ON-SITE

Fall 2014

Objective: Make money

Get to know the 3 states of profitability

Year end tax planning

Don't overlook the Section 199 deduction

Defending your job sites from theft

PLUS

The Contractor's Corner

What is a zero net energy building?

Objective: Make money

Get to know the 3 states of profitability

The primary difference between a charitable organization and a for-profit business is, of course, the "for-profit" part. Businesses need to make money! But, for contractors, the daily minutiae of finding, winning, running and completing projects can make keeping their eyes on the profitability prize difficult.

One way to simplify matters is to determine in which of three "profitability states" your construction company lies and where to go from there. To get started, grab your most recent profit-loss statement — this is the section of your financial statements that summarizes the revenues, costs and expenses incurred during a specific period. It will get us where we need to go.

1. Operating at a loss

If you look at your profit-loss statement and see a minus sign in front of the figure under "net profit," you operated at a loss during the period in question. Then again, you might not need to look at your financials to know that. A variety of day-to-day red flags pop up when a contractor is losing money, including:

- Trouble paying the bills,
- Delays in making payroll,
- Cutting one's own salary, and
- Asking family members to work "pro bono."

There are many reasons why a construction company is unprofitable. They should be addressed immediately and specifically in consultation with your financial advisor.

One common cause, believe it or not, is the owner being *too involved*. Typically, owners of top-performing construction businesses aren't

negotiating subcontracts, scheduling crews or equipment, or ordering materials. They're watching the numbers and setting their companies' strategic directions.

If micromanaging day-to-day operations is causing your business to drift into trouble, either reassess your ability to delegate or review the skill level of your staff (or both).

2. Breaking even

If your profit-loss statement shows a zero under net profit (and no loss), you're a member of the breaking-even club. In other words, all income is going toward job costs and overhead. This isn't bad news, but you won't turn a profit until total sales exceed expenses. And you want to reach this point as early next year as possible.

First, calculate the sales you'll need to stay at the breakeven point. Divide your total overhead (as defined for your construction company) for the period in question by your percent of gross margin. If you can make this sales volume at a reasonable markup, you'll likely stay at breakeven.

Next, target excess volume for the period to create profitability. Doing so requires paying close attention to each salesperson's sales-to-leads ratio. Healthy ratios depend largely on your specialty and market, but they're subject to a couple of industry rules of thumb: 1) one sale per four leads for remodeling or specialty work, and 2) one sale per 10 to 14 leads for new home construction.

Higher sales still won't mean profitability if projects aren't completed and collected on in a timely fashion. So if you're only breaking even — or particularly if you're losing money — look closely at your completion times and collection process.

3. Turning a profit

If you see a plus sign next to the net profit figure in your profit-loss statement, fantastic. But the question then becomes, "*How* profitable?"

Another industry rule of thumb: A contractor needs to have at least an 8% net profit to reasonably ensure his or her company's long-term survival. Again, your "must-meet" percentage will depend on the type of work you do and the state of your market. Still, it's important to establish a minimum profitability line and, preferably, exceed it.

To do so, watch your financials and work even harder to control expenses. When money starts rolling in, some contractors start buying new vehicles and equipment, upgrading technology, and hiring more staff. One or all of these moves might help grow your business — but only if you can stay profitable.

Ask yourself

Every construction business owner needs to constantly ask, "Where are we? And where should we be?" If your company is operating profitably, you have the gift of time. There's likely no need to make rushed moves to get more profitable.

If you're only breaking even — or especially if you're operating at a loss — immediate action is warranted. Work with your financial advisor to take a close look at your numbers and determine specifically what you need to do to get into the black.

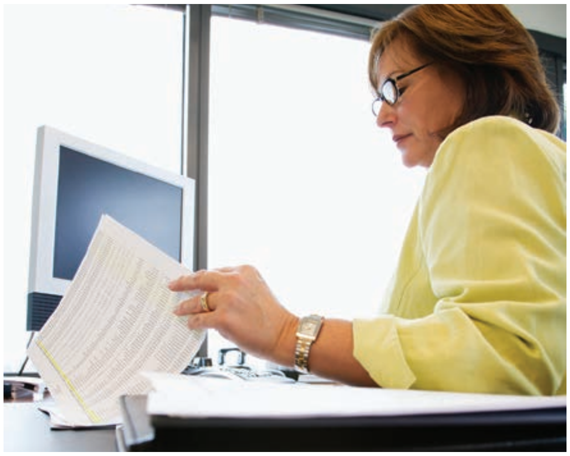
Sales vs. marketing — what's the difference?

