3 Emerging Industry Structure

Remodeling remains an unusually fragmented industry. Joint Center estimates from the Census of the Construction Industries indicate that 530,000 contracting businesses primarily served the home improvement market in 2002. Of these firms, fewer than 38 percent—or about 83,000 general remodeling contractors and 117,000 specialty trade contractors—had even one employee.

Even contractors with payrolls are typically small operations. Over half (54 percent) of these general remodeling firms reported gross revenues of less than $250,000. Only 12 percent had revenues of $1 million or more, and just 1 percent had revenues of $5 million or more. While an updated look at the remodeling industry will not be available until the second half of 2009, there is no evidence of significant concentration since the 2002 census.

In addition, firms have increasingly focused only on the residential remodeling market. For example, more than 80 percent of general remodeling contractors reported that 100 percent of their 2002 revenues came from remodeling projects. During upturns, this specialization means that contractors can narrowly target their activities, which helps to improve their efficiency and competitiveness. During downturns, however, specialization limits the ability to branch into other market segments where business might be better.

This structure exposes contractors to considerable risk during even normal business cycles. In the current downturn, improvement spending probably did not begin to decline until the third quarter of 2007, but contractors felt the impact almost immediately. According to US Department of Labor reports, average hours worked by employees at general remodeling firms started to decrease in that same quarter and the number of payroll employees began to fall shortly thereafter. By the third quarter of 2008, remodeling contractor payrolls had shrunk 5.6 percent from a year earlier, while payrolls in the overall economy had declined just 0.3 percent.

Performance of Larger Firms

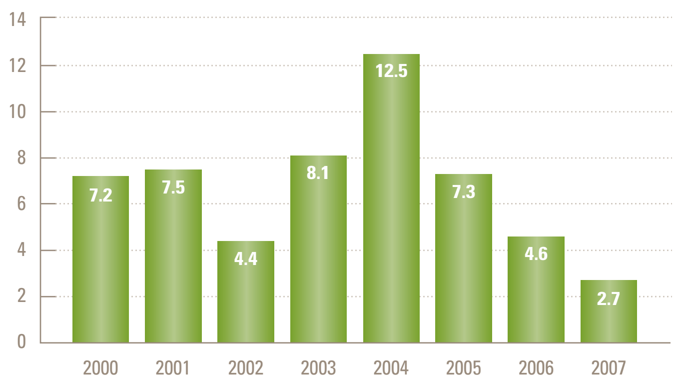
While smaller contracting firms no doubt bear the brunt of the spending slowdown, larger firms are by no means immune.

Joint Center analysis of information collected annually by *Qualified Remodeler* magazine on the nation's top 500 remodeling contractors reveals that revenue growth among larger firms peaked in 2004. By 2007, these contractors averaged just 2.7 percent annual revenue growth and an increasing share reported declines **(Figure 11)**.

Figure 11

Even Larger Remodeling Contractors Have Felt the Spending Slowdown

Median annual revenue growth (Percent)



Note: Includes remodeling firms reporting revenue in any two consecutive years.
Source: JCHS tabulations of *Qualified Remodeler* magazine's Top 500 Remodelers List.

Some types of larger firms, however, performed much better than others in 2007. Thanks to extreme weather events, insurance restoration contractors saw strong revenue gains. More specialized firms, such as exterior replacement contractors and kitchen and bath firms, also posted above-average growth that year. Design/build and full-service remodelers, in contrast, reported scant revenue gains.

