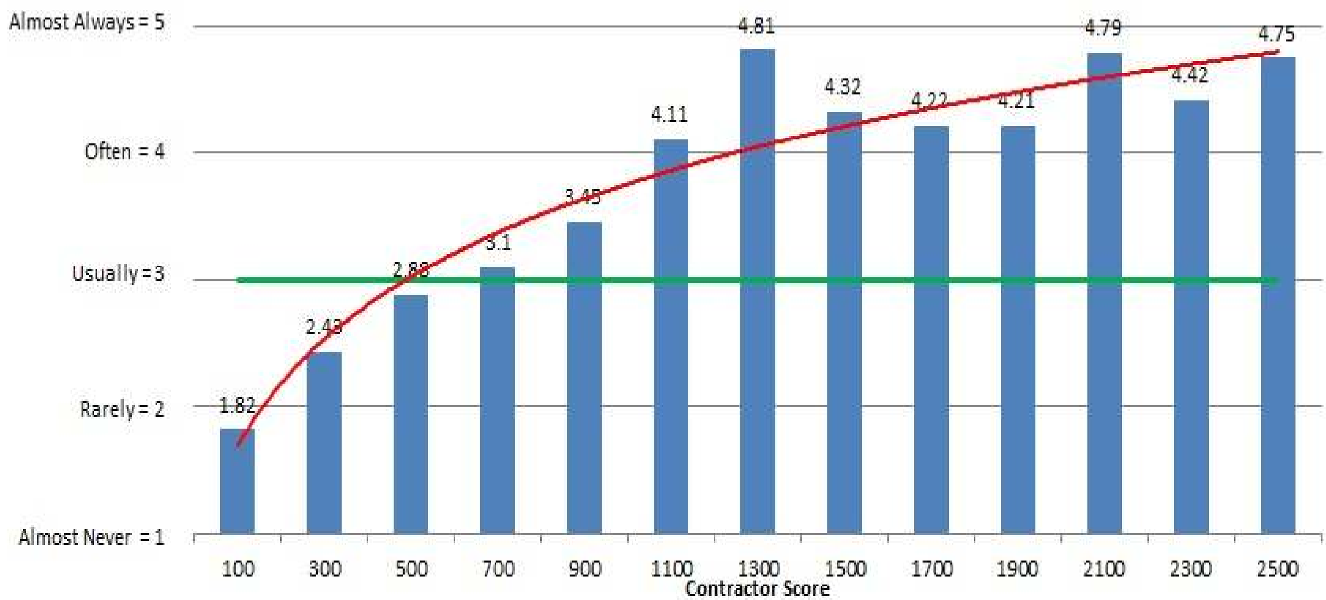
Predictive Performance by Contractors

By Glenn Matteson, President of Contractor Score LLC

The Premise

Is there a way to predict if a contractor will create problems on a job before they start? This is an interesting idea and one that has been kicked around for a while. The most obvious predictor is the contractor's reputation, real or exaggerated, first-hand experience or hearsay. A lot of anecdotal evidence also exists about contractors with weak financial positions causing delays and problems on jobs. Conversely, contractors with strong financial positions are often cited as being easy to work with, however their financial strength is rarely seen as the reason why.



A contractor's strong financial position is usually not the direct cause for a successful project, but it can provide a foundation for good procedures and people. And, flipping that around, good processes and people can often lead to healthy finances. This is typically not the case for a contractor in a weak financial position. An inadequate balance sheet and mounting, continuous losses often make for desperate actions, both bidding work and while on the job. It can drive behavior that negatively impacts everyone on the project. Short-cuts in workmanship, under-manning, delaying material delivery, under-staffed administration and over-stretched supervision all can contribute to schedule delays and project headaches. Safety practices can sometimes even be at risk with a financially struggling contractor.

Sooner or later, a financially weak contractor will be part of your work-in-process. They may sneak in through the qualification vetting or simply have the irresistible price that cannot be ignored. Managing that risk is just part of the expected responsibility in construction.

