Methods Residential Construction Firms Have Taken in The Past to Survive a Recession and How to Apply Them Towards the Next One

Dustin Thompson
California Polytechnic State University
San Luis Obispo, CA

The success of construction firms and the health of the U.S. economy have always been interdependent. Recessions continually set back the construction industry in terms of growth, production, layoff rates, profit, and cause a high number of firms to go out of business. No other sector in construction feels the painful effects of a recession more than the residential side. This research aimed to produce a playbook of steps a residential builder should take to come out of a recession successfully. In order to create this playbook residential professionals who have experienced recessions in the past and pulled their companies out of it with success were interviewed to learn about their experiences to find out what decisions worked and what to look out for when trying to save a company during a strong economic downturn. The resulting findings are as follows; a builder should put more money into their product, be sure to protect the business's credit and reputation, stay aggressive with pricing against competitors and the market, push focus on projects that will keep production during the downturn, and have a team willing to be adaptable with their roles.

Key Words: Recession, Downturn, Residential, Experience, Success

Introduction

Recessions, like death and taxes, are a certainty in life. A recession can be defined as a business cycle contraction where there is a significant decline in economic activity spanning across the entire economy for more than a few months. The construction industry is already one of the riskiest in the United States with roughly 20 percent of construction firms failing in the first year, "50 percent within 5 years, and 66 percent within 10 years" (Kokklenberg). As if the risk of opening a construction firm was not enough, one of the most hard-hit industries during a recession is construction. The great recession starting in 2007 caused nearly 150,000 construction firms to fall "between 2007 and 2013 and over 2.3 million jobs were lost due to layoffs, early retirement, and workers leaving for greener pastures" (Jones). Adding even more risk to the equation is the challenge of running a residential construction firm. Unlike other sectors in the industry such as Heavy Civil where projects are publicly funded and most likely are able to not have their projects canceled and have funding continue, the success of residential firms really follow with how the economy is doing. Therefore construction business owners and especially residential ones should start and/or continue to look at steps they can take to recession-proof their company. Making the right decisions now to ensure a firm is resilient to the hardships a recession brings with it will mean continued success in the future before, during, and after the next recession hits.

Literature Review

At the height of the Great Recession, single-family homebuilding was at the epicenter of economic hardship with dramatic declines in homebuilding as there was an excess of homes on the market, falling home prices, and underwater borrowers. Much of the research published so far about recessions and their link to the residential sector is highly generalized and often summarized into a quick study/blog post. The success of the residential industry linked with how healthy the economy is doing is not a hidden fact, it is well-known that the construction industry is one of the riskiest businesses to get into in terms of economic success. This is why some material exists attempting to provide a generalized overview of steps a construction firm should do to help prepare them for a recession.

Construction Connect, an outlet for industry news and information, created a quick summary of what a firm could keep in mind when thinking about preparing for a downturn in the economy. The author of the article, Kendall Jones, hit six points he felt would help "recession-proof" a construction company:

- Have Cash on Hand
- Don't Rely on Backlogs
- Keep Your Best People
- Know Your Costs
- Play to Your Strengths
- Cut the Fat

Have Cash on Hand: When work becomes scarce a firm should have enough cash on hand to cover operating expenses and overhead for a few months.

Don't Rely on Backlogs: Jones writes "during the last recession ('08), many construction firms saw backlogs of nine to twelve months slowly disappear as projects were put on hold or canceled". A firm should turn their focus on how they are going to keep business coming in during an economic slump.

Keep Your Best People: A business's workers will be the ones getting the business through another recession. That means keeping your best employees by offering competitive wages, incentives, and winning enough work to keep them busy.

Know Your Costs: A combination of rising material costs along with complexities in projects has resulted in extremely low profit margins for companies who do not understand their actual costs that goes into a project. Having an accurate understanding of how much each job is going to cost will lead to better estimates and higher profit margins.

Play to Your Strengths: Understanding what sets a company apart from others means when work begins to dry up a business can lean into the type of work they excel in and are able to weather out the storm.

Cut the Fat: Taking on too many projects at once, having equipment sitting idle for months, or employees that are not pulling their own weight all already weigh down a construction firm financially. A recession is going to exacerbate existing financial problems which is the reason a business should focus on tightening their cash flow, spending money that directly relates to strategic growth, and work on improving how efficiently the company is run.

Another example of existing literature describing the relationship between recessions and the construction industry is this graph created by the Federal Reserve Bank of St. Louis. This graph illustrates the effects on the growth of the construction industry during the Great Recession as well as the construction industry's closest partners.