At many construction companies, sales and marketing tend to get lumped together. But they're two distinct entities that must complement each other. So what's the difference?

Metaphorically speaking, *sales* is the way that you speak; *marketing* is the way that you dress. Your sales process is how you directly interact with prospects and customers. Your marketing initiatives, on the other hand, need to establish and promote your construction company's brand, expertise and reputation.

Setting a marketing budget can be tricky for construction companies. If margins are already thin, you don't want to overspend. Many contractors start with marketing outlays of between 0.5% and 4% of revenues, but your chosen percentage may vary. The idea here is to distinguish your business from competitors and then maintain visibility through "non-salesy" educational efforts such as blog posts or other social media activities, articles in local newspapers and commerce publications, webinars, and videos.

Then, of course, your sales process needs to follow a consistent tone with your marketing efforts. That way, customers will see the continuity between the brand and reputation you've established and the work you actually do.



Don't overlook the Section 199 deduction

The Section 199 deduction got plenty of attention when it was first introduced as part of the American Jobs Creation Act of 2004. But it's since become just one of several complex but intriguing tax breaks that come into play at year end. Construction company owners should remember that much of what they do may still qualify them for this potentially valuable deduction.

Acronym soup

Popularly known as the "manufacturers' deduction," Sec. 199 entitles eligible taxpayers to a domestic production activities deduction (DPAD) based on the company's domestic production gross receipts (DPGR) and qualified production activities income (QPAI) for the tax year.

Eligible construction activities include those directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure.

For contractors, DPGR generally refers to gross receipts from the construction of real property performed in the United States in a construction trade or business. QPAI is the excess, if any, of DPGR over the sum of cost of goods sold allocable to DPGR and other expenses, losses or deductions allocable to DPGR.

For tax years after 2009, the DPAD is equal to the lesser of: 1) 9% of the taxpayer's QPAI for the taxable year, 2) 9% of the taxpayer's taxable income for the taxable year, or 3) 50% of the taxpayer's eligible Form W-2 wages for the taxable year.

Eligible job tasks

What job tasks do and don't qualify for contractors? For starters, eligible construction activities include those directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation includes structural improvements but not cosmetic changes (such as painting).

Furthermore, "substantial renovation" is defined in the regulations as the renovation of a major component or substantial structural part of real property whereby that renovation:

- Materially increases the property's value,
- Substantially prolongs the useful life of the property, or
- Adapts the property to a new or different use.

Real property is defined as buildings (including items that are structural components of such buildings), inherently permanent structures, inherently permanent land improvements, oil and gas wells, and infrastructure.

Possible exceptions

Some "tangential" activities performed by others — such as painting, hauling trash and debris, and delivering materials to the job site — generally don't constitute DPGR on their own, even if such services are essential to an existing construction activity. But if a construction company performs these activities in connection with its other work involved in the erection or substantial renovation of real property, then some tangential activities may qualify as DPGR provided other basic requirements are met.

Similarly, services such as grading, demolition, clearing and excavating, along with any other activities that physically transform land, generally don't qualify on their own. But if these activities are performed in connection with a construction company's other project tasks toward erecting or substantially renovating real property, they typically do become eligible for the Sec. 199 deduction.

Worthwhile effort

We've just scratched the surface regarding which activities may help a construction company claim the Sec. 199 deduction. Although the administrative demands of this tax break are significant, the potential savings on your tax bill could make the effort worthwhile. Consult your tax advisor on whether this deduction may apply to you and, if so, specifically how.

Defending your job sites from theft

The threat of thieves infiltrating construction sites is nothing new. But it's a danger that demands constant attention from contractors, as the drag on a construction company's bottom line from theft can go deep and heavy.

What do they want?

Just this past July, security giant LoJack Corp. released its annual *Construction Equipment Theft and Recovery in the United States* study covering the 2013 calendar year. Per the data, the most common types of commercial construction equipment stolen were light utility vehicles/work trucks and trailers.

Because of its greater resale value, newer equipment was stolen more often than older assets. Indeed, according to the study, 46% of equipment taken was less than five years old.

Other highly in-demand equipment includes tractors, backhoes, skid-steer loaders, compressors

and generators. Job-site raiders will resell these assets either on underground black markets or to unsuspecting contractors seeking discount prices. Sometimes thieves will break down equipment into pieces for resale parts as well.

