

CYCLE TIME

THE GIFT THAT KEEPS ON GIVING

TIGHTLY MANAGED CYCLE TIME IS CRITICAL FOR ACHIEVING SUSTAINABLE, PREDICTABLE PROFITS. NEGLECT IT, AND YOU'RE PLAYING A DANGEROUS GAME WITH YOUR BUSINESS

BY SCOTT SEDAM, CONTRIBUTING EDITOR

Cycle time, as discussed in last month's column "Getting Serious About Cycle Time," has inflated significantly since emerging from the downturn, costing home builders millions in lost profit. The U.S. Census Bureau numbers show the build-to-close schedule up 30 days since 2012. Take that on back to 2007, 13 years ago, right before the hammer came down hard on home building, and everything my TrueNorth team observes shows cycle time is up closer to 60 days, on average.

Cycle time is an insidious thing. For most builders, pushing back a day here or there over the months-long course of building a new home doesn't strike them as disastrous. Annoying maybe, but nothing to panic about. Losing one day out of 180 during an inflated schedule gets lost in the process, making the slip of that day easier to stomach. Besides, with around 26 Saturdays in a 180-day stretch, surely you'll make it up somewhere—or not. Drop that same day during a tight 90-day schedule, however, and there's a good chance you'll put your critical path at risk. Just where do you make that day up?

THE IMPACT OF SCHEDULE CREEP

Sincere 90- to 120-day schedules for production builders were the norm prior to the big crash, and 60- to 90-day schedules were not unusual. Today, a no-tears assessment shows 150- to 180-day schedules are closer to the norm, and you'll often find higher. Woe be to those who fail to turn over their assets at least two times, which is the best 180 days will get you. Three turns should be the absolute minimum standard, and four turns is an achievable goal for most.

Yet, in my travels around the country, I don't find the same sense of schedule urgency that existed 12 or 15 years ago. There are multiple explanations for this, but from what I've observed, the biggest cause is that builders don't fully understand the scope, severity, or total cost of the impact of lost schedule. It's time to work on that.

Last month's column broke down cycle time into five distinct elements and discussed the ins and outs of calculation and how to avoid common measurement pitfalls. Ongoing evaluation of cycle time and its components can't be optional, just as closing your books and financial statements cannot be skipped.

If you do track cycle time and its components continually, your processes will talk to you and tell you where the pain points and losses are. This always works, but it begs sober, reflective insight, not knee-jerk reaction over short-term variation in your processes. Wide-eyed caution is advised. If you neglect your cycle time measurements, fail to track them over time, and react to them ad hoc, you are only guessing ... and that's a lousy way to run a business.

UNDERSTANDING ABSORPTION RATE

Bill Pulte, the very best of my mentors, used to say, "As goes the schedule, so goes the builder." Absolutely nothing has changed about that statement in 30 years. For Bill, each day was a precious commodity, and the shared belief, which was part of the company culture, was a lost day could never be recovered. Yes, you might make up a day on a Saturday, but there was a price to pay, both monetarily and psychically. At Pulte, at least in those days, you lived and died by "absorption rate"—the distribution of fixed cost over the number of units built in a given time period. Bill Pulte preached this daily, along with admonitions to never neglect quality, customer satisfaction, trade relationships, or taking care of your own people.

Increasing absorption rate, while simple in concept, is harder to achieve: Build more units without raising overhead and everything gets better. Build fewer units with the same overhead and there goes the Christmas bonus, next year's raise, perhaps even your job.

Back then, communities doing 10 or 12 units per month were the ultimate, but the corporate asset management team wouldn't even entertain a new community pro forma from the field without a solid projection of at least three units per month. Below that, the numbers quickly turned south. Once it was agreed a community could support the minimum unit requirement, projected pretax net wasn't enough on its own. Our internal rate of return was heavily dependent on cycle time. You could meet the minimum units with acceptable gross margin and pretax net, yet a slow cycle time could doom the project to failure. Consider the following example.

We have two communities set up as LLC profit centers for the same builder. Both will build identical plans with equal options and selections, projecting four closings per month for a project total of 48 closings. The pro forma average sales price is \$300,000, and the average hard cost is 50% or \$150,000, with an identical finished lot cost at 20% or \$60,000, producing a substantial gross margin of 30%, out of which we'll pay for sales, marketing, general and administrative

expenses, finance costs, salaries, bonuses, benefits, etc. That \$30,000 in overhead leaves a nice pretax net of 10%, or \$30,000 per unit.

It's important to note: There are innumerable practices and philosophies about where to put costs such as permits, development fees, superintendent salaries, model maintenance, finance costs, etc., making builder-to-builder comparisons difficult. You may calculate your gross and net numbers differently, but the principles addressed here apply, regardless. We work with many strong private builders that do better than 10% EBIT (earnings before interest and taxes). Many others, especially the publics, rarely reach that level, but 10% is above the national average and is considered a strong return.

However, there's one big difference between these two communities: Community A's cycle time from foundation dig to close is 180 days—fairly typical in current times. Community B, on the other hand, turns its homes out in 90 days—impressive and challenging, but definitely achievable. Consider the impact of that cycle-time difference.