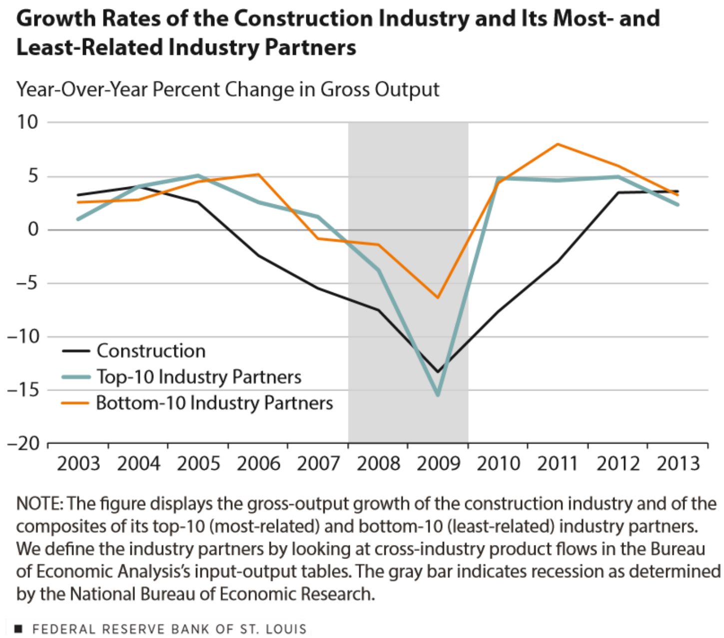

Figure 1: Growth Rates of the Construction Industry created by the Federal Reserve Bank of St. Louis

Figure 1 makes a clear point showing how the success of construction firms share a relationship with how healthy the economy is doing. The gray bar depicts the recession and reveals this is where the construction industry as well as its closest partners saw the steepest drop in gross output. When a recession occurs the entire construction industry feels its effects as even industry partners related to construction suffer as much or even more change in gross output.

Another important graph is the following Figure 2 which uses data from the St. Lous Fed to show the steep drop in employment during past recessions and how much harder the residential sector is hit even more than the already suffering sectors of construction.

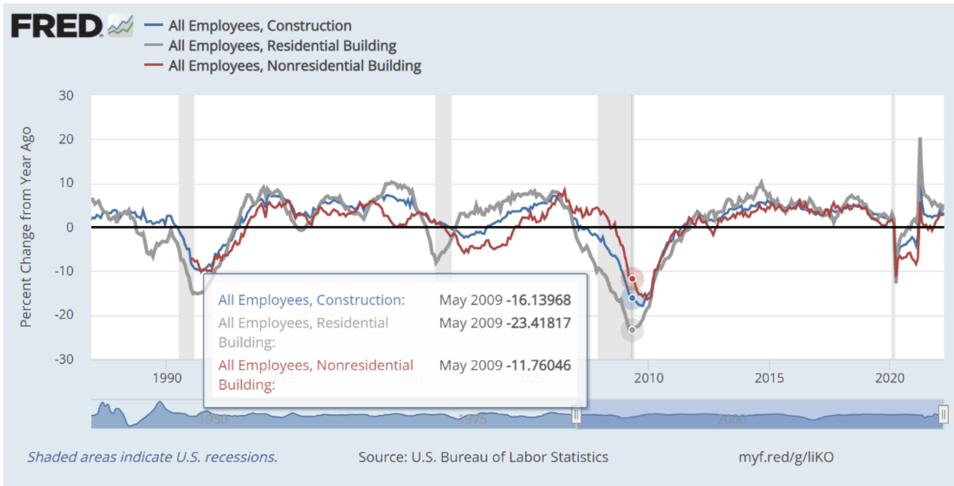

Fig 2: Data from the St. Louis Fed illustrating employment in the construction industry from the mid 1980's to right after 2020.

The relationship between the construction industry and the U.S. economy is once again strongly illustrated by this graph as it clearly shows heavy drops in employment in the construction industry during the two most recent recessions (the housing crash in '08 and the covid-19 pandemic in 2020). The blue line is meant to represent the construction industry, the red being non-residential builders, and grey demonstrating the residential sector. During the worst point in both previous recessions the residential sector suffered the steepest drops in employment with a 23% drop in employment in 2009 compared to 11% in nonresidential building. No other sector in construction has their success so tightly related to the health of the economy than residential building.

