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# An Exploratory Study of Problems Facing Small and Medium Sized Contractors in the Free State Province of South Africa

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## 1. Introduction

The construction industry has unique characteristics that sharply distinguish it from other sectors of the economy. It is fragmented, very sensitive to the economic cycles and political environment, and has a significantly high rate of business failure (Enshassi, Al-Hallaq and Mohamed, 2006). The South African construction industry is an industry that is increasingly becoming more complex in terms of growth which is caused by the amount of investments made by the public and the private sectors in constructions projects. The industry's fortunes tend to fluctuate with the general economy, and it has a cyclical nature and quick response to the changes in the economy (Enshassi, Al-Hallaq and Mohamed, 2006).

Ogunlana. (1996) stated that the industry's problems in developing economies can be categorized into three areas: (1) problems of shortages or inadequacies in industry infrastructure, (2) problems caused by clients and consultants, and (3) problems caused by contractor's incompetence/inadequacies. Ogunlana and Olomolaiye (1989) indicated that the major problems faced by contractors in developing countries have been classified as problems imposed by the industry's infrastructure, problems of inaccurate information and frequent changes in instructions and failure to meet obligations on the part of clients and consultants, and problems imposed by their own shortcomings. In 2004 minister Stella Sigcau was quoted saying:

*“Liquidation is one indicator of poor sustainability and the failure rate is unacceptably high. It is evident from the findings on industry performance, which follow, that the high rate of failure reflects demand volatility and high levels of competition. Industry respondents confirmed that there has been a long-term decline in profitability in the industry and many companies confirm profit levels as low as two percent. Many of the enterprise failures are taking place in the emerging sector, which is of particular concern, reflecting low entry levels, the awarding of contracts at unprofitable levels, poor and inconsistent procurement practices, abuse of subcontractors by main contractors, and an oversupply of micro and small businesses.”*

Any person who goes into business, their ultimate goal is to get maximum profit and it is no different to the contractors, which means them cutting their profit margins is making them run their business in difficult situations and having to cut costs in almost everything they

do, and sometimes compromising quality of work (Kashiwagi and Johnson, 2003). Complexity, risks involved in the construction industry have led to enormous failures especially in small contractors and those small emerging contractors harboring the wrong impression that there is quick money to be made are the mostly affected (Mvubu and Thwala, 2007). The aim of this paper is to investigate the causes of Small and Medium sized Construction Contractors to fail.

## 2. Problem statement

The problem statement to be addressed is the high failure rate among small and medium sized construction companies in South Africa. Statistics South Africa (2005) states that from 1995 to 2005, about 5907 construction companies were formally liquidated. The CIDB (2004) also highlighted that more than 1,400 construction companies were liquidated over the past three years. The Free State Province was used as a case study, were the majority of the companies in the Free State Province are companies that are not older than 10 years. This means that there is not much of experience involved within the company, therefore the management or the executive team (which includes the Owner, the CEO, Contracts Director, Financial Manager, Project Manager and the Construction Manager) is often faced with difficult situations which need great experience to tackle them. However the companies that are also young in their existence but with relevant experienced team members from either working at other companies for a long period of time or having a tertiary qualification or a combination of both can be an exception. Therefore can it be said that causes such as managerial, financial, expansion, and environmental are the ones that cause companies to fail?

**Objectives:** The objective of this research will be highlighted as follows:

- To investigate the problems facing small and medium sized contractors in the Free State Province that leads to the high failure rate.
- To investigate strategies employed by small and medium sized contractors in countering the challenges they are facing.

## 3. Research methodology

The study was conducted with companies that are situated in Welkom, Virginia, Kroonstad, Odendaalsrus, Allanridge, Theunissen, Winburg, Ventersburg and Hennenman which are towns that are all in the Free State Province. Each town had a maximum of four companies except Welkom and Kroonstad as they are bigger towns with more companies. The author worked as the fieldworker by undertaking visitations to these companies was over a period of approximately four weeks were the questionnaires were distributed and verbal conversations took place, and the primary focus was on their management styles in the company and interactions with everyone involved in the company.

