A CIRT Special Report

FOURTH QUARTER 2009

Strategy in the Eye of the Storm

By Briston Blair

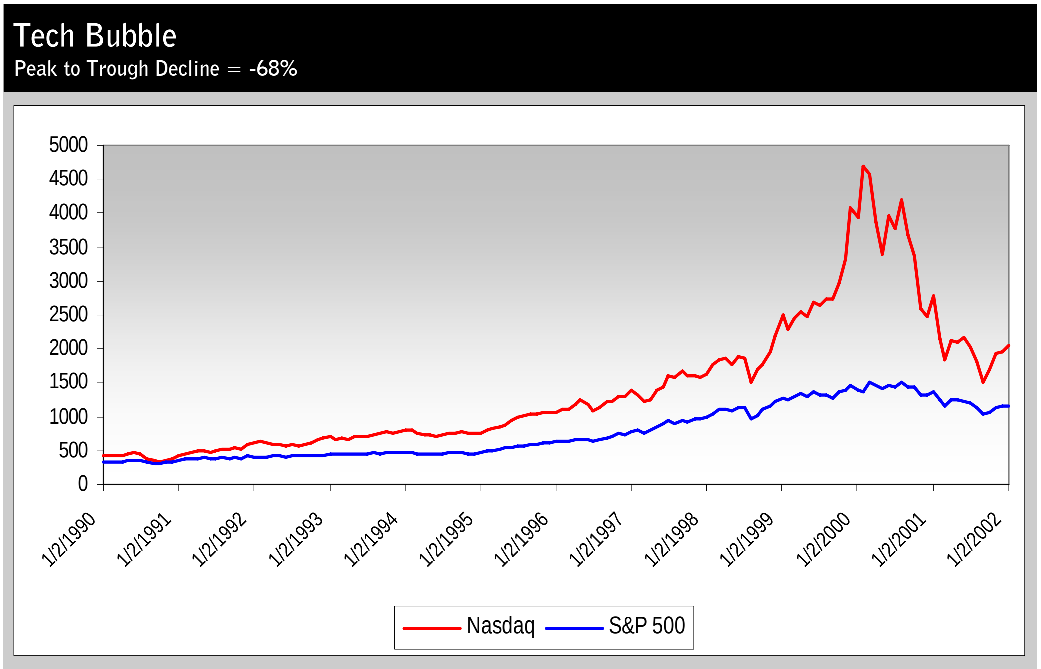
Introduction

While the analogy between the current financial crisis and the "perfect storm" may be a bit cliché, it nevertheless captures the violent nature of change that has emerged to test our firms. At this crucial moment, we must understand the implications of this "storm" as a critical test of strategy and leadership for firms engaged in the nonresidential construction sector.

As a, or *the,* key leader of your business, you must be aware of the potential misperceptions that may ultimately lead you astray and down a path from which it will be difficult to recover. Some of these errors can be strategic, some organizational and others simply uncontrollable.

We've Seen This Before

Is the current "storm" facing our industry different from the typical cycles we have been through over the past 20 years? Familiarity may breed some complacency (been there, done that). But, a quick look back at another storied boom/bust cycle reminds us all of the devastating consequences and structural market changes that can remain in the "perfect storm's" wake. Take for example, the now infamous "Tech Bubble/Bust" of the late 1990s – early 2000s.



But the technology bubble was different, was it not? If one views the FMI General Construction and Engineering Index (shown on the following page) without its labels, it would be difficult to tell the differences between the construction bubble and the technology bubble.

