

DIVERSIFICATION & THE SMALL BUILDER

The ups & downs of having many irons in the fire

by Chuck Moriarty

I'm a principal in a small well-diversified building company in Seattle, Wash. At the time my partner and I established our business in 1976, our sole purpose was to purchase, improve, and resell or rent single family residences within the city limits of Seattle. Our goal was to simply acquire enough rental property to provide ourselves with sufficient income to enjoy our "golden years" (you know-when we turned 40). We have since diversified into several related fields including property management, construction management, custom home building, design/build, marketing real estate partnerships, home inspections, bookkeeping for small companies in related fields, and consulting for other contractors and sub-contractors. Obviously some endeavors have fared better than others and what follows is my experience in the various fields. We have kept the ones that worked for us, thrown out the ones that didn't. One must understand that our successes and failures are strictly a function of our personalities and strengths and I would encourage you to try any and all diversification opportunities that present themselves, even though they may have failed for our company.

Some of the areas we have explored have been natural extensions of our original business, some have just been things we were interested in trying. But all have been done with an eye towards simplicity of structure and operation. What we have never wanted to do was to run a top-heavy organization fueled by its subsidiary parts in a never-ending quest to pay for all the additional overhead.

We have particularly been interested in businesses that involve strong selling and personal relationships that the partners excel in while leaving the mundane (and all-important) business operations to our general manager and staff.

Delving into Real Estate

When we started our business, we were buying, rehabbing, and reselling or renting single-family homes. As the market tightened, we sold our inventory of rental homes and bought a couple of larger buildings for rehab. Some of these we kept for rental income and long-term gain, some we sold on contract to produce interest income, and some we sold for cash to produce working capital. All the components of this end of our business are shaped by both income tax issues and our long-term retirement goals.

A natural extension of this business was offering partnership opportunities to other investors. As the General Partner, we acquire an interest in the building without using any of our own capital. Additionally we charge a management fee to the Partnership for the

management of the building.

It is surprisingly easy to come by investors for real-estate opportunities. We have never advertised for investors but instead have often been approached by people who know what type of work we do. These people include past clients, friends, employees and many professional people we have met through our years of business.

Most people recognize the value of investing in real estate but don't want the hassle of maintaining and managing the buildings. I myself can't stand it and would not own any investment property if I had to manage it. But I love looking for property, working deals, and selling partnerships. Fortunately, my partner doesn't mind showing rental units, and our secretary does quite well in collecting the rents.

Our rental buildings are smaller units, either mixed use or apartments. Although the smaller buildings probably take more time to manage (percentage-wise), they are easier to keep full and are much more liquid than larger

and provide a bookkeeping service. Depending on the owner's needs, we can pay underlying mortgages, taxes and insurance, or simply subtract our fee and send the proceeds to the owner. Additionally, we furnish the owner a monthly statement and a year-end profit and loss statement on their building.

Reluctant Remodelers

Since the housing market was explosive during the early years of our business, we were able to successfully market our rehabbed single-family units ourselves, and through our site signs and advertising, our name became synonymous with quality remodeling work. Our first diversification opportunity presented itself when we somewhat reluctantly began taking on remodeling contract work. I say reluctantly because I still don't quite know how I ended up doing so much contract work and making so little money at it. But since our speculative business was extremely profitable, we were able to

20, 30, even 50 percent over the competition. By this time, we were a lot smarter than when we had started out, and had joined the local chapter of the National Association of Home Builders. Our membership gave us educational opportunities that we hadn't known even existed. Through the local chapter's Remodelers Council I had the pleasure of meeting many remodeling contractors in my area. It amazed me how open and friendly these contractors were and how willing most were to help us out with answers to our questions.

My best educational opportunities came when I started attending the annual NAHB show. Through participating in seminars and roundtable sessions I gained the friendship of remodeling contractors from across the country and these have been my best resources for making my remodeling division a profitable venture.

Design/Build

Since I couldn't get a job at my price through the competitive bid process, we diversified into design/build. Every time I met someone that was into design/build I would grill them on how they did it and what their experiences were. It took several years to get good at it but now it comprises 95 percent of our residential work. We still do a bit of bidding for a select few architectural firms, but we always find out who our competition is so we don't just waste our time when there is no chance we will get the project.

There are a multitude of advantages in design/build, not the least of which is control. When a consumer hires you to do both the design and building, you are the undisputed expert and the project just rolls along smoothly.

Another advantage is that you are getting paid to do the budget. When you are bidding work you have less than a 50 percent chance of getting the job, depending on how many bidders there are and whether the project even gets built. With design/build, you have a 100 percent chance of getting the job.