The study also focused on qualitative data analysis where data was collected by talking to the managers and asking the experiences of running a company as well as the hidden challenges they face on a daily basis. Reviewing past studies on causes of company failures topics around the world and related literatures as well as gathering information through journal articles, internet, and construction magazines was used to gather literature on the

topic. Data analysis and identification of the most relevant factors influencing causes of contractor failures were the primary and secondary sources. The author then wrote a report that combined the relevant theory and previous research with the results of the practical research done.

#### **4. Significance of the study**

The significance of this study is to bring the difficulties faced by the small and medium contractors in the Free State Province to the attention of the development boards and government, that they are an important factor within the South African economy. Government then needs to adopt strategies to develop the small and medium sector because of the high failure rate amongst them. This will help the sector to grow so that it can be economically viable by contributing and strengthening the region's economy as a whole.

#### **5. Limitations**

The paper concentrated mainly on small and medium sized contractors in the Northern Free State region. The study did not look at the whole Free State Province. Being an outsider was also limiting to what was revealed, especially during observations.

#### **6. Literature review**

Small and Medium construction companies play an important role in the South African economy. For example at the end of June 2007, the total number of employees in the construction industry was 543 686 and large enterprises employed 35.6% (193 786) of the workers in the construction industry, followed by the micro enterprises employing 30.8% (167 620) and an increase of 24% in the last quarter of 2007 (StatsSA, 2007). In addition to earlier statements, recent studies have found out that despite their significance, small and medium contractors are faced with the threat of failure with statistics indicating that three out of five fail within the first few years (Thwala and Phaladi, 2009). According to Thwala and Phaladi (2009) lack of effective management during their early stages is a major cause of business failure for small and medium sized contractors and some key features of small-scale contractors are that they are largely unregistered, operate in informal sector of the economy and have very little formal business systems. Thwala and Phaladi also stated that these challenges include, amongst others, the lack of resources for training contractors, such as funds, poor construction procurement systems and lack of management capacity and resources to equip managers to operate their business enterprises effectively and efficiently. In addition, the relative lack of success facing emerging contractors in South Africa was discussed by (Rwelamila, 2002; Miles, 1980; Croswell and McCutchen, 2001; Mphahlele, 2001 and Ofori, 1991); International Labour Organization -ILO- (1987); as follows: Inadequate finance and inability to get credit from suppliers; Inability to employ competent workers; Poor pricing, tendering, and contract documentation skills; Poor mentoring; and fronting for established contractors; Lack of entrepreneurial skills; Lack of proper training; Lack of resources for either large or complex construction work; Lack of technical, financial, contractual, and managerial skills; and late payment for work done (Thwala and Phaladi, 2009).

## 7. Managerial factors

Experience in any kind of management is very important and it plays a crucial role in ensuring that a business succeeds or fails. Poor management has been posited as one of the main causes of failure of small enterprises (Longenecker, *et al.*, 2006) Lack of experience in the constructions industry can lead the manager to make bad business decisions. Good management implies an awareness of all factors making up a successful business namely good strategy, marketing, pricing and financial control (Douglas, 1985). Financial mismanagement and management incompetence have been cited among the attributes that lead to the prominence of construction failures (Kangari, 1988), (Henry, 1991), (Schleifer, 1990), (Potgieter and Frank, 1990).

## 8. Financial factors

The high competition among emerging contractors has contributed to increase financial failures of the emerging market, making the market unsustainable (Mvubu and Thwala, 2007). Financial Management is the key, which determines business growth (Young and Hall, 1991). The most prominent causes of failure with construction companies' results from inadequate cash resources and failure to convince creditors of the availability of money (Hsing-Hui, 1989), (Ren, 1992), (Jach, 1985) and (Tong, 1990). Jach (1985) concurs with this view that even profitable firms could be forced into liquidation, because the demand for payment or settlement of outstanding accounts could not be met at the critical time despite the fact that the assets are tied in long-term investments. Furthermore, capital is often required to smoothen out the strains on the cash flow resulting from the occurrence of cost and uncertainty (Ren, 992). Lack of access to finance both during pre-construction which disqualifies emerging contractors from meeting guarantee and performance bond requirements and during construction which leads to cash-flow problems, incomplete work and even liquidation are financial constraints facing emerging contractors able (Mvubu and Thwala, 2007).