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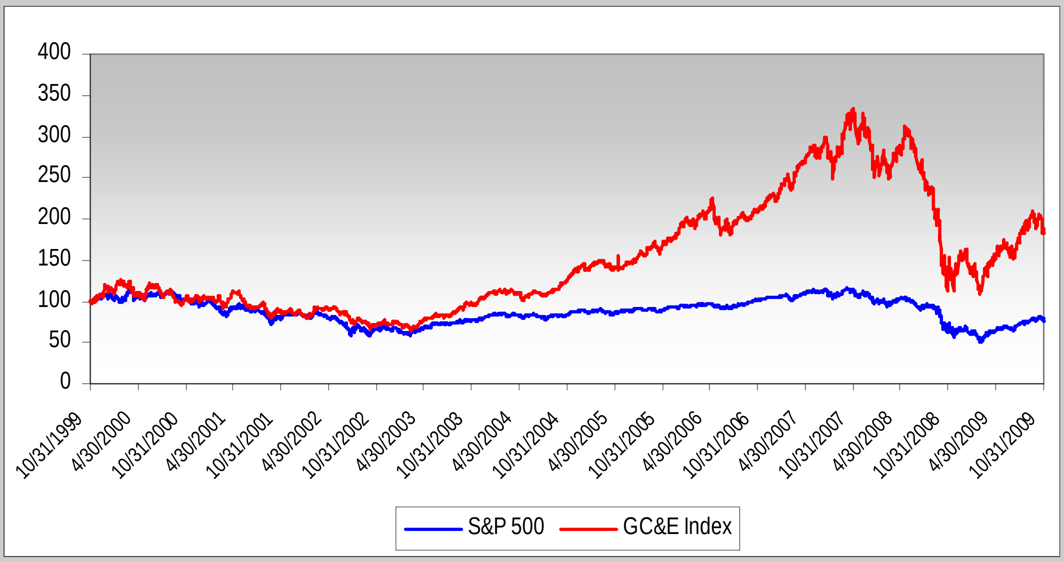
The causal factors for the boom/bust cycles were similar, and the resulting aftermath will bear an uncomfortable resemblance. The structural changes that this type of catastrophe forces in an industry provide both opportunities and threats, and a focus on true strategy has never been more important. [In fact, the NASDAQ has still not come close to reaching its peak at the height of the tech boom, which is now some ten years ago.]

Construction Bubble
Peak to Trough Decline = -67%



We often hear common misperceptions and generalizations with regard to strategy. As with most myths, there is often an embedded element of truth. However, it is the intent of the ensuing report to view the CIRT strategy survey results through the prism of several of the most common strategic generalizations seen throughout our industry to better enable you to navigate some of the most treacherous markets we have experienced in decades.

Four Common Strategic Misperceptions

1) The future is likely to mirror the past.
2) Yesterday's strategy will be sufficient to guide our organization into the future.
3) If we can just make it through 2010 and early 2011, we will be fine.
4) Now is not the time to make bold changes.

Strategy Myth #1: The future is likely to mirror the past.

Results

One of the most common flaws in strategic thinking comes from human cognitive bias; in other words, we all have an innate faith in our ability to predict the future based on our prior experiences. The standard paradigms for thinking about the future are under attack, and some of the assumptions that we took for granted in developing past strategies are simply no longer valid.

With this in mind, we polled CIRT members about their perceptions of the degree of change facing their organizations. The key question aimed to understand the participant's perceptions of the fallout that the financial crisis posed to their organization's core activities or assets.

Definitions of these two terms (core activities and core assets) are as follows:

- *Core activities* are recurring activities that have historically generated profits (e.g., delivery systems, operating procedures, etc.).
- *Core assets* are durable resources, including intangibles such as knowledge and brand capital that have historically made the organization efficient at performing core activities (e.g., people and their skills, technology infrastructure, equipment, etc.).

Exhibit 1: Degree of Change

Core activities and assets are both threatened with obsolescence.	13%
Core activities are threatened but not core assets, which retain their ability to create value.	35%
Core assets are being threatened but not core activities, which are stable.	8%
Neither core assets nor core activities are being jeopardized.	44%

Implications

The single-most startling finding was that **13% of CIRT members believed that their core business model (both activities and assets) was facing obsolescence.**

In a broader content, 56% are facing some type of threat to their core activities, assets, or both (35% + 8% + 13%). It is also important to note that 18% of firms with annual revenues in excess of $1 billion identified that both assets and activities are vulnerable due to the changing landscape. Considering the industry leaders comprising CIRT, the magnitude of these change-driven threats is staggering when thinking about the implications for firms in the broader industry.