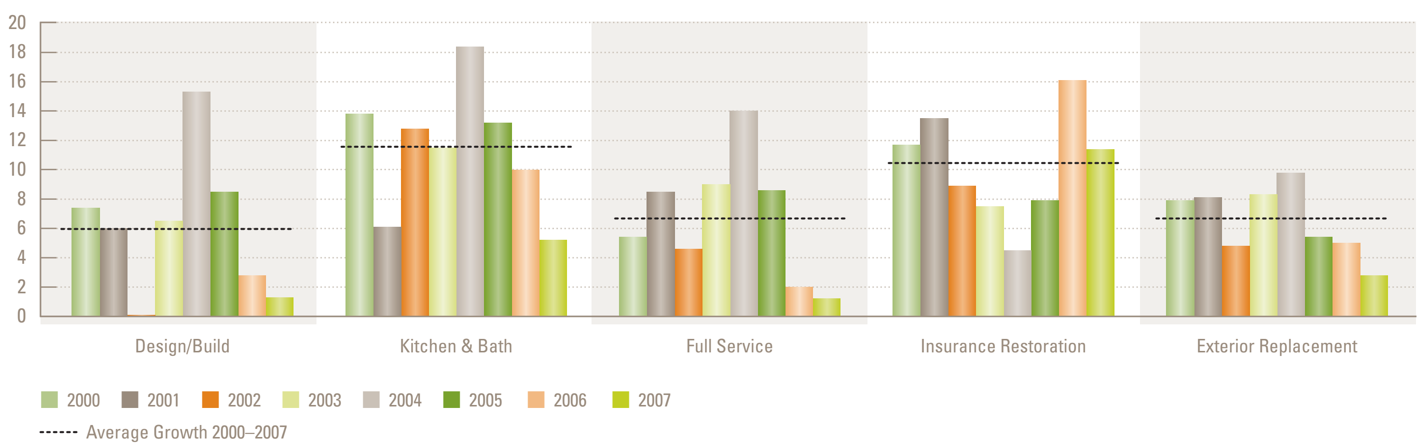
The weakness in 2007 revenues apparently reflects a decrease in the size rather than in the number of remodeling projects. Fully 50 percent of design/build firms reported a decline in average job size that year, as did 47 percent of full-service firms. Meanwhile, less than one third of exterior replacement firms and kitchen and bath specialists indicated that their average job sizes had decreased.

Volatile performance is nothing new for the remodeling industry. So far this decade, larger contractors have seen tremendous disparities both in average annual revenue growth across specialties and in year-to-year variations within specialties. For example, with strong demand for kitchen and bath remodels between 2000 and 2007, the few larger firms specializing in these projects averaged 11.4 percent annual revenue growth, outpacing gains in every other specialty **(Figure 12)**. Insurance restoration firms were not far behind with average annual growth of 10.2 percent. Meanwhile, the other three types of remodeling specialists—design/build, full-service, and exterior replacement firms—saw more modest growth in the 6.0–6.7 percent range.

Figure 12

While Kitchen and Bath Firms Have Had the Most Revenue Growth, Replacement Firms Have Had the Most Stability

Median annual revenue growth (Percent)

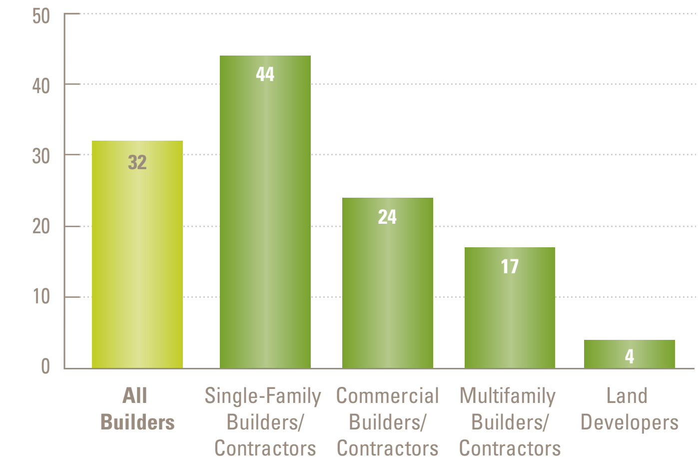


Notes: Includes remodeling firms reporting revenue in any two consecutive years. Remodeling firm categories are shown in order of highest-to-lowest standard deviation (SD), i.e., how much annual growth differs from average growth over the period. Design/build firms had an SD twice that of exterior replacement firms.
Source: JCHS tabulations of *Qualified Remodeler* magazine's Top 500 Remodelers List.

Figure 13

Many Residential Builders Have Entered the Remodeling Market

Share of NAHB builders reporting residential remodeling as a secondary activity (Percent)



Source: National Association of Home Builders, Member Census, October 2008.

But even more important to longer-term viability is the year-to-year volatility of revenue growth. Sharp swings—and particularly declines—typically create challenges for contracting businesses. Slow, steady revenue growth, in contrast, allows firms to gradually adjust their procedures and maintain control of their operations. Between 2000 and 2007, design/build firms reported the greatest volatility in revenue growth, followed by kitchen and bath, full-service, and insurance restoration firms. Meanwhile, exterior replacement firms reported the most stable annual revenues over the period.

The variation in year-to-year revenues appears to be related to the typical job size in a particular specialty. In 2007, design/build firms reported a median job size of more than $90,000. Job sizes in the other specialties were a fraction of that number, averaging $38,000 for full-service firms, $13,000 for insurance restoration firms, $12,000 for kitchen and bath firms, and $9,000 for exterior replacement firms.