Managing that risk *effectively* first requires being able to *identify* it before you can act accordingly. We certainly do not claim a Contractor Score can point to specific potential problem contractors or stars for that matter, but we do offer a survey that shows a correlation between the Contractor Score and some project performance attributes. Interestingly, default which is perceived as a project catastrophe is actually quite rare as a percentage of the number of contracts and subcontracts let. On the other hand, delayed schedules and blown budgets are all too common. While there are many reasons for delays and missed budgets, a common one is a financially vulnerable contractor. Additional oversight, joint checks, site inspections, material and equipment vendor contacts can all be established when needed. Real value is derived by knowing when and which contractor to apply the additional attention. You need to know their current financial position prior to them starting and the whole time they are on the job.

Contractor Score has undertaken a survey to address some of these questions. The objective was to see if there was any correlation between a Contractor Score, which can depict the contractor's current financial position[i], and the occurrence of some common project performance attributes. There is no basis or claim in the survey to identify causality. The project performance criteria used in the survey is not exhaustive and there are many contributing factors besides financial position that can drive exceptional positive or negative job performance. **Two core project performance criteria were targeted: schedule and quality.** Quality refers to both workmanship and the quality of management processes.

The questions were posed to general contractors and owner representatives. The questions required a subjective response rating on a scale of one through five. All survey participants were operational people. Most were superintendents, project managers and VPs of operations or divisions. They were asked to recount exceptional (good or bad) contractor and subcontractor performances on recent jobs. They then identified the contractor and rated each on the ten questions using the 1-5 scale.

The Survey

Questions were rated on a 1-5 scale using the Description below.

1. Maintained their schedule
2. Properly manned the job
3. High quality workmanship
4. Strong safety practices
5. Good technical knowledge
6. Good cooperation and participation on jobsite
7. Oversight effort was normal
8. Correct and timely invoices
9. Proper change order procedures
10. Good quality, timely project docs, i.e., submittals, RFIs, lien waivers, close-out, etc.

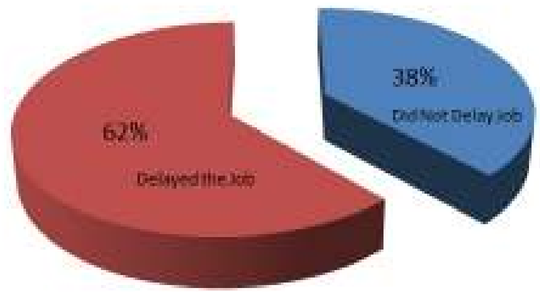
Description	Rating
Almost never	1
Rarely	2
Usually	3
Often	4
Almost always	5

We then matched individual survey results from the operational personnel with the identified contractor's Contractor Score. Survey ratings were then put into the appropriate Contractor Score ranges.

The ten questions were analyzed individually and the ratings variance between questions turned out to be insignificant amongst the ten. Consequently, all ten questions were aggregated into one presentation. The average response rating for each range of Contractor Scores (200 point intervals) were plotted as a column and a logarithmic trend analysis applied. The curved trend line clearly shows a steeper slope change in the lower Contractor Scores. The mid-point response, *"Usually = 3"*, is colored green for a reference.

A final **Yes** or **No** question was asked of the survey participants about each contractor they rated. *"Did the contractor cause a delay on the job?"* We tallied the responses and separated the contractors by Contractor Score into those above and below a score of 600. Those that scored below 600 caused a delay a majority (62%) of the time. As the Contractor Scores rose, the percentage of, *"Yes",* answers (they delayed the job), decreased significantly.

While there may be many reasons why delays occurred with lower scoring contractors, the results indicate a higher probability of delay may occur with lower scoring contractors. The 600 level score was chosen as that was approximately the break between contractors scoring at least the mid-point response, *"Usually = 3"* on the previous ten survey questions.



Contractors Scoring Below a 600 Contractor Score

Habitually low scoring contractors tend to have weaker management processes in place and consequently, their financial results reflect that. The project management team, if aware of this risk early in the job, may be able to take some mitigating actions.

The Immediate Take-Away

The ten question survey results show that contractors with lower Contractor Scores (below 600) did not rate as well in project performance as contractors with higher Contractor Scores (650 and up). The higher Contractor Scores show better and level project performance results. Basically, any Contractor Score over 1000 looks to perform equally. Obviously, this does not rule out a lower scoring contractor from performing admirably on any given job or a high scoring one behaving badly.

