VINCI BLOG

Strategies for Increasing Profitability: Insights from the Construction Industry

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The construction sector is an important part of the Dutch economy.

The sector employs 293,000 people, includes 159,095 companies, produces about €60 billion per year, and is responsible for about 4.5% of Dutch GDP.

The sector is cyclical, and strongly related to the macroeconomic conditions. Currently, the sector is growing (2.2% per year), and margins are increasing (from 5.5% to 6.5%). The industry is still recovering, however, from the financial crisis.

During the financial crisis, the basis of competition shifted to 'price competition' – in the sense that companies competed in terms of price -- which led to a pricing race-to-the-bottom; those that charged the lowest price won the most contracts.

The effect was two-fold: Firstly, it increased the number of market exits (bankruptcies) and the number of consolidations (mergers and acquisitions). This decreased the number of firms, and increasing the level of concentration. Secondly, it changed the industry's investment strategies, from investing in new knowledge and technology, and innovation, towards cost-cutting and outsourcing. This decreased the industry's level of innovation, and increased its dependency on external partners.

Both strategies, we suggest, are harmful to firms in the construction industry, to the health of the industry and, given its significance, to the wider Dutch economy too.

In collaboration with Bouwend Nederland, with financial support from the Netherlands Organisation for Scientific Research (NWO), and with technical assistance from Architectenbureau van Manen en Zwart BV, Brancheverenigingvan Architectenbureaus (BNA), and Gemeente Groningen Economische Zaken, Killian McCarthy and Thijs Broekhuizen, and their assistants, Annika Zwanenberg and Viktoria Undesser, spent a year studying the construction industry, looking for viable alternatives to price competition. They looked at 5 strategies, adopted by other industries for increasing profitability, and survey the 4,000 members of Bouwend Nederland, to consider which, if any, could be used in the construction industry. The strategies, the mechanism by which they can be used to increase profitability, and their viability in the context of the construction industry are discussed below:

1. Strategy 1: Innovate

Innovation allows the firm to create something new, and by offering something new firms can increase their margins. Apple, for example, had a margin of 69% on its competitors, at one point, due to the novelty of their products.

Our study of the construction industry shows that industry is innovating, but the current focus is on: (1) cost-cutting process innovations, rather than value-creating product, or marketing innovations; (2) 'new to the firm' innovations, as opposed to 'new to the world' innovations, in the sense that firms are extending their product and service lines with products and services that already exist in other firms, and are not creating anything truly new. Neither are effective long term innovation strategies and we suggest that the industry should take advantage of the current recovery to invest in value-adding innovations.

2. Strategy 2: Focus on Sustainability

Sustainability can be used as a differentiation tool, and by differentiating itself, and its products, the differentiated firms can charge higher prices. Tony Chocolonely, for example differentiates itself as a fair trade producer, and because of this it is able to ask for a higher price to its competitors.

Our study of the construction industry shows that the industry is actively exploring and investing in sustainability, but sustainability is not yet an effective way to increase profits; sustainability is seen as a requirement in the industry, required by customers, regulators, and by the firms themselves, but is not a key differentiator.

3. Strategy 3: Collaborate

Collaboration is about creating value by working together. It is about developing partnerships with customers, competitors, suppliers, or other parties in the ecosystem. It is an important strategy because it provides the firm: (1) with access to new resources (physical, human, financial, intellectual) to grow the firm and its offerings; (2) with option to reduce costs by, for example, sharing Research & Development costs, establishing new production standards, or through outsourcing arrangements.

Our study of the construction industry shows that collaboration is a useful strategy, and the industry is eager to collaborate. However, as is true of many industries, we see that the construction industry has trouble identifying partners with which to collaborate, and in extracting value from those collaborations. We suggest that there is a role of associations, like Bouwend Nederland and the Branchevereniging van Architectenbureaus to help with these issues, such that money can be made by the partners of the cooperation.

4. Strategy 4: Protection

Protection is about creating value by protecting the firms offerings. There are two protection mechanisms: legal mechanism, such as trademarks and patents, and strategic mechanisms, such as secrecy. Both are important tools, in the sense that they allow firms to protect their core resources and capabilities. Coca-Cola, for example, uses legal protection (trademarks) to protect its brand name, as well as nonlegal means like reputation and strategic mechanisms (secrecy) to protect against undesired imitation. When effectively deployed, such mechanisms improve firms' profit margins.

Our study of the construction industry shows, however, that protection mechanisms are not extensively used in the construction industry, and they do not appear to be useful for creating value, because the industry focuses on open and co-created solutions. The industry is open, and believes that it is important to being open. While we would agree with the sentiment, we would warn that this is an optimum level of openness, and would suggest that protection has an important role to play in all industries. We would again, suggest, therefore, that there is a role to be played by the branch organisations to help the industry to make better use of protection mechanisms, while still be open to collaboration.

5. **Strategy 5: Change the Boundaries of the Firm**

   Changing the Boundaries of the firm is about changes at the organizational level, including: integrating, or outsourcing, individual products, services, functions, or companies, to create value. Changing the boundaries of the firm is a useful strategy because it allows the firm to grow, to cut costs, and/or to focus on core activities, by outsourcing non-core activities or by integrating areas in which the firm wants to grow.

   Our study of the construction industry shows that the industry is actively involved in integrating and outsourcing products, services, functions, and merging with companies, and as such is actively changing the boundaries of the firm. It sees this as an important way to grow, and to create and capture value. We would agree, but given that 85% of such organizational moves fail, and given that outsourcing creates dependencies on external partners, we would also sound a note of caution. We again see a role for the branch organisations in communicating the dangers of changing the firms' boundaries.

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