But the best part of design/build is you can quit competing on price and begin selling value. I personally find it extremely rewarding to take a family's dreams and work through the design process to give them the project they want at a price they can afford—and at a price that I can make a fair profit on.

Design/build also seems less prone to lawsuits. This is probably because both you and the client have a chance to truly know each other before your crew moves in with them. It's far easier to walk away from a project with a difficult client during the design stage than when you have it half under construction.

Tenant Improvements

We have also enjoyed tremendous success in the field of tenant improvements. Back in the days when I couldn't



Before

Spec remodeling has paid off for both the contractor and the investors who put up all the cash (in return for 50 percent of the profits upon resale). This Seattle bungalow was transformed into a two-story contemporary and yielded these figures:



After

Purchase	\$58,000
Rehab	55,000
Sales price	157,000
Sales cost	11,920
Net profit	32,080
50% to investor	16,040
= 29% return on investor's money	

complexes. We have found our best opportunities in the more marginal (affordable) type of apartments than the higher and lower-end units. The middle income tenants just seem better at paying their rent on time.

Our mixed-use buildings are generally in neighborhood business districts and typically have one to four commercial spaces with apartments above. We spend a lot of time looking for buildings that are underutilized and under-managed. The best ones are buildings where we can re-lease the commercial space to tenants that have money to spend on improving the space.

Because of our need to manage our own buildings, it was natural to begin managing rental projects for other owners. For 10 percent of the gross, we show apartments and collect the rent. If the tenants have problems, they call our office and generally don't even know who the owner is. All advertising and maintenance costs are additional. Basically we relieve the owner of all the headaches of owning rental property

make many families happy by unintentionally subsidizing their remodeling projects.

It wasn't until we got out of the single-family resale market that I realized how poor this end of our business really was. Not having the benefit of being active in my local homebuilders association, I was busy re-inventing the wheel on pricing and mark-ups. Since my accounting system would not give me the information I needed to accurately assign the overhead costs related to the contracting side of my business, as opposed to the speculative side, it was quite a shock to realize how much this business was costing me. With that knowledge in hand, I quickly raised our prices—and our construction gross dropped from \$450,000 to \$80,000 in one year's time.

But at least I made money on that \$80,000.

Now I knew how to make money in the contracting business but unfortunately the contractors I was bidding against still didn't. So I was consistently

get any bid residential work, I started calling on building managers and architects looking for office and retail improvements. Here was a field in which I could be extremely competitive since I was at the smaller end of the scale in company size. The repeat business is also fantastic. Since most retailers upgrade their stores about every five years, you can enjoy a relatively stable work load by developing a good list of commercial clients.

Custom Home Nightmares

And then there's custom home building. The opportunity to build someone a custom home is something most of us don't want to pass up, probably because it satisfies our egos. I have built half a dozen homes, generally for people that didn't have the money to pay for them. So not only did I get ego satisfaction, I was given the opportunity to make a charitable contribution to the "underprivileged." Oh well, my attorney certainly benefited from our foray into custom home building.

Actually, the biggest problem in custom homes is that the owner generally does not pay the architect enough to provide a complete set of drawings and specifications to accurately price the job from the site work to the towel bars. (I suspect another good opportunity for design/build is the custom home field, although in my case I would have to hire the design expertise to do this.)

Since I don't want to hire a house designer, how can I build custom homes without the benefit of complete plans and specifications but that I can still make money on? Enter the concept of construction management. We will build your home for you at cost plus a predetermined fee. My one experience in this has the court date set for July 1988.

This particular owner dragged me out to a subdivision and 'took me through a model home he liked. The house was priced at \$150,000. Could I build him one like it with a "little better quality" for the same price if he furnished the lot? No problem, I stupidly replied. He started in on his drawings and we both looked at several lots and finally he purchased one in a relatively complete development of \$200,000 homes. We received several generations of drawings and by the time the actual building had started, the construction budget had grown to \$190,000. The lot cost \$50,000 so we were now in the \$240,000 range, definitely at the top end of this particular subdivision.

While the foundation was being poured, I was trying to get the finish package together. We were having a difficult time specifying what was going into this house, so I went on a Sunday drive with the owners to see several examples of what they would like. By the end of the day I was very quietly sitting in the backseat thinking "How am I ever going to get out of this one?" All the homes they had shown me were in the \$400,000-plus range and I knew we were in big trouble. While they were busy quacking about swim spas in the basement, I was trying to figure out how we were going to build this home without any lumber so we could use the framing budget for the interior finishes.