Sometimes a well-run subcontractor suffers at the hand of an incompetent GC or all contractors can be hurt with a difficult owner. All of the general contractor survey respondents (78% of all respondents) were with firms that had Contractor Scores over 800. The remaining 22% of the respondents were owners or owner reps that did not have a Contractor Score. All respondents were experienced managers of construction.

If additional project management and oversight resources are applied to weaker contractors, will that added cost impact the budgeted gross margin? Perhaps, but that depends when the budget was developed, before or after (as it should be) buy-out. The additional resources would have to be significant or very costly to overcome the cost of a project delay, especially the tarnished reputation received from an upset owner. Also, the main reason for using a financially weak contractor to begin with is often their lower price.

The Conclusions

Qualification of contractors is important. Both pre-qualification and re-qualification on a regular basis provide a stronger job performance for all participants. Financial positions change continuously and the smaller the contractor, the faster their financial picture can change. A re-examination of financial qualifications every six months is prudent and sometimes quarterly updates make sense.

> *"The leading cause of Subguard® claims is financial distress, and our data indicates improper subcontractor pre-qualification is a factor in more than half of our claims. Substantial pre-qualification procedures and continued qualification are critical for our Subguard customers."*[ii]

Look at building your qualification processes into a back-office function. This can alleviate your project management from rote collection tasks to more important management decisions. Log updated financial reviews just as you would collect lien waivers or insurance certs.

A financially weak contractor may be just as competent as a strong one to perform the work, but perhaps additional safeguards or support should be brought to bear just to mitigate risk. The savvy buyer of construction will know this and manage their contractors accordingly with price, scope, quality and competency through the contract agreement. Knowing their financial positions and how to accommodate accordingly through the contract is a highly effective strategy.

Maintain a flexible, but well established contracting process. Allow for terms and conditions to vary as the job and contractor dictate. Have the most common additional oversight requirements pre-written to drop into the contracts. Educate your project teams, especially the field and front-line PMs and Assistant PMs, to understand these add-ons and how they should manage them. Make sure they all understand that working with a challenged contractor is "part of their job" and their expertise in doing so will set you apart from your competitors.

Include in your pre-construction or turn-over meetings, specific tactics for every subcontractor. Detail precise responsibilities and expected tasks to specific individuals for any contractor that needs special attention. Make sure the Project Manager reviews these tasks and action items regularly throughout the job.

Have one of your principals contact a counterpart of any "special needs" contractor that has been identified. Communicate to them the necessity of teamwork and the specifics of how you will be working with them. Almost all will welcome any additional help to make their job run smoother.

Conduct a contractor (subcontractor) review with each project team at or near the conclusion of a job. It should be part of a regular "post-mortem" where all the job's pros and cons, budget and schedule outcomes are discussed. This "what-did-we-learn" step is more than an exercise, its sharpening, honing and developing all your project personnel. Build and maintain a contractor (subcontractor) database that includes past performance grades. Identify specific people within the evaluated contractor's organization you should request or avoid on future jobs. Experience as a management consultant to contractors for over thirty years, we have seen this step often skipped as everyone gets excited about the "new" job coming up. Discipline yourself to execute on this process and it will pay major dividends into the future.

Communicate your risk management tactics to potential clients in your sales process. Some will not care how <u>you</u> manage risk as they believe their contract with you compensates for that. Today's market, however, is witnessing a change in that old perspective. Owners and clients are more attuned to knowing that overall project execution will impact their plans and schedules regardless of any redress or damage clause a contract may provide them. They recognize a professionally run contracting company when they see one.

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[i] The Contractor Score contains 50+ data points from the contractor's most recent year-end financial statement, most recent YTD financial statement, WIP report and bank LOC statements. The score emphasizes short-term liquidity, overall leverage and net profitability weighted in that order. Other inputs weigh different aspects of the ratios and factors dynamically, or in other words, weighting increases or decreases depending on where the ratios fall.

[ii] Nils Sorenson, Subguard® Product Manager, Zurich North America