## 9. Expansion factors

There are small and medium contractors who get to win more tenders than others, which means that the number of project they do increases but they cannot always manage because of the required production capacity. Over-expansion can drive a company to a higher-risk investment with financial debt; hence, increasing its chance to business failure (Enshassi, Al-Hallaq and Mohamed, 2006). A change in the type of work and where that work is going to be done also contributes to the expansion factor, when a contractor goes to do work outside his normal territory it might bring some difficulties as he will have to adapt to the new geographical location.

## 10. Economical factors

Rwelamila and Lobelo (1996) states that these factors are perceived to be beyond the control of management. Ntuli and Allopi (2009) states that while economic factors are worth nothing, however, they may be perceived as being external to a firm's operations, failure by firms to recognize that their efforts may lead to the termination of a firm's operations. It has been asserted that the construction industry has distinct characteristics that render it much

more susceptible to failure than others (Ren, 1992; Jack, 1985); Kangari, 1988; Davis, 1991). These are:

- Trading within a high uncertain environment e.g. uncertain ground conditions, unpredictable weather and labour availability.
- The necessity to price a product before it is produced.
- Competitive tendering as a means of pricing.
- The low fixed capital requirements for entry into market results in market being over capacitated.

There are many other exogenous factors like high interest rates, stringent rules, and regulations etc., which are set by the government which have been identified as prominent causes of business failure (Hall and Young, 1991). These factors are not under industry control and hence completely outwit the sphere of small and medium companies influence.

## 11. Findings and discussions

The findings provided were in respect of primary objective of the study which was to investigate the causes of failure among small and medium construction companies in the Free State Province and some of the possible factors were mentioned in the literature review in chapter two. As the problem statement brought it to light that there is a high failure rate of small and medium construction companies in the industry, the analysis will therefore provide evidence that there is indeed a high company failure rate and in the Free State Province in this regard and the possible causes.

Based on the first objective of the study *“to investigate the factors that cause failure amongst small medium contractors in the Free State Province”* financial factors were found to be amongst the leading causes of company failures, whereby 24% of the respondents in the questionnaire said that lack of finance was one of the main causes and 20% of the respondents said financial mismanagement. The response from the questionnaire also showed that the companies did not have adequate cost and accounting practices and systems in place which also affected the estimating and procurement systems to be done properly and efficiently. The long periods it took the clients to pay the contractors were detrimental because it also affected the whole companies' cash flow to be in a negative state. The researcher also established from talking to the different managers that the usage of company finance for personal usage was also common amongst small companies because these companies are not always audited and it was easier for them to use and therefore the companies suffered in that regard.

It is of vital importance that any company, whether small or large that it has got proper cost and accounting systems in place because it is were the companies' finances are directed. 56% of the respondents said that their companies did not have adequate cost and accounting systems in place while the other 44% said that their companies did have adequate cost and accounting systems in place.

It is anticipated that the higher the level of small and medium contractors' education the more skills they will have in managerial positions. Notably the small and medium contractors mostly hold a matric certificates and a post matric diplomas or certificates. These comprise more than half of the population sample with matric qualifiers making up 35% of