What Can One Do About This? (An Exercise for Senior Managers)

To provide clarity to CEOs and senior leadership teams wrestling with the magnitude of future shifts in our industry, FMI and a cross-section of leaders from the architecture, engineering and construction community recently completed a study of potential scenarios for the A/E/C industry's future. A few of the downstream results (Exhibit 2) provide a backdrop against which your team can begin thinking about the velocity and direction of changes facing your firm.

Exhibit 2: A/E/C Futures Study – Drivers of Industry Change

Forces of Change in the A/E/C Industry	Areas of Strategic Significance – Is Your Firm Prepared?
Global	- Infrastructure - Competition for resources - Interdependent global economies
Social	- Consumer technological literacy - Work force mobility - Aging population
Technological	- New technology - International standards - A/E/C industry technological advances
Economic	- Continued volatility in commodities and energy - Public/private partnerships - Erosion of U.S. economic dominance
Political	- Increased government control - Increased regulation - Limited restrictions on labor mobility
Environmental	- Sustainability - Increased regulation

Recommendations

While there are certainly no easy answers for leaders facing these types of fundamental shifts, a few areas to consider:

- Think deeply about how well-prepared your firm is for a dramatically different future by benchmarking yourself against known long-term trends and industry drivers. Perform a gap analysis between your current state and potential states of the future.
- Incorporate scenario planning into your strategy development process to ensure that plausible, and seemingly far-reaching, states of the future are evaluated.
- If you are one of the 56% who responded that a threat is facing your core activities, assets or both, challenge your management team to think both practically and creatively about how the organization is going to adapt and survive.
- Challenge the conventional wisdom that inevitably creeps into your strategy discussions and identify those past assumptions that are no longer valid. Pursue outsiders to help challenge the status quo – avoid the trappings of insular thinking.

Strategy Myth #2: Yesterday's strategy will be sufficient to guide our organization into the future.

Results

In the face of increasing uncertainty and competitive pressures in our industry, we have seen a large number of firms fail to adapt their historical strategy to align with the new (rapidly changing) business environment. Intense competitive pressure is impacting firms at all levels of the industry, including many middle-market companies – many of whom are experiencing the most dramatic effects.

Understanding that this competitive dynamic was unfolding across the industry, CIRT members were asked to choose which broad primary strategy their firms had followed in the previous boom market, and which strategy they were most closely following today.

Exhibit 3: Past versus Present Strategies

	Was the Strategy 3-5 Years Ago	Strategy Today	Risk Level
Pursuing the same business model/ approach as in the past, but with better execution.	68%	48%	Low
Pursuing new businesses or services.	11%	8%	Med.
Pursuing new customers or markets.	13%	27%	Med. - High
Focusing on remaking the company to move into new lines of business with new customers or markets.	9%	17%	High

The results highlight that many participants are holding onto the same strategy today as that of the recent past, although notable shifts have occurred. For some well-positioned firms, better execution of the existing strategy is absolutely the right approach to maintain and expand share in key markets with growth potential. Yet, there remains a disconnect between the 56% of participants who said they are facing a threat to their core business (Exhibit 1) and those *still* holding onto the same strategy used in the past.

By digging a bit deeper into the survey results [see Appendix for detailed results by firm type and size], a few more interesting findings presented themselves:

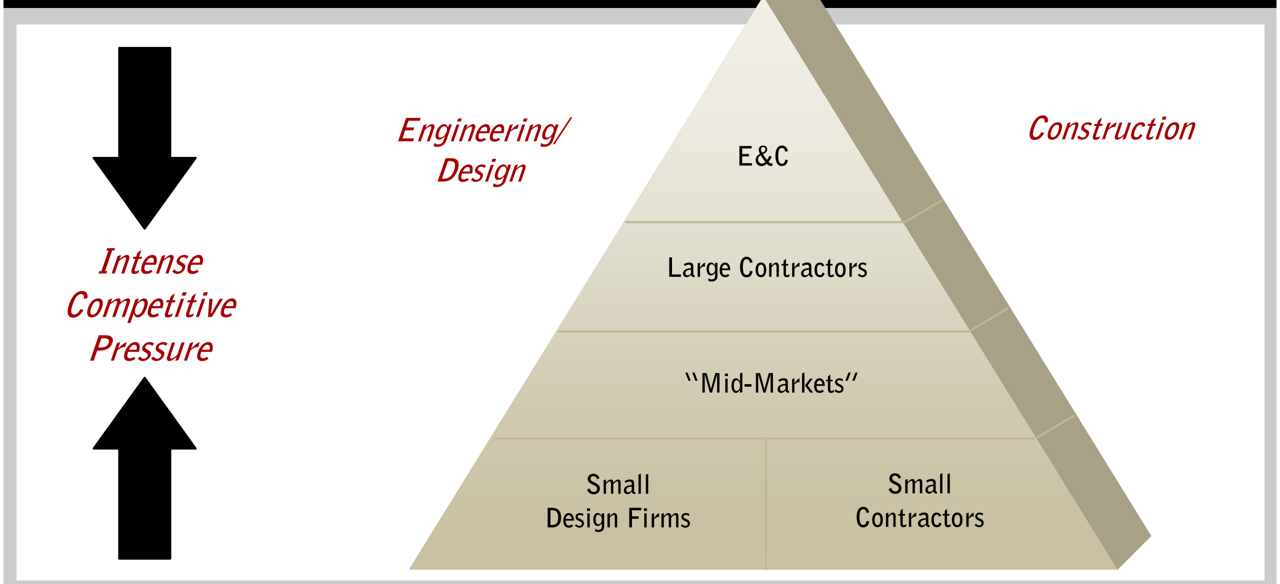
- Sixty-three percent of A/E firms are using the same strategy today despite 75% identifying a threat to their core business.
- Of the smaller firms in CIRT's membership (annual revenues less than $200 million), 100% are pursuing the same strategy despite 50% identifying a threat to their core business.
- Firms with annual revenues over $1 billion have diversified dramatically toward new customers and markets. Of these companies, 27% are now pursuing this strategy today whereas 0% identified with the strategy just three to five years ago.
- Encouragingly, but also with risk, 18% of companies with annual revenues from $200 million to $1 billion made bold leaps to diversify by focusing on remaking their companies to develop both new lines of business and new customers.

Implications

FMI's original industry strategy survey found that many middle-market firms anticipated a high degree of future uncertainty, yet they had failed to adapt their strategies. Since 44% of respondents to the CIRT strategy survey are in the middle market, it is important to understand the perils of relying on a past strategy when faced with a new business context[1].

It is especially critical to consider the overall industry structure (Exhibit 4) and understand that the middle market faces urgent competitive threats in volatile times. In a challenging environment, mid-size firms are squeezed from the top of the market by large firms and from the bottom of the market by savvy smaller competitors. Also, many middle-market companies have grown with the rising tide of construction activity over the last few years and have yet to reach the "next level" of sophistication and adaptability. Based on information from around the industry, many of these firms are forecasting revenues for 2010 and 2011 that will be half of their peak volumes.

Exhibit 4: U.S. Construction Industry Structure



Recommendations

While some of our historical assumptions about the future may be invalid going forward, there are still considerable lessons to be learned from a study of past business failures. The CIRT/FMI 2007 study of "Why Contractors Fail" provides a lens through which to assess the current thinking in your organization and guard against the common strategic pitfalls prevalent in this type of market environment.

[1] FMI defines the business context as the overall environment in which a firm competes. This environment consists of a company's macro business climate, its customers and markets, its competitors, and its own (company) capabilities and constraints. Changes in any area of the business context can require shifts in strategy.

Below, are the main points from the study and an indication as to whether we are seeing evidence of shifts in these causal factors across the industry given current market conditions.