Methodology

Qualitative research was conducted so that firsthand data could be collected from experienced individuals who successfully got their companies out of previous recessions. This data was achieved through the use of interviews with successful individuals in the residential sector who have experienced past recessions and successfully navigated their company through them. The point of these interviews was to find out about the experiences these individuals went through and what decisions they made in order to keep their company going. The lessons learned from these interviews were then summarized and put together to help create a playbook of how a residential builder should prepare and navigate through a recession successfully.

Interview Questions

Listed here are the standard set of questions asked to every individual during the interviews. From there the professionals interviewed would often expound and provide more information on their personal experiences. Every interview took its own turn as I let the individual walk me through their own story and the decisions they faced which allowed me to collect unique perspectives from everyone and compile them together.

- What were you/the company doing right before the crash in ’08 (or covid if ’08 is not applicable)?
- What were some of the immediate effects felt from the crash?
- What were some decisions you/the company had to make quickly in order to survive?
- Can you share some examples of successful business decisions that worked so the company could continue making a profit or at the very least not go under?
- Looking back what are some examples of business decisions that did not end up working out well?

Analysis

Mark Montoya – Morley Builders. Mark Montoya, Vice President of Morley’s Residential Division during the Great Recession was one of the residential professionals interviewed. Morley Builders is a general contractor who self-performs their structural concrete as well. Mark and his residential division were succeeding in the market rate housing business up until the crash building projects like for-rent apartments, student housing, and low-income housing. August of 2008 is the date Mark described as “when the phone stopped ringing”. By this point the housing crash and recession was in full effect, the phone was not ringing because everyone in the United States was feeling the brutal effects of an economy that hadn’t been this bad since the Great Depression. To save money and keep the company running no one received any raises for a couple years as the company was battling the recession. Company execs went through a whole staffing list and tried to layoff as few people as possible. Luckily for Mark he felt his division did not feel the effects as deeply as others at the company because a majority of his projects were low-income housing funded by non-profit, private owners. During the rest of the recession Mark continued to push the focus on low-income housing as they were able to continue to get funding for their projects which meant his division was still able to make money for Morley.

Josh Lysen – Merit Homes. Josh Lysen, President and Co-Founder of Merit Homes, a homebuilder based in Kirkland Washington, was one of the individuals interviewed about the ’08 crash. Josh founded Merit Homes in the early 2000’s with his friend Greg Griffus, a construction professional who had been operating his own small residential construction firm prior to starting Merit. By the time 2007 rolled around Merit was on a successful roll constructing homes in the Kirkland area and only picking up momentum as they built more houses each year and quickly earned a solid reputation. When the banks began collapsing in 2007 Merit had 20 lots on the books and they were paying interest on those lots. That means they could not just sit there and wait for “bad times” to roll over. As the housing collapse in America happened it was a given no one was looking to buy homes during that time. The first thing Merit did to combat this problem was surprisingly putting more money into their homes. Josh wanted Merit houses to have more amenities in them than their competitors. What happened after this was they received a ton of lowball offers from buyers because of the market conditions however by putting more amenities into their projects Josh would show the buyers a detailed report of exactly how Merit got to their asking price. By doing this it made the lowball offers look ridiculous because the price buyers were trying to offer did not clearly match what was inside the home so buyers would accept Merit’s asking price. Josh and co-founder Greg next had to negotiate with lenders in the area as banks were closing down and everyone was hesitant to give any construction firms a loan. Josh emphasized protecting a business’s credit, don’t borrow so much to get through the hard times that the business’s credit and reputation gets taken through the mud. One of the biggest takeaways from Josh's interview was finding out how adaptable the team became so that they could hold onto all their team members with no layoffs. Everyone on board Merit's team began performing duties that were not part of their job description, Greg Griffus would perform landscaping activities on the site, the foremen and superintendents would put up siding, drywall, and other building activities usually reserved for subcontractors. This kept team members busy and allowed Merit to save money by not hiring certain subcontractors when their own guys were able to perform the tasks.

Danielle Molyneux – Holland Construction. The interview with Danielle Molyneux, a Project Manager for the residential owner-builder Holland Construction, was unique when compared to the other interviews in this study. Danielle is a recent graduate from Cal Poly and was still a student during the time of the housing crash. The interview with her became more of a lesson rather than sticking to the original interview questions. Danielle created this graph to explain how the effects of price surges caused by covid-19 were affecting Holland.