Increasing Competition

With the residential construction market near record lows, home builders are expanding into other activities to help ride out the recession. A member census conducted by the National Association of Home Builders (NAHB) in October 2008 found that 45 percent of builders had diversified into other construction and non-construction projects since the beginning of 2007. Another 20 percent planned to diversify in 2009.

With low barriers to entry, remodeling is a market that home builders can easily pursue. In fact, some portion of residential contractors has traditionally worked on home building when that market is strong and then shifted to remodeling when home building is weak. Given the severity of the current housing market cycle, many builders seem to be following this strategy. Indeed, the NAHB census found that 32 percent identified remodeling as a secondary activity—a significantly higher share than for any other option **(Figure 13)**.

Among single-family home builders (including custom builders, general contractors, and speculative and tract builders), fully 44 percent listed remodeling as a secondary activity—far ahead of the 24 percent who selected land development, the next-most commonly cited secondary activity for this group. Almost a quarter of commercial builders and contractors also identified residential remodeling as a secondary activity.

While residential remodelers may also diversify into other areas of construction, their options are more limited. Commercial remodeling was the most commonly mentioned secondary activity, an attractive market given the strength of the non-residential construction sector in recent years. Other common secondary activities reported by residential remodelers were single-family custom building, single-family general contracting, subcontracting/specialty trade contracting, and architecture, planning, designing, or engineering.

With increased competition from both inside and outside the remodeling industry, many contractors emphasize project pricing (rather than their credentials, customer satisfaction record, or breadth of services) as their principal advantage. A late 2008 poll conducted by Angie's List, an online contractor referral service, found that 76 percent of contractors said that, in this slowdown, they would consider dropping their prices to get a project. Of these, 70 percent were willing to cut prices up to 10 percent; 25 percent were willing to cut prices 10–20 percent; and 5 percent were willing to offer even steeper discounts.

Rising Contractor Failure Rates

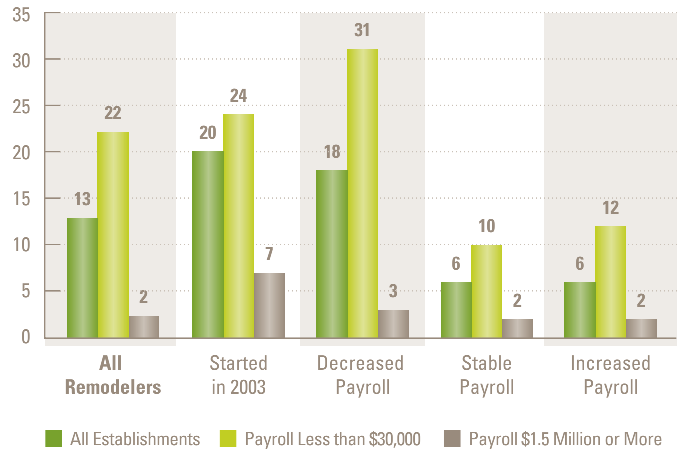
As primarily small businesses with limited capitalization and little formal business background, remodeling firms typically have high failure rates even when business conditions are favorable. Indeed, Joint Center analysis of US Census Bureau estimates indicates that failure rates reached 12.9 percent during the middle of the strong remodeling upturn in 2004. While high for most types of residential contracting firms (ranging from 8.1 percent for plumbing and HVAC subcontractors to 12.6 percent for painting subcontractors), failure rates for general remodeling contractors topped the list for the industry.

Furthermore, smaller general remodeling contractors are much more likely to fail than their larger counterparts. Firms

Figure 14

Startups and Firms with Declining Payrolls Are at High Risk of Failure

Establishments no longer operating in 2004 as a share of all general remodelers in 2003 (Percent)



Note: Failures are defined as firms that did not report employment or revenue to government agencies in 2004. Stable payroll is defined as growth of 0–4.9% in 2002–2003; increased payroll is defined as growth of 5.0% or more in 2002–2003.

Source: US Census Bureau, Business Information Tracking Series.

with payrolls of less than $30,000 that year (with estimated gross revenues of less than $100,000) had failure rates exceeding 22 percent—about twice as high as the rate for all contractors **(Figure 14)**. Meanwhile, those with payrolls of more than $1.5 million (with estimated gross revenues of $5 million or more) had failure rates of only 2.4 percent.

In addition to size, business experience greatly influeces a firm's chances of survival. Fully 20 percent of contractors that started up in 2003 failed in 2004. Firms that reported any decline in payroll, however, had failure rates almost as high (18 percent). By comparison, failure rates for firms that had either stable or increasing payrolls in 2003 were much lower, averaging just 6 percent.