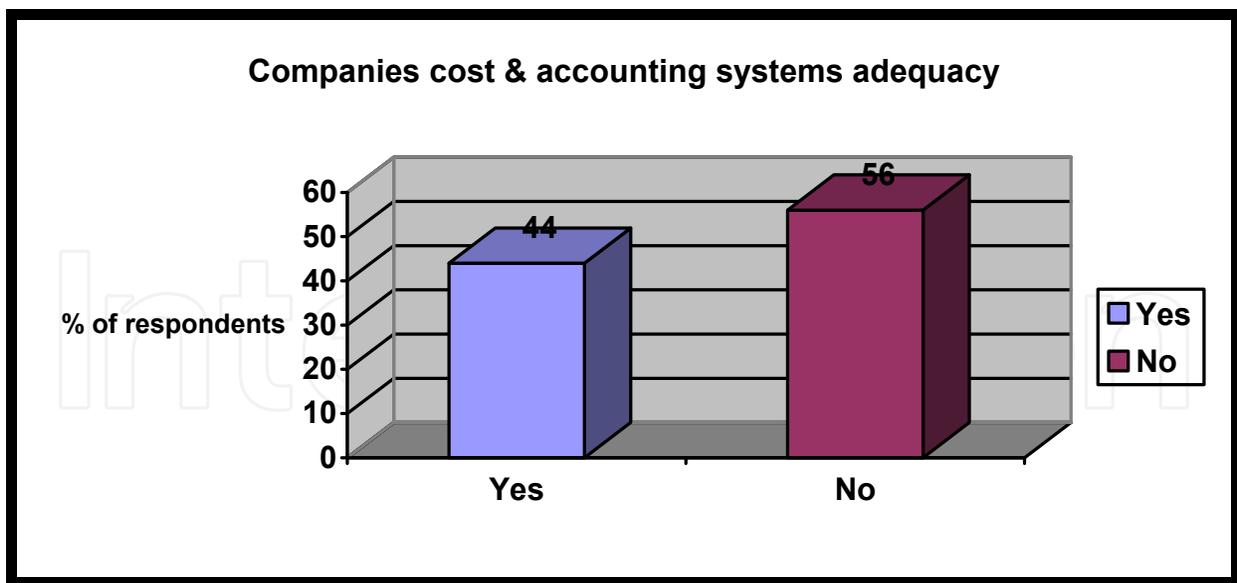


Fig. 1. The cost and accounting systems adequacy in the companies

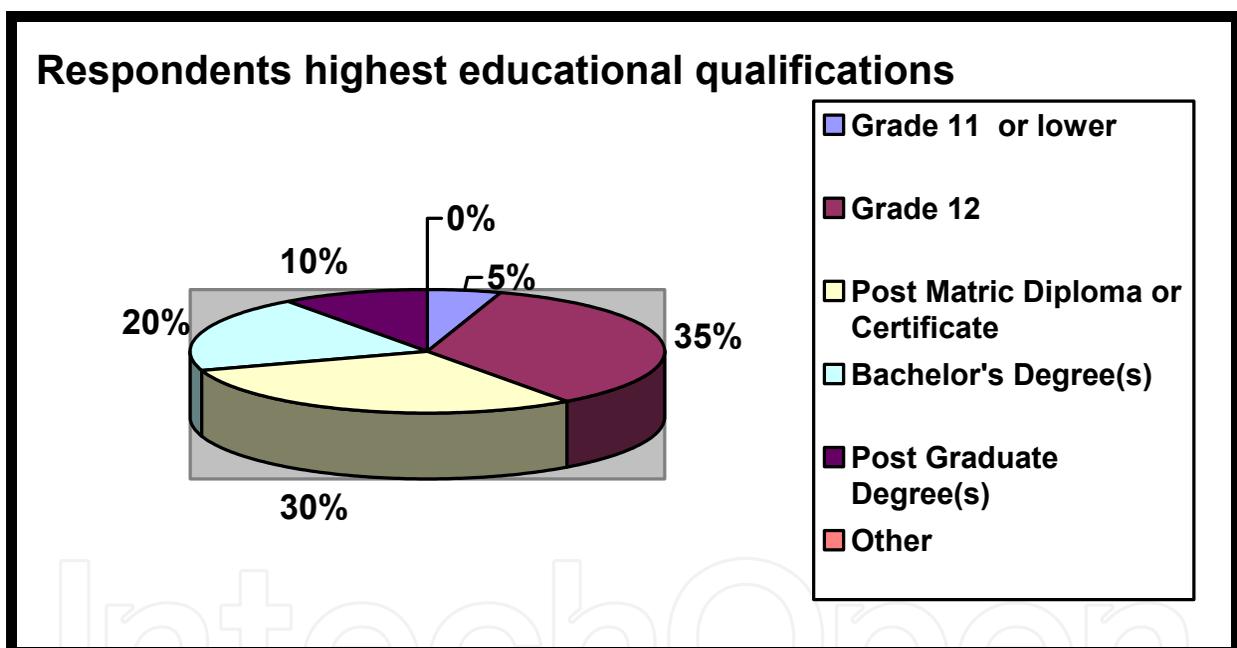


Fig. 2. The respondents' highest educational qualification

the companies. It was followed by post matric diploma or certificate at 30%. 20% is of those who hold a bachelors degree, while 10% have post bachelor's degrees. Evidently this is a group of educated people hence the assumption is that they are aware of methods of running a company in relation with experience. It is expected that the small and medium contractors should have qualifications in construction