Exhibit 5: Why Contractors Fail – State of Causal Factors in Today's Market

Nature of the Construction Industry		General Economic Conditions	
High leverage		Interest rates	
Man power shortage		Material shortages	
Industry cycle	√	Global economy	√
Hard-bid process	√	Bonding status	√
Project timing	√	Demographics	
Derived demand	√	Government policy	√
Hyper-competitive	√	Tax law	√
Unique projects	√	Consumer confidence	√
Culture and Systems of the Organization		**Mind of the Contractor**	
Financial discipline		Driven to grow	
Succession planning	√	Numb to risk	√
Project/owner selection	√	Hyper-optimistic	√
Innovation process		Overconfident	√
Strategic planning	√	Afraid of layoffs	√
Capital reserves		Action oriented	√
HR systems	√	PM versus CEO	√
Corporate culture	√	Feast or famine	√
Public versus private	√		

In addition to understanding whether many of these factors have permeated your organization's approach to the future, here are a few additional things to consider as you move forward:

- Know thyself. Research shows that many failures occur when firms chase new markets – you have to be brutally honest about your capabilities to move into markets where others have made a living for years.
- Diversify logically and prudently into areas where risk can be effectively managed. Avoid big leaps unless you have a strategy in place to bridge the gap between current competencies and those required for success in the new arena.
- If you are well-positioned in a viable marketplace, segment your strategy between what is necessary to protect market share and what is required to grow market share. Markets with real project opportunities are fast becoming everyone's specialty.
- Take advantage of an increasingly favorable mergers and acquisitions market to quickly gain competence in a new area, deploy excess capital on the balance sheet, drive substantial post-recession earnings and alter the competitive landscape.

Strategy Myth #3: If we can just make it through 2010 and early 2011, we will be fine.

Results

A frequent misperception tossed around in strategy meetings these days is that once 2010 and early 2011 are behind us, everything will be back to normal. In addition to the long-term industry changes identified in Exhibit 2, a look at simple economic forecast data can highlight the dangers inherent in this line of thinking. [Exhibit 7 on the following page represents FMI's most recent forecast for put-in-place construction activity.]

In light of all of the uncertainty prevalent in the industry, and considering the pace and depth with which some key markets have turned downward, CIRT participants were asked to weigh in on whether long-range planning still had value in today's market environment. The results are presented in Exhibit 6 below.

Exhibit 6: CIRT Members on the Value of Long-Range Planning

"Short-term strategy is focused on execution; and long-term strategy is focused on growth, people development, geographic expansion and markets."	66% find long-range planning important
"Yes, long-term planning is valuable, but in these times, we have found that we need to be nimble and conduct environmental scans every six months."	
"Three to five year planning is focused on transformation – what does the business want to look like from a service, market, skill, value and geographical basis. One to three year plans focus on actions and execution."	
"We have an overall five-year plan, but every year have annual priorities and expect our SBUs to develop an annual plan with specific actions and objectives consistent with our vision."	
"Our business is core to the construction industry, so we don't face the threats from technology/outsourcing that others do. We focus more on the near term."	34% see little value in long-range planning
"We see no value in long-term planning; too many variables and even two to three years out is a long time. We prefer one year maximum."	

Implications

Beyond the unexpected finding that 34% of some of the industry's leading firms chose to forego long-range planning was the fact that this stood in stark contrast to the value attributed to long-term planning by the other 66% of respondents. Several participants explicitly mentioned that their long-term planning efforts led directly to their strong market position today.

The construction sector will again be a trillion-dollar industry in 2013, but the composition of the market will be much different. For instance, lodging, office and commercial will not regain their 2008 level of activity by 2013. In fact, neither total nonresidential buildings nor residential buildings will regain their 2008 highs over the next four years.

Exhibit 7: FMI's 3Q09 Economic Forecast

Construction Put in Place
Estimated for The United States
Millions of Current Dollars
3rd Quarter 2009

