

The Best of Times, The Worst of Times

Construction in a Buyer's Market

BY BILL KESLAR, PRESIDENT, BUILDING SOLUTIONS



Demand for commercial and institutional (C&I) construction has declined in many areas of the country since 2008. The cost of construction as tracked by industry cost indices is now dropping, and fell by as much as 1 to 1.8% in cities like Dallas, Atlanta, Pittsburgh, and Los Angeles during 2009. Until mid-2009 the industry-standard McGraw-Hill Building Cost Index (BCI) continued to rise on an annual basis, but recent month-to-month price declines in many cities may lead to construction deflation on a national scale in the next few years. This would be an historic event: the BCI, a 20-city material-and-labor average, hasn't declined in a calendar year since 1935.

Knowing local trends and understanding how they impact a typical independent school capital program may help the business officer guide the school and its governing body in obtaining the "best building for the buck."

If your school is fortunate enough to have raised money during better economic times and is now ready to hire a contractor at today's reduced prices, you are living in the best of all worlds. If you proceed with prudence and knowledge, you can benefit from a construction buyer's market.

First, as a knowledgeable buyer you should have a realistic perspective.

Construction markets are local. While the U.S. commercial buildings market demand dropped precipitously in 2008, price declines haven't been felt until recently in many cities, and prices are actually still rising in some. Of course, some regions of the U.S. are affected more drastically than others, and in remote submarkets, the supply-demand relationship for contractor resources may deviate from the national averages significantly.

Commodities are only a part of construction costs. The financial industry executive who sits on the board lives in a world of efficient international markets where prices change daily for clearly defined goods and services. Custom-designed, specialized buildings for independent schools are the farthest thing from a commodity (though they incorporate commodities as components of materials). They are more like handicraft work, which requires strong and specialized skills, applied in a management-intensive environment—the skilled labor and professional management component accounts for 60-70% of the cost of a school building. Plummeting prices of copper and concrete will affect only a portion of the building cost, so a 30% drop in the commodity contributes to an overall 3% reduction in the cost of building construction.

Savings are relative to expectations. We've all heard about projects that were reported to be "\$1 million under budget" when bids were received, especially in the depths of the economic downturn. We should ask ourselves when hoping to extrapolate this good news to our project: "when was the budget prepared?" As recently as the third quarter of 2008, the market was experiencing annual escalation of 5-7%, and even more in some regions. Well-conceived budgets accounted for this escalation, so a budget on a \$10 million project prepared last year should have \$500,000 in savings, if costs had stayed flat. Combine the general price deflation with a local market situation, and "\$1 million under budget" is not a big surprise. However, savings of this magnitude will not continue to occur, as recent cost experience is reflected in current cost estimates.

Nonetheless, industry professionals are agreed that prices are extremely volatile at this time. Owners (schools) are justifiably cautious about engaging competitively priced, but financially strapped general contractors or construction managers. The general contractors have similar concerns about bargain-basement prices, from desperate subcontractors who may not be able to perform. A bankrupt contractor on a project can spell disaster. However, many solid companies who are operating with their strong core staffs are delivering quality work for a reduced profit margin, and eagerly serve the reduced number of customers who are buying construction.

How do you benefit from this opportunity and minimize risks to your school, especially on big projects?

1) Pre-qualify the contractors that you consider doing business with. This is not a time to take a risk with a low bidder, a new company without a track record, or a company who may not have the financial and human resources to adequately manage your work.

2) Interject a pricing competition wherever you can. Even on simple projects or tasks that may not require many trades, it may be worthwhile to have bid specifications prepared so you can have multiple firms vying for the work and expect to receive bids on the same scope from each. When selecting the GC or CM for a major project, you should definitely obtain competitive quotes for fees and general conditions before any one contractor is on board. An experienced professional advisor can assist in soliciting competitive proposals and comparing them.

3) Talk to the marketplace. Check with as many people in the market as you can, especially before making a major contractor selection, regarding recent performance. Check out rumors about layoffs, non-payment of suppliers, slow responses in correcting warranty work, key employees leaving the company. Architects, subcontractors friendly to your school (but without a vested interest in the project), materials suppliers, other schools, current clients—all of these are excellent sources of information. The key is to

gather current information, and not make a decision based purely on reputation from years past.

4) Look at recent workload patterns. If a contractor is completing a major project and doesn't have work to replace it, this may be an ideal time to contract with him/her. If s/he has been suffering without sustained work for several months, s/he may be down to a skeleton crew and will have a hard time managing your project. Gather the information and make the judgment.

5) Require a specific personnel commitment from the contractor. If you're impressed with whom they sell you, stipulate in the contract that those personnel will remain on your project. In tough times, staff are shifted from one project to another. Schools are sometimes less demanding than other clients, so their projects are handed off to less experienced or less capable management.

6) Be aware of the impact of the economy on other team members. Architects, engineers, other consultants, materials manufacturers, even city building departments have been affected by the same forces that have squeezed contractor profit margins. Delays by architects with reduced workforces and understaffed city plan review offices can add inconvenience and expense to your project. Ask questions, anticipate challenges, and build in extra time and money to deal with problems if they occur.

This is potentially the “best of times and the worst of times.” By being informed, seizing the opportunities, but exercising prudence, you can make this the very best time to construct your major capital project.