Deconstructing construction finance to build stronger contractors

By Allon Raiz

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South Africa is readying itself for an infrastructure development boom. On 24 October, 2012, the *Business Day* newspaper reported that President Zuma had announced, at an infrastructure investment conference in Joburg, that the government was drafting legislation to enable infrastructure development, as well as trying to find funding methods for 18 strategic infrastructure projects. These projects are estimated to be worth R4 trillion over 15 years.

The huge prospects for companies at all levels of the construction industry that this represents are clear. But whenever huge opportunities like these present themselves to business, they bring with them several dangers. In this article, I would like to draw attention to some of the common mistakes made by small construction firms when big projects are in the offing.

Single-project focus

Firstly, many small construction companies spend all their time and energy on bidding for and servicing large projects. This is understandable - on paper, the figures attached to these projects look extremely tempting. However, this single focus leads companies to become simply project-based operations, making them highly susceptible to a feast-or-famine situation. When their single big project is finished, many such companies do not have a pool of smaller projects that will sustain them until the next big opportunity arrives.

The single-project focus must be avoided by dedicating time to look continually for new opportunities, even when at work on a large project.

Unclear profitability

In addition, I often see that the profits attached to these projects are not as high as the contractors expected them to be. This is due to a number of factors, chief among which is a lack of experience and understanding in project costing. This leads to the expected profits being gradually eaten away by unplanned-for expenses. The nett effect is that profits on big projects are often nominal, if not ultimately negative.

The lower-than-expected profit is a major cause for concern in the industry. A 2011 report on financial support options published by the Construction Industry Development Board (CIDB) states that the reason that, between 2007 and 2009, more than 1400 construction enterprises failed is "the current lack of profitability in contracting: a measurement of profitability established within the industry has indicated a continual decrease in this regard over the long term".

Lack of diversity in offerings

Backing up this general claim that contractors shouldn't rely solely on profiting from single projects, a report published in

August 2011 by two members of the University of Cape Town's Department of Construction Economics and Management, Dr Abimbola Windapo and Professor Keith Cattell, indicates that "the ability of a company to grow, improve turnover and gain greater market share is linked to its ability to diversify its services and products". Most of the successful companies that they surveyed were "active in at least three types of product/service markets - most commonly in civil engineering contracting, general building contracting, property development and housing development".

In other words, to ensure the sustainability of its operation, a construction firm should focus not only on having a number of projects at hand, but also on diversifying the range of products and services it offers.

Overextending working capital

The second issue that I'd like to raise is an almost Catch 22 situation that many construction companies find themselves in when they are handling projects. To increase their turnover and improve their CIDB ratings, thereby making themselves eligible to bid for even larger projects, these companies overextend themselves in the projects that they take on.

Having taken on projects too big for their own resources to cope with, they find themselves both without the working capital they need to continue with the project, as well as having to subcontract various aspects of their projects continually to other companies - which reduces profits even further.

The lack of working capital and access to finance is a major constraint on contractors at all levels of the industry. In their report referred to previously, Windapo and Cattell found that the leaders of the successful firms whom they interviewed were unanimous in "acknowledging that the specific strategy responsible for their company's development, growth and success, was their decision to develop a strong financial base for the company".

Developing a strong financial base - which is often described as a company having cash reserves of between one-and-a-half and two times its monthly turnover - is not an easy feat, particularly given the low profit margins in the industry. It is made even more of a challenge in the South African context by the extreme delays in payment that are often encountered when projects are undertaken for public sector clients.

Financing mechanisms

To build a strong construction sector, the development of financing mechanisms that take into account the specific needs of upwardly migrating contractors must be promoted. In its 2011 report on financial modelling options mentioned previously, the CIDB found that there are "limited options available from banks or other lending institutions to cover [contractors'] large working capital requirements, especially in the absence of sufficient collateral. The various banks in South Africa have developed and implemented a project finance model but it has not been implemented successfully".

An aspect of financing that may assist lenders to overcome their reluctance, and which is described as "not fully understood, recognised and exploited" and "a missed opportunity for many companies" in the same CIDB publication, is enterprise development.

Enterprise development in the construction sector

Enterprise development programmes offer an opportunity for emerging black-owned construction firms to build their capacity, which will enable them to bid for larger projects, as well as improve their profitability.

The CIDB report on financial modelling options lists several benefits of enterprise development programmes for emerging black-owned firms, including recognition by both banks and large construction companies for subcontracting purposes. Furthermore, enterprise development is a focused intervention designed to grow emerging businesses with measurable results, which encourages large corporations to support these programmes for the various rating credits they can obtain.

Case study

The impact that an appropriate enterprise development programme can have on an emerging construction firm is dramatic. Among several construction firms in Raizcorp's ARIZE comprehensive enterprise development programme is Turnkey Group, owned by Khomotso Choma.

Prior to the recession, Choma built Turnkey Group into a recognised name in construction, with a turnover of about R21 million. But then the recession hit. The company struggled to get paid for the work it had done, its suppliers were demanding payment and threatening legal action, and a severe cash-flow crisis was looming. Turnover spiralled down to R7 million and the company faced a bleak future.

At that juncture, Choma applied to join the ARIZE comprehensive enterprise development programme run at the BECSA Business Support Centre in eMalahleni. The learning and guidance provided by the programme enabled Turnkey Group to implement rapidly the processes and structures required to turn the company around. Moreover, the company was able to create a strong platform for future growth in terms of capacity for new work and job creation.

Within a year of Turnkey Group being accepted into the programme, the company's turnover grew by 114% and it won the Govan Mbeki Housing Award for the Best Informal Settlement Project of the Year 2012.

Conclusion

The CIDB's Business Conditions Survey for the third quarter of 2012 reflects none of the optimism that one would expect in light of the president's announcement with which I introduced this article. It states: "Respondents are generally pessimistic about current and expected business conditions, building activity and employment levels are low, and profitability is under pressure." The reason generally given respondents is - no prize for guessing - "inadequate access to credit".

However, the coming infrastructure boom and the opening that this presents for contractors to diversify their offerings, as well as the possibility of using enterprise development programmes to increase capacity and develop business skills, there is a great opportunity for contractors with an entrepreneurial approach to lay firm foundations for their companies' future growth.

ABOUT THE AUTHOR

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