THE CRITICAL LINK

Many factors contribute to how well a project runs in the field, but one thing's certain: the job superintendent is the critical link. The role is known by many names, including construction manager, project manager, or the thoroughly confusing "builder," leaving people puzzled as to whether we're talking about the builder as the individual or the company. Whatever you call it, the super is held accountable for meeting the schedule. If we launch on January 2 under the 90-day schedule, we have closings available April 1. This community of 48 lots projected four per month, so we'll close it out by April 1 of year two. Job well done. The most units this field manager would have to carry at one time would be 12.

Now compare that with the 180-day schedule where the first unit isn't available for six months, until July 1. The entire cash flow net of the deposit is pushed back a full quarter. In the 90-day example, we launch a house per week, and after three months, each start clears the schedule—and the ledger. In the 180-day schedule, that three-month delay before units sell causes them to pile on top of one another. We wouldn't see revenue for six months, and the project ends at the same 48 sales, but a full quarter later. WIP (work in progress) builds up significantly, requiring far more capital and more carry costs. I'll leave it to your financial people to cost-out the impact on profit, but it is significant, and I'll wager it's larger than you expect. Your pretax net may still look fine, but your return on assets for a one-year period falls precipitously.

How do you fix this problem on a 180-day schedule if you're on the hook for 48 units in the same financial period as the 90-day community? Unless you have the wherewithal to make a completely focused effort on cycle-time reduction, the only solution is to start more homes, carry more WIP, and place a heavier load on your superintendent. This scenario brings up one of building's perennial questions: How many homes can a field superintendent reasonably carry at a time and maintain schedule, quality, and supplier/trade

relationships—not to mention his or her own sanity? The old maxim for field construction management is “Every house, every day,” meaning the super inspects, and something productive happens, on each house, each day.

In a single community, it’s almost impossible to inspect, evaluate, and respond to the needs of 25 to 30 units per day, given all of the activity house walks generate. In multiple communities, it’s physically impossible. There are heroes who try to pull it off for a period of time, and for a few builders that have homes so simple and repetitive, with limited options and selections, high volumes can be done. Yet, ultimately, for most supers, it’s a self-extinguishing practice. Twelve to 15 homes per day? An average superintendent with decent training can handle that level (more or less), depending on complexity. With a lot of experience, simple product, and a tight process, I’ve seen some who can handle 18 or 20, maybe more for simple starter homes.

Back to our case study: At the end of the year, Community A with the 180-day schedule has reached its 48-home goal but has also loaded up on starts early to meet the standard set by Community B. The super is burned-out, running around every day with his or her hair on fire, now looking for another job; countless problems and errors were missed, causing massive rework; suppliers and trades were paid much later, causing considerable unrest; the warranty burden soared; and customer satisfaction has fallen. Pretax net is good, but return on assets (ROA) is depressed due to the increased WIP and slow take-down. Owners and investors aren’t happy.

Community B also closed 48 homes, with a cycle time of 90 days. The superintendent carried 12 homes at any given time, getting into each home daily, staying on top of every need, and continually communicating with suppliers and trades. He also had time to talk with inspectors, homeowners, and even some prospective homebuyers the sales team brought by the jobsite. Variance was minimal, profit up, quality great, and customer satisfaction strong. And, at four turns, ROA is excellent, keeping the owners and investors happy, indeed. Now more money is available to the builder, and at lower rates, meaning more units at higher profit. Everyone wins.

Can this super now carry more than 12 homes at a time? That depends on the product, process, and experience. If the homes are second or third move-up, “high bling” with numerous plans, multiple elevations, and a large design center—and especially if the builder offers structural options—it’s rare to find a super who can carry more than 12 or so on a 90-day schedule and do it well. In today’s reality, only a very small number of builders fit this description and consistently build in 90 days. As you simplify product and process, you can increase the load on your field

managers, but a realistic assessment is required.

INSIDIOUS IMPACT

The impact from overloading due to a drawn-out schedule isn’t limited to the field superintendent alone. Similar effects are experienced by sales, the design center, purchasing, and administration of all forms. On the surface, if you’re putting out the same number of units annually, shouldn’t the amount of work be the same? Hardly.

If you double the number of units under construction, you have twice the WIP, twice as many customers to keep informed and happy, twice the options and selections to track, and twice the opportunity for late changes. And everyone knows: When it takes longer to build, more things go wrong due to weather, theft, changes in trades, etc. I’ve written a great deal about complexity in the past, and extended schedules are a key culprit.

Reducing cycle time and reaping the benefits isn’t an overnight endeavor. Imagine your field staff’s meltdown if you announced you were cutting cycle time in half. They already can’t keep up with the current workload, and suddenly you’re going to cut their time to build? Instead, tell them you are significantly cutting the number of units each super manages, and say nothing about cycle time. Their jubilation will drown out the average New Year’s Eve celebration.

They’ll sober up quick enough when you add that to make those numbers work, you’ll all have to work together to significantly cut cycle time. How? Threats, “just do it” memos, and incentive plans based in part on things they don’t control won’t yield success, they will just make things worse. To achieve significant and sustainable cycle-time reduction, you will need real thought and genuine change in your systems, processes, and people.

As I finish writing this column the week before Christmas, after doing some last-minute shopping (online, thankfully), it’s natural to think about gifts. Not many of us have ever thought of cycle time as a gift, I’ll bet, but a tight building cycle and everything that goes with it will reward you each day of the year. However, it can also be that proverbial “gift that keeps on giving” in the negative sense. A long, loosely managed schedule robs you of profit and it robs the psyche of your people, plus your suppliers and trades.

So, which will it be? It’s in your hands. We’re more than a month

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