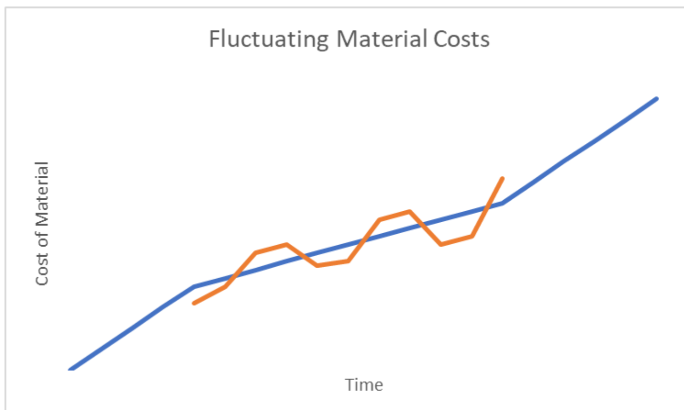

Fig 3: Costs of materials graph created by Danielle Molyneux.

The curve of Figure 3 depicts the price of materials over a period of time. Blue represents the cycles of the U.S. economy and orange is the constant fluctuating costs of materials. Ideally when writing a contract and signing agreements a PM would want to be paying for materials where the orange is at the bottom of the dips. What happened to Danielle's current project is they accepted the cost of materials at the peak of the orange line as no one was expecting prices to skyrocket. Holland is now over their original projected budget for material costs because they did not expect things like the cost of wood to soar 100%, the usual expected increase in costs is 5-10%. The takeaway from this lesson is a firm can take advantage of the little drips in material costs by locking in pricing agreements with their subcontractors when the dips are happening.

Brad Webb – D.R. Horton. The interview with Brad Webb, Superintendent at D.R. Horton, was based around what his company is currently doing to prepare for a shaky looking economy and some decisions D.R. Horton made during the covid-19 pandemic. Brad graduated in 2018 from the University of Alaska with a degree in Construction Management after spending several years in the residential sector of construction. He now lives in Greenville, South Carolina working as a superintendent for D.R. Horton, the largest homebuilder in America. Since Brad was too young to be in industry during the great recession he shared his insight on what his company is currently doing to prepare for a downturn as things currently look bleak for the economy. What D.R. Horton will generally do is either ramp up production or slow it down based on the feedback provided from sales on where the market is at. D.R. Horton is a large enough company that they are able to have whole teams on board where their purpose is to study the housing market/economy and relay that information back to the company. With the economy's current conditions and with every sign pointing towards a recession next year, the company is beginning to dial it down due to demand however in Brad's area of Greenville, South Carolina the population is growing immensely. Within the past year Brad's area has ramped up production to the highest it has ever been at. So as of right now as the construction division is relying on sales to provide data on demand in the market and while some areas are starting to dial down production, Brad's area is taking advantage of their little bubble and continuing full steam ahead. His office in Greenville currently has 17,000 lots in the pipeline and just purchased 40 acres of land. Brad explained when a downturn hits they simply cannot stop production and sit on the land they own as people and stockholders are invested in these projects. The good thing is D.R. Horton is continuously procuring land creating more work in the pipeline so when a dip happens in the market or the economy begins to head towards a recession there is work in the pipeline already and they can continue building. The rate at which they continue building would be based off the feedback from sales on the demand of houses at the time in a certain area.

Steve Carmona – Holland Construction. The interview with Steve Carmona, Superintendent at Holland Construction, provided great insight of what happens out in the field when the company is faced with a struggling economy. Covid-19 caused a shortage of everything from materials to equipment, so Steve shared how the field team and himself immediately began getting their hands on equipment. That meant a constant effort of coordination and planning to ensure the right equipment would be on-site when it was needed. Due to material shortages Steve and other supers are now scheduling their pours month in advance. These pour dates have become the priority and the project schedule now works around these pour dates because re-scheduling is simply not an option if they want to stay on track. Another situation the field is facing due to shortages caused by covid is they are having to bump up orders on concrete because projects now have limited "clean up" they are allowed because of how tight material is right now. So to combat that Steve is having to order extra concrete than originally needed for a pour to ensure they have enough when performing the final finishing and cleanup process. Steve stressed that during difficult times it is crucial to bring a constant effort everyday to the field in order to be successful in scheduling, coordinating, and having a continuous relationship with the trades in order to stay up to date with what is happening on-site.

Conclusions and Future Research

These personnel interviews conducted with five residential professionals yielded valuable information that contained successful and wise experiences. Either from face-to-face interviews or over the phone these professionals were able to share where their companies were at before the economy took a downwards turn, what the impact of that felt like, decisions they had to make in order to keep the company going, and shared advice that they felt would help strengthen a company in preparation for the next recession. After speaking with all five individuals and compiling their past successful decisions, the average of their data on what a residential construction firm should do during a recession can be separated into five main points: 1) Investing more money into the product 2) Protect the business' credit and reputation 3) Stay aggressive with pricing against competitors and the market 4) Push focus on projects that will keep production moving during the downturn 5) A successful team should be adaptable to their roles and responsibilities.