	2008	2009	2010	2011	2012	2013
RESIDENTIAL BUILDINGS						
Single Family	187,609	121,946	128,043	147,249	164,919	181,411
Multi Family	47,823	39,215	38,823	41,540	44,448	48,004
Improvements*	121,977	107,339	110,559	114,982	118,431	121,984
Total Residential	357,408	268,500	277,425	303,771	327,799	351,399
NONRESIDENTIAL BUILDINGS						
Lodging	35,818	25,789	16,763	17,433	18,305	19,586
Office	70,305	54,838	41,128	39,483	41,063	43,526
Commercial	84,942	59,459	42,216	39,683	42,064	45,009
Health Care	47,699	45,791	44,875	45,100	49,610	55,067
Educational	104,081	97,836	95,879	101,632	109,763	120,739
Religious	7,125	6,056	5,269	5,374	5,536	5,702
Public Safety	12,936	13,712	14,261	14,688	15,276	16,040
Amusement and Recreation	21,488	18,265	14,794	15,090	15,694	16,322
Transportation	33,953	31,916	32,873	34,846	36,936	39,522
Communication	25,649	16,672	15,171	15,778	16,567	17,561
Manufacturing	61,269	67,396	43,807	36,360	37,814	39,327
Total Nonresidential Buildings	505,265	437,730	367,038	365,469	388,628	418,400
NONBUILDING STRUCTURES						
Power	80,160	86,573	91,767	100,026	110,029	122,132
Highway and Street	81,801	85,073	88,476	92,900	98,474	104,382
Sewage and Waste Disposal	25,143	25,646	26,928	28,005	29,966	32,063
Water Supply	16,951	17,121	17,805	18,339	19,623	20,801
Conservation and Development	5,405	5,675	6,243	6,805	7,145	7,431
Total Nonbuilding Structures	209,460	220,087	231,219	246,075	265,236	286,809
Total Put in Place	1,072,133	926,317	875,683	915,316	981,663	1,056,608

*Improvements include additions, alterations and major replacements. It does not include maintenance and repairs.

Both the market forecast above and the recent results of the CIRT Sentiment Index, showing that 48% of CIRT members have backlogs of less than 12 months, indicate that long-range thinking is required to prepare and position for different market realities.

Recommendations

Our primary recommendations for combating this myth are to closely re-examine your strategic planning process.

- Avoid thinking of strategic planning as just a "process to go through" that results in a plan document with some good ideas – we often find strategic plans that do not contain any real strategy. Instead, think of strategy development as a way to find game-changing solutions that will allow you to exploit opportunities in the shifting business context. Strategy in this type of market environment must be answer-focused versus process-focused to yield real results.
- Incorporate fact-based analysis into your strategy process. Critical changes can rapidly occur within the business context that can be easily overlooked without strong analytics. Leaders depend on sound instincts to make decisions, but good information in volatile times can provide valuable insight.
- Segment your strategy between what is necessary to survive in the short term and what will be required for the future once market conditions stabilize. This is a best practice, and some members of CIRT do this well based on the feedback received.

Strategy Myth #4: Now is not the time to make bold changes.

We also often hear companies say that now is simply not the time to make any fundamental changes. To that misperception we often point out the lessons learned by the residential building sector firms who have been living the worst of the recession for over two years. Below are a few of the fundamental themes common to companies that have ultimately emerged well-positioned:

- Those that recognized the urgency of the situation early (e.g., cost structure, right-sizing, etc.) and made changes quickly, ultimately did better than the ones who held on hoping for improvement.
- They asked themselves hard questions such as, "Should we be in market A, B, C?" And if not, "Can we exit and how fast?"
- They also recognized that cost cutting would not do it alone. The leading firms also figured out ways to build, maintain and grow their revenue base.

While intuitively simple, these responses required a fundamental reassessment of the firms' current strategy and quick action to reposition. It is with this in mind that we asked CIRT participants to identify which common shortcoming of their existing strategy was most applicable.

Exhibit 8: Common Strategy Shortcomings and Implications

Shortcoming with Strategy	Response Rate	Implication
We say we are the best, but our competitors are often just as good.	18%	Need for *differentiation*
Our strategy is not working as well as it has in the past.	32%	Need to *adapt to the changing business context*
Given our size and capabilities, we have wondered if there is something more we should be doing to gain market share.	34%	Need to *uncover innovative or game changing ideas*
Slower growth makes it difficult to keep our shareholders and best employees satisfied.	16%	Need for *renewed growth strategy*

Implications

For the 66% of respondents who identified with the problem of a changing context or a need for better leverage of size, scale and competencies, our experience suggests that a fundamental shift in the core strategy is likely required.

