DISTRESS SIGNALS: lessons of 2012

You need to know how to identify the signs of impending problems in a business so that you can take action in time. By Costa Nicodemou,

Costa Nicodemou CA is a Director of BRI Ferrier.

Last year was a difficult one for the construction industry. Household names such as Kell & Rigby, Reed, Hastie, St Hilliers, Nahas and Southern Cross went into administration along with hundreds of smaller operators – almost a quarter of the 10,000 insolvencies that occurred across Australia.

There are lessons that members should continue to heed. An understanding of the qualitative and quantitative signs of distress can help identify problems and minimise the impact of failures.

QUANTITATIVE SIGNS OF DISTRESS

◆ Underquoting

Quoting at or below margin is often a sign that a contractor is "front end loading" in order to generate the cash needed to address pressing creditors and provide vital working capital to fund overheads. If this strategy fails, the operators are left with contract losses and subcontractor claims that further weaken the Balance Sheet.

◆ Forward book

The forward book is a proxy for future revenues. Generally, the forward book will reveal whether an operator would be able to generate revenue to meet ongoing overheads. Industry standards dictate that a healthy forward book of 1-2 years' worth of revenue should be in hand at any one time.

◆ Warranty claims

Mounting warranty claims under statute (the Home Owners Warranty provisions under the *Home Building Act 1989*) for residential projects or contract for commercial projects may put significant pressure on company resources.

As warranty claims generally come to light 5-7 years after contract completion they tend to be difficult to forecast in value and to identify and are contingent claims which often sit outside the Balance Sheet, for mid-tier, unaudited operators. An unfavourable judgment can therefore have a significant material impact.

Appropriate allowance should be made for contingent claims.

◆ Liquidity ratios

A Working Capital Ratio (Current Assets – Current Liabilities) or Quick Ratio (Current Assets – Inventory – Accounts Receivable) (Current Liabilities) of less than 1 is an indicator that a company would struggle to match its short-term liabilities. Liquidity constrains were a common theme in most of the 2012 failures in the Industry.

◆ ATO as lender

A contractor should be up-to-date with their ATO obligations (remittance of GST, PAYG, income tax and Superannuation Guarantee Charges) and lodgements as the ATO is often the creditor which is paid last but has the greatest recourse against the company (by issuing winding up orders).

QUALITATIVE SIGNS OF DISTRESS

◆ Deviation from core competencies

Deviation from areas of expertise (for example, contract building) to unfamiliar fields (for example, development) can introduce unfamiliar commercial risks, outside of contracting including, exposure to new markets, supply and demand variables as well as planning and finance risks. This can also divert management focus away from its core capabilities and other active projects.

◆ Loss of key customers

Whilst operators may benefit from close relationships with a handful of contractors in boom times, the loss of a key work-provider may be fatal. Sources of work should be reviewed to identify key risks, where a contractor's revenue is strongly linked to a primary source.

Last year's large company failures mean that many subcontractors continue to feel the effects of revenue-loss as they try to replace work flows to sustain the employee and infrastructure base.

◆ High staff turnover

Businesses may shed staff to cut costs (through redundancy or outsourcing key functions) or as staff begin to doubt the company's ability to continue. In both cases, this is often an indicator of distress.

◆ Recovery action by creditors

The relationship with suppliers may be pressured as cash-constrained operators seek to generate liquidity by delaying payments.

Late or incremental payments to suppliers may lead to a loss of faith, demand notices, legal action, stop supply and/or tightening of supply terms (for example, limiting supply to COD only).

The recent independent report into Construction Industry Insolvency in NSW by Bruce Collins QC noted that the standard cycle for payments has risen from 45-60 days to as much as 120-day terms.

There are various creditor warning websites that provide regular updates to creditors. Monitoring these warning notices will identify credit risks earlier.

More info: www.briferrier.com.au