Rising Interest Rates Bring Risk For Construction Contractors

By **Kevin Riexinger** (August 31, 2023)

Kevin Riexinger

The amount of volatility in construction over the past five years has been no secret. Owners, designers and general contractors alike have had to make uncomfortable decisions on numerous occasions to compensate for at least one of the many prevalent issues.

Just prior to and immediately after striking a new contract, all parties are spending significant time reviewing risks to the time and cost of their project due to supply chains that have been stretched to their limits by the fallout of COVID-19 lockdowns and labor issues, freight disruptions due to derailments and waterway incidents, and limitations to all modes of transportation due to war along critical routes.

All the above are important but can be managed. Interest rate hikes are one risk that poses more difficulty, but which may be managed after a contract is executed.

Prior to the pandemic and up until about a year ago, the construction industry had been thriving with historically low interest rates. The low rates meant easy access to funding and allowed those with even a thought of a capital project to design and build with very little interest capitalization.

Ever since the Federal Reserve started and continued raising federal interest rates in March 2022 in order to control inflation, the low cost of borrowing for capital projects has disappeared.

The pace at which projects are being halted is causing a whiplash effect for general contractors who may have been preparing to expand, take on larger projects or consider a larger quantity of projects. A common example of how this happens industrywide goes something like the following.

A midsize general contractor wins a bid and enters into contract negotiations with a well-known potential client that has a capital project in mind. The potential client is not only well known but well funded, and can provide proof of funding, so the general contractor is confident they can afford to pay for the project without an issue.

The contractor executes the deal under amicable negotiations. This general contractor has a booked or close-to-booked revenue plan, but this is a client they would like to work and build a lasting relationship with so, at this point, the general contractor may need to hire some additional staff to service the new project.

The general contractor in this example decides to hire two or three full-time employees in anticipation of the job they won. Shortly thereafter, the client starts to slow their pace. Perhaps the client comes to the contractor asking to decelerate and maybe only have a soft start to the project, meaning, work on procurement, plan, maybe mobilize, but do not execute any major operations.

Say the contractor in this scenario signed on for a $10 million project expected to take 10 months. The contractor's work in place averages $1 million per month. That monthly budget

pays for all trades, costs, insurance, fees and overhead.

However, in a soft start, the client may tell the contractor only to complete the demolition stage and then hang tight. Or perhaps they instruct the contractor only to clear the site but hold off on ordering any concrete or steel.

This is happening more frequently now because clients, like the one in this hypothetical, are funding projects through a series of loans. As interest rates continue to rise, their cost to build goes up in lockstep. Thus, clients are seeking to pause projects to either wait for decreases in interest rates, or to find alternative funding.

In the meantime, the contractor in this instance has just made a large capital investment by hiring three new people for their workforce. The contractor then has only vague assurances from their client that the job will continue eventually.

Billings for overhead are typically based on progress, so in our scenario, at month two with $2 million in place and 20% complete, the contractor may have billed 20% of their overhead. Now with the progress curve loading later, the contractor's billings are now lagging behind their actual overhead costs.

In such instances, which are happening ever so much more frequently in 2023, the general contractor is stuck in the unenviable position between having to choose between firing these new hires or keeping them on payroll without the immediate income from the project they were supposed to staff.

The contractor knows they need those new hires for when the job goes forward, but in the meantime, that job is not supporting the cost of their salaries. The risk in terminating those new employees is that — in theory — the client could ask for the job to start the next day, and then the contractor would be panicking to restaff those positions.

Thus, the contractor may instead simply continue to carry on and pay for those additional staff members while absorbing their overhead. That overhead becomes debt — a grave they merely hope to dig out of eventually.

Now imagine the above scenario playing out on a much grander scale. The larger the project, the larger the losses. And what if the client eventually cancels the project entirely? What repercussions are contractors left with? Unless contractors have provisions for collecting damages written into their contracts, they could be left in debt that could cause them to lose their staff or worse — close their doors.

Throughout the summer of 2023, would-be builders have truly felt the strain of overhead piling up. In some of the worst cases, projects are being slowed, paused or even indefinitely mothballed after having already been fully designed, permitted and booked.

As interest rates continue to spike, clients are being forced to make hard decisions. They have had to reassess their spending on capital projects.

When a construction project becomes delayed or stopped after being booked, staffed and locked into revenue plans, the trickle-down effect is felt throughout the entire construction industry. It creates anxiety among would-be builders and seasonal skilled labor alike due to a dangerous level of uncertainty.

General contractors are finding themselves in the precarious position of having to either

stop projects or overpay for raw materials at prices above what they quoted. The former benefits nobody. The latter means eroding profits to the point where project overhead leaves no room to pay the staff who are generally compensated via project revenue.

Most American Institute of Architects-based contracts have termination clauses under Section 13, but these clauses are frequently unaddressed during contract negotiations between builders and contractors.

Some smaller residential contractors have sought to fold into their contracts a fee to be paid if the project is paused or canceled due to material costs. While this helps alleviate losses when staff is small — meaning one to 25 employees — these fees are seldom large enough to help contractors on larger jobs staffed with 25, 50 or even upward of 100 full-time employees.

Naturally, the cost of staff wages, which cannot be paid out of project revenue, leads to significant debt for contractors.

As always, threats to construction contractors can be addressed, minimized and often neutralized by heightened attention to contract terms. It is paramount that general contractors, large and small, pay specific attention to terms that can protect them from risk from owner-driven schedule modifications.

There are measures that contractors can take on their own to ensure that taking a job won't lead to significant financial loss.

Contractors should insist on being provided with proof of finance by would-be clients. Once they're satisfied that the client is in a financial position to pay for the project, the contractor should seek to include strong language in their contracts that would allow for billings of general conditions or minimum overhead costs if a start date fluctuates beyond a reasonable duration.

Furthermore, contractors should seek to include in their construction agreements language that protects against loss of income. These terms serve as somewhat of a backstop to contractually protect the contractors at least partially from losses caused by building pauses or outright cancellations.

The unfortunate truth is that as interest rates rise rapidly, the effect will reverberate with losses due to delayed starts and cancellations until the construction market catches up and equalizes, or rates take a turn back in the other direction.

Kevin J. Riexinger is a partner at Gfeller Laurie LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.