When the results are sorted by revenue, other implications emerge:

- Thirty-two percent of firms with annual revenues greater than $1 billion identified most with the challenge of adequately leveraging their size and scale to create competitive advantage. This challenge becomes more prevalent as competitive pressures increase in the marketplace and operating subsidiaries seek ways to utilize the advantages of the larger enterprise.
- Thirty-two percent of middle-market firms with annual revenues between $200 million and $1 billion identified most closely with the challenge of adapting their organizations to the shifting business context. When viewed in conjunction with Exhibits 3 and 4, the results indicate that many mid-sized firms have taken preliminary steps to reposition, but some are still trying to adapt.
- Seventeen percent of smaller firms are struggling with ways to find growth opportunities for the benefit of their key stakeholders.

Recommendations

As we presented in Exhibit 3, many companies are making strides to adapt their strategies and reposition their organizations for the future. However, the analysis indicates that lingering doubts and shortcomings still permeate the discussion around strategy at member companies. For those firms that feel their strategy still needs some fine-tuning, we offer a few thoughts:

- Do not miss an opportunity to reshape your organization for the long term. Many executives have been using the cover provided by a deep recession to fundamentally recast the future direction of their firms.
- Outlier events have occurred that necessitate a bold strategic response. Be cognizant of paralysis, and act quickly once the right decision or opportunity presents itself.
- If your firm is well-positioned in key markets, or has a strong balance sheet, take advantage of the opportunity to acquire attractive targets and weaken the competition.
- If you choose to stay in place, do so intentionally. Know that you are operating in your sweet spot and respond appropriately to the environment. Doc Fails coined the phrase, "Profit Thrills, Volume Kills," which could not be more appropriate in this environment.

Conclusion

No one can doubt that the construction markets have been severely disrupted by the global financial crisis, but the sky has not fallen. Savvy firms have made money in the past during similar times of uncertainty. Successful companies will use this time to refocus the business, examine strategic opportunities and right-size their operations.

The latest storm will leave a world of opportunities in its wake, but the next boom may be a long-time coming. There are many possible futures facing the industry, and those firms preparing and adapting their strategies now will be there to win big when the market recovers.

APPENDIX

Exhibit 9: Size of the organization in annual revenue

Size of the Organization	Response Totals
$201 million - $1 billion	22
More than $1 billion	22
$200 million and below	6
Grand Total	50