Investing more money into product: During an economic slump productions rates will more than likely slow and home/apartment prices will fall. Putting more money into the project rather than cutting it out trying to save will allow a builder to justify their prices when speaking with customers and give them an edge over their competitors. Yes, profits for a project during a recession will more than likely be smaller than what a firm would have taken home during a healthy economy but by investing in quality appliances in a kitchen, nicer finishes in the bathroom, etc. means the product will be of higher quality than the competition and a firm will still be able to make a sale during a tough market.

Protecting the business' credit and reputation: Holding onto debt is what takes builders out of the business. Borrowing money is usually one of the first moves any firm will take to keep their business going in the foreseeable future. However all individuals stressed the importance of protecting the business' reputation as well as its credit. Destroying a business' credit in order to survive a recession will mean tarnishing the reputation it once had and even after the economic turmoil has passed the firm will be in a place where no one wants to do business with them.

Staying aggressive with pricing: The following graph, Figure 4, illustrates the new knowledge created between Josh Lysen and myself as we took his previous experiences and constructed this graph together called "The Tahiti Plan". The main focus is to stay aggressive, either on the way up or heading down, staying aggressive is key. The orange line depicts what a firm "should do" and the blue line represents the competition and the market price. As the market is doing great and prices are increasing a firm should price their homes higher than the competition. When the market takes a dive and prices are dropping a firm should aggressively price lower than the market. This method of pricing brings a high number of sales as well as profit as projects done with high quality can sell for more during a healthy economy and during tougher times a firm is still able to make sales, beating out their competitors with lower prices. The joke about Tahiti is one should vacation during the rock bottom spells of the market as their business is following this model.

Tahiti Plan

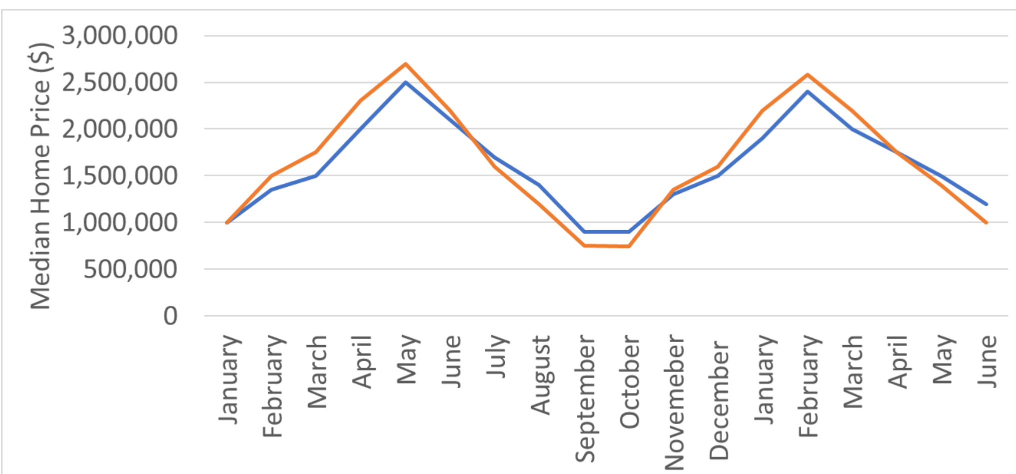

Fig 4: The Tahiti Plan created by Josh Lysen and myself.

Projects that keep production going: A common theme among all the professionals interviewed was their companies shifting their focus onto projects that would still continue through a recession. One of the biggest effects felt in construction because of a recession is a drop in production. Finding a niche of projects that still has the demand to be built means a firm can continue their building production which means they can retain more of their team members rather than face layoffs and still produce money for the business.

Adaptable Team: When a team member joins a firm they are given their role and a list of responsibilities expected of that role. What was common among successful companies who survived previous recessions was their team's adaptability to those responsibilities. Those team members who took on more work outside of their usual scope in order to save money, keep the project moving, and stop layoffs were key in their company's success of survival. Team members should be willing to go outside of their comfort zone when tackling a recession in order to help the company make it through.

Future research on this subject could be a whole volume set of each decision already published either here or in previous works going into great detail of how to perform each one. The five main points written here could have their own books filled with examples of how and when to perform them. This set of books could become a volume of manuals on the subject of how a residential construction firm should tackle a recession successfully.

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