The combination of firm size and recent financial performance has even more impact on a firm's survival. For example, among the 20 percent of firms that started up in 2003 and failed in 2004, the failure rate for small companies was more than three times higher than that for larger ones. Similarly, among the 18 percent of firms with declining payrolls in 2002–2003, the 2004 failure rate was 31 percent for small firms compared with only 3 percent for larger firms.

Now faced with economic recession and increased competition, even large contracting firms are likely to fail. In 2007, 47 percent of remodeling contractors that had revenues of $1–5 million reported revenue declines, up from 31 percent in 2003. Meanwhile, 33 percent of firms with revenues above $5 million also posted declines in 2007, up from 23 percent in 2003. Even conservatively applying the 2004 failure rate, business failures in 2007 would have increased 21 percent among firms with revenues in the $1–5 million range and 12 percent among firms with revenues of more than $5 million. While current information is not available, actual business failures are likely much higher, especially among smaller contractors.

Emerging Markets

Smaller firms do, however, have some competitive advantages. In addition to lower overhead, they tend to be more entrepreneurial than larger firms and therefore quicker to adapt to emerging opportunities and to adopt new technologies. The sustainable or green remodeling market provides a case in point.

Rising home energy costs and growing environmental concerns have boosted demand for green remodeling projects in an otherwise soft market. Some contractors have responded by enrolling in certification programs, learning about environmentally friendly products, and targeting their marketing to develop niche practices. Having a "green" reputation is a competitive strength in that these contractors can assure customers that they will use appropriate products and installation procedures to ensure favorable results.

Smaller contractors have made greater inroads into this emerging market than their larger counterparts. According to a recent national survey of remodeling contractors by the Joint Center, smaller firms have been better able to identify a client base that is enthusiastic about environmentally friendly products such as high-efficiency toilets, renewable-species flooring, and low-VOC paints and finishes **(Figure 15)**. While larger contractors may eventually close this gap, smaller firms have so far gained a substantial lead.

The Outlook

The remodeling industry remains extremely fragmented, with few signs of consolidation. How well an industry primarily composed of very small businesses can cope in the current economic environment remains to be seen, but many remodeling firms will no doubt fail.

Nevertheless, being a small business can be both an asset and a liability. Smaller firms generally have a lower cost structure and can often successfully compete on price with larger firms. For their part, larger firms typically have more resources to ride out downturns and a larger customer base to turn to when looking for new work. Regardless, the intense competition for remodeling projects will make it difficult for contracting firms of any size to grow their revenues significantly in the near term.

The recent trend toward specialization is likely to reverse during the current downturn as intensifying competition pushes contractors to pursue a broader range of projects. Just as many home builders are now focused on remodeling, remodelers will also attempt to extend their reach beyond their traditional specializations.

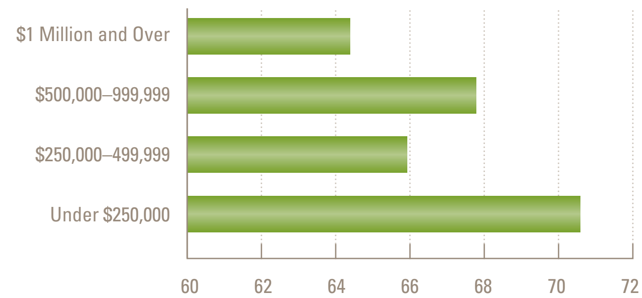
Once the economy begins to recover, however, the incentives for industry consolidation and specialization will revive. Given that remodeling is a profession with low costs of entry, competition is a constant. Consolidation is a way to achieve a scale of operations that generates the greatest efficiencies in terms of marketing, scheduling, and project management. Over the coming decade, a new business model is likely to emerge that enables remodeling companies to serve multiple markets by establishing systems and operating procedures that can successfully be replicated in several locations.

At the same time, though, firms can remain small and profitable. Specialization will continue to grow in popularity because it is a strategy that allows contractors to gain business efficiencies without having to achieve economies of scale. Indeed, specialized contractors can compete effectively with larger diversified businesses in terms of service, staff training and certification, product purchasing power, and reputation—all by focusing on a key market niche.

Figure 15

Clients of Smaller Firms Generally Look More Favorably on Environmentally Friendly Products

Share of remodeling contractors reporting increased consumer interest in environmentally friendly products by contractor revenue (Percent)



Notes: Environmentally friendly products were identified by the Partnership for Advancing Technology in Housing (PATH). See JCHS Working Paper W09-1 for more details.

Source: JCHS 2008 national green remodeling survey, administered by Specpan.