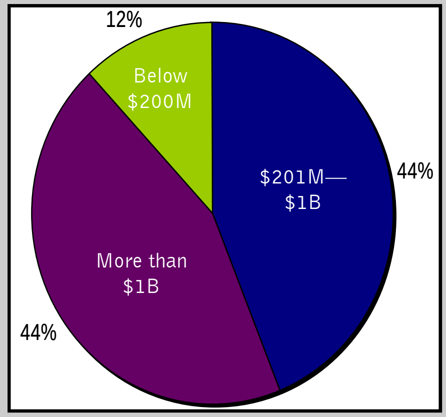


Exhibit 10: Type of contractor

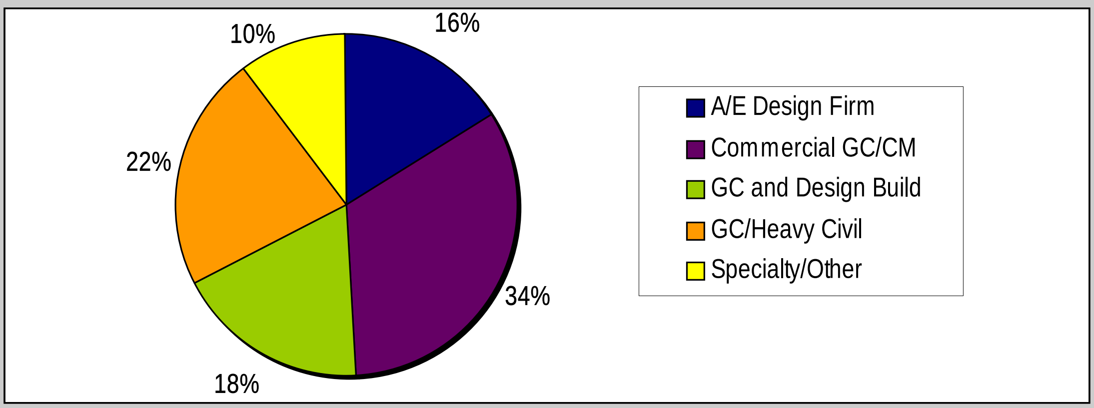


Exhibit 11: Survey results by firm type and size

		Revenue			Type				Total
	Strategy Shortcomings	<$200M	$201M-$1B	>$1B	A/E	GC/CM	Heavy	Specialty	
Q1	We say we are the best, but our competitors are often just as good.	0.0%	18.1%	18.1%	12.5%	20.0%	18.2%	0.0%	18.2%
	Our strategy is not working as well as it has in the past.	50.0%	31.8%	18.2%	12.5%	20.0%	36.4%	60.0%	31.8%
	Given our size and capabilities, we have wondered if there is something more we should be doing to gain market share.	33.3%	27.2%	31.8%	25.0%	32.0%	27.3%	40.0%	34.1%
	Slower growth makes it difficult to keep our shareholders and best employees satisfied.	16.7%	9.1%	18.2%	37.5%	12.0%	9.1%	0.0%	15.9%
	Threat								
Q2	Activity threat	33.3%	40.9%	27.3%	62.5%	32.0%	27.3%	20.0%	35.4%
	Asset threat	0.0%	18.2%	0.0%	0.0%	12.0%	9.1%	0.0%	8.3%
	Total threat	16.7%	4.5%	18.2%	12.5%	12.0%	18.2%	0.0%	12.5%
	No threat	50.0%	36.4%	45.5%	25.0%	36.0%	45.5%	80.0%	43.8%
	Strategy - Yesterday								
Q3	Same game	50.0%	63.6%	68.2%	50.0%	72.0%	54.5%	60.0%	68.1%
	New customers / mkts	16.7%	22.7%	0.0%	37.5%	8.0%	9.1%	0.0%	12.8%
	New biz / svcs	33.3%	9.1%	4.5%	0.0%	4.0%	18.2%	40.0%	10.6%
	Game changer	0.0%	4.5%	13.6%	12.5%	8.0%	9.1%	0.0%	8.5%
	Strategy - Today								
Q4	Same game	100.0%	36.4%	40.9%	62.5%	28.0%	54.5%	80.0%	47.9%
	New customers / mkts	0.0%	31.8%	27.3%	12.5%	40.0%	9.1%	20.0%	27.1%
	New biz / svcs	0.0%	13.6%	4.5%	0.0%	8.0%	18.2%	0.0%	8.3%
	Game changer	0.0%	18.2%	18.2%	25.0%	16.0%	18.2%	0.0%	16.7%

Q1: Which of the following statements most accurately describes your firm's strategy given current market conditions?
Q2: Which of the following descriptors accurately reflects the degree of change your firm anticipates occurring in the industry at large?
Q3: Which of the following best describes your firm's strategy three to five years ago?
Q4: Which of the following best describes your firm's strategy today?

ABOUT THE CONSTRUCTION INDUSTRY ROUND TABLE (CIRT)

The Construction Industry Round Table (CIRT) is exclusively composed of approximately 100 CEOs from the leading architectural, engineering and construction firms doing business in the United States.

CIRT is the only organization that is uniquely situated as a single voice representing the richly diverse and dynamic design/construction community. First organized in 1987 as the Construction Industry President's Forum, the Forum has since been incorporated as a not-for-profit association with the mission "To be a leading force for positive change in the design/construction industry while helping members improve the overall performance of their individual companies."

The Round Table strives to create one voice to meet the interest and needs of the design/construction community. CIRT supports its members by actively representing the industry on public-policy issues, by improving the image and presence of its leading members, and by providing a forum for enhancing and developing strong management approaches through networking and peer interaction.

The Round Table's member CEOs serve as prime sources of information, news and background on the design/construction industry and its activities. If you are interested in obtaining more information about the Construction Industry Round Table, please call 202-466-6777; or contact us by email at cirt@cirt.org.

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