Theft has increased so much in recent years that some contractors factor stolen equipment into the cost of doing business. Unfortunately, the costs of replacing stolen equipment, short-term rentals, project overruns and wasted labor can drive profits into the ground.

Are you doing enough?

You can protect yourself by taking proactive steps to secure your sites, materials and equipment. In doing so, you may not only lose fewer assets, but also qualify for discounted insurance premiums. (Check with your carrier for specifics.)

Many of these proactive steps may sound familiar. But it's critical to check and double-check them to ensure they're being taken properly. For example, regularly examine job-site fencing and locks. A single hole, perhaps hidden behind foliage or equipment, can spell doom. In higher-risk areas, add razor wire around the fence top.

Your security lights should automatically activate in low light. Drive by each new work site in the evening to ensure these lights are working and adequately illuminating at-risk assets. Be sure that there's also plenty of light on your signs throughout the job site stating that you have security measures in place and will prosecute violators to the fullest extent of the law.

In addition, check your keys. Like having only one password for every website and computer system, deploying one universal key is risky. Instead, rekey equipment and storage sheds to diversify which keys fit where. Install antitheft devices such as tire locks, alarms and ignition-disabling devices, too.

When it comes to job-site security, people can make a difference. After you've checked the lights, as suggested, continue conducting random site visits. Put in a phone call to the local police department to see whether they'll allocate an officer to drive by your site after hours and on weekends. For particularly at-risk projects, you might even engage a security contractor to place guards on-site.

Who can help?

No matter how carefully you protect your sites, prepare for the worst by maintaining an equipment inventory that includes the year, make, model, serial number and date of purchase for each asset. Also, document identifying marks such as company logos and phone numbers, and photograph all pieces of equipment from a number of views. Then store the pictures, along with ownership documents, in a secure place.

Last, register your equipment with the National Equipment Register. The organization maintains databases of registered and stolen equipment, assists in tracking stolen equipment through its 24-hour hotline, and works with law enforcement agencies and the insurance industry to identify stolen equipment. Check out its latest efforts and offerings at ner.net.

Like having only one password for every website and computer system, deploying one universal key is risky.

Will it ever end?

Theft on construction sites will more than likely always be an issue. The temptation is just too great when equipment is so valuable. But you can keep these losses from ruining your bottom line by not just putting security measures in place, but continually monitoring and upgrading those measures.

The Contractor's Corner

What is a zero net energy building?

A local developer just issued a call for bids. I believe my construction company is well suited to the job, but one thing gave me pause. The office to be constructed is a "zero net energy" facility. I know this has to do with "green building," but could you give me some details on the concept? And should I expect more such projects in the future?

Indeed, zero net energy (ZNE) building is a sustainable construction approach that's shown some significant growth lately. For example, the *2014 Getting to Zero Status Update*, a report issued by the New Buildings Institute, revealed that the number of buildings that are achieving or pursuing ZNE has more than doubled since the last such study in 2012.

Defining the term

A ZNE building, as defined by the National Renewable Energy Laboratory, is one that generates enough renewable energy on-site to equal or exceed its annual energy usage. Designers accomplish this in a number of ways, including:

- Solar power,
- Wind energy, and
- Sub-basements that gather stable underground air temperatures.

Insulation plays a huge role as well. ZNE buildings are typically "superinsulated," from the design of the basic structure to the density and amount of the insulation itself.

Facing the challenges

Contractors may face a variety of challenges when undertaking a ZNE project. These jobs tend to follow the integrated project delivery format. So you'll be collaborating with the owner, architect and engineer from day one. This won't be a "here are the plans, get to it" type of job.

In addition, ZNE jobs usually involve building information management (BIM) software systems. BIM enables anytime, anywhere collaboration among everyone from the owner to the subcontractors. So it's perfect for creating and implementing complex ZNE designs. If you've never used a BIM system or have limited experience with it, you'll need to get up to speed quickly.

When it comes to costs, these projects can involve a lot of discussion and even debate. ZNE building systems are still evolving, yet owners don't want to spend big money on assets that will be outdated in 10 or 20 years. Thus, you'll likely be working with materials that are of the highest quality, but are also durable and relatively upgradable.

Making the scene

Yes, ZNE is on the scene. The American Institute of Architects Foundation, in partnership with Pacific Gas and Electric Co., held a ZNE design contest earlier this year. If you're up for the challenge, getting in on one of these projects now could position your construction company as a leader in this sustainable building trend going forward.