega Mint assayer M.F. Stephenson tried to persuade miners to stay in Dahlonega. From the steps of the town's old courthouse in 1849, he proclaimed to over 200 men, "Why go to California? In that ridge lies more gold than man ever dreamt of. There's millions in it." This excerpt was retold to Mark Twain by the miners who moved to California from Georgia, and it may have inspired his character Mulberry Sellers, a comical schemer in the 1873 novel *The Gilded Age: A Tale of Today*. Sellers was famous for his lines "There's gold in them thar hills" and "There's millions in it."