Now I had known the husband for years and had done some business with him since he was a mortgage broker. His wife is a real estate appraiser so it's not like I had a couple of novices on my hands.

The following day I met with the husband and explained my fears of the cost overruns involved. He immediately rec-

ognized the concerns, but the house was his dream home—so let's do our best on the budget and just build it. In order to save money, we would just set the fiberglass swim spa in the basement and he would hook it up in a couple of years when he could afford the dehumidification system required.

Of course when the HVAC man arrived, it was only an additional \$10,000 to install the system—so let's go ahead and do it. I reminded him of our tight budget but since the owner was paying all bills directly, I gave in and figured he knew what he was getting into.

To make a long story short, I think the house finally cost a total of somewhere around \$350,000. Like I said, I guess I'll find out in July 1988.

Profitable Partnerships

Over the past couple of years, we have begun to do some speculative projects in partnership with private parties. Because of the low interest rate banks are currently paying on CDs, we have found many people interested in financing the acquisition and rehabilitation of existing homes for resale.

The concept is simple. The investor puts up all the cash, we put up the expertise. We buy the homes on real-estate contracts with short-term cash-outs to keep the acquisition costs low. We retain 10 percent of the gross construction cost as an offset to our overhead for doing the project, and split the net proceeds 50/50. The investor is protected as he holds title to the property; we protect ourselves through the lien provisions of our state law. The hard part is finding a property that has the potential for the return we expect. There has to be substantial profit in it or it simply isn't worth doing. Over a typical six month period, our investors have enjoyed returns of 14 to 60 percent on their money.

This system works well for both parties, but gets bogged down if you are borrowing money from a bank. The additional fees and interest charged by the bank make many of these projects strictly marginal.

Over the years, some of our past clients were asking us to look at homes they were considering purchasing. For a nominal fee, we would go out and look over their prospective purchases. As these calls increased, we decided to formalize the business and actually started marketing home inspections. Because of the risk potential, we decided early on to keep this business small enough so only the partners handle the actual inspections. We already earn our attorney a pretty good living so we didn't need the risk exposure of a hired inspector signing off on a crawl space without actually inspecting it.

Home Inspection

I think home inspections are an excellent opportunity for the owner of a small company to generate some additional income without having to add to his overhead. If you run a company that does not require your constant presence on the job sites, you could begin marketing for home inspections and create a nice little cash cow with just a little better organization of your day. The fees for, home inspections seem to be very market sensitive so you would need to do a survey to find what the going rate is. In our area it seems to average about \$200. Our housing market is relatively stable right now, so it is fairly easy to schedule the inspections to meet our needs. Our early marketing efforts were directed towards

real-estate agents and we spent a lot of Sundays at open houses meeting them.

Direct your efforts at the top agents in your community and you can keep yourself busy during the next recession. The best agents continue to sell year in and year out, just like the best remodelers continue to work right through the downturns in the economy.

There's Always Consulting

Over the years many subcontractors have asked for my advice and expertise on business management. I offered to help some of the people that I knew and particularly liked, but quickly found I had to start charging for my time. So another natural diversification was to start business consulting on a fee basis. Surprisingly enough, not only were people willing to pay me, they were much more likely to follow my advice than when I was advising them for free.

I have consistently found that this industry is made up of expert craftspeople who are lousy business people. To be successful does not mean running a million dollar business. It means making a profit. Far too many of us have absolutely no handle on the costs of doing business and can only afford our Porsches and Mercedes because we have such dynamic cash flow. When that flow is turned off, we suddenly find we can't make last month's payments with this month's retainers. The biggest hurdle I have is convincing contractors that it is *not* the gross dollar amount done yearly that makes their business successful.

As our business became fully computerized, we decided to turn our office into a profit center and started marketing bookkeeping services to other small companies. Although we do some retail shops, we concentrate on small contractor companies where the owners can spend their time more profitably in areas other than bookkeeping. Of course this is also a natural extension of my consulting practice. Our contractor clients easily pay our fees through their increased profitability.

Over the years we have found our business goals and strategies changing and some years we emphasize some areas of our business more than others. The general economy, our hired expertise, the partners' personal goals, all play a part as we plan our future business strategies. We retain our ultimate goal (enjoying our golden years) but the road there is ever changing. Ours is a well-diversified company—which is ideal for us. Others, however, find it better to do just one thing and do it extremely well. We find it best to do many things, throwing out the unprofitable ones along the way, and retaining the ones that interest us. Because of our diversification, our workload is extremely stable and we find we are well equipped to ride out the economy's ups and downs.

As I said in the beginning, our successes and failures are strictly a function of our personalities and strengths, and each reader has to determine what works best for him. ■

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