in order to run their businesses. Only 5% of the respondents have a qualification of grade11 or lower.

In every industry it is important to have experience in order for the role to be performed to excellence. The majority of the respondents are people who have a lot of experience in the industry which they acquired from working for other companies and then decided to go and establish their own companies. 40% of the respondents had experience of between

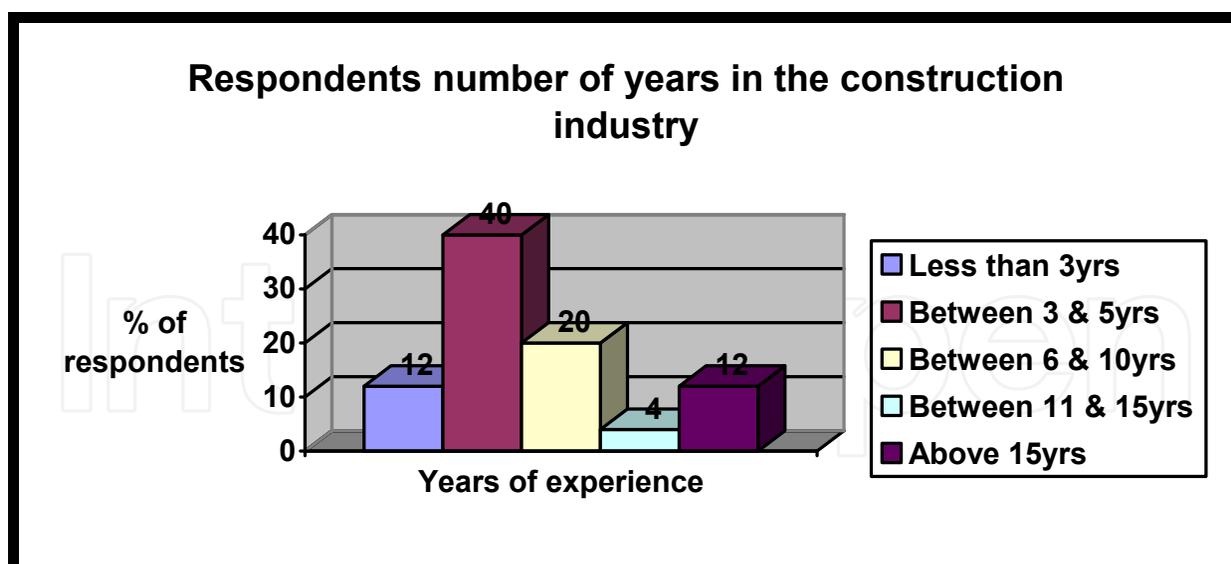


Fig. 3. The respondents number of years within the construction industry

3years & 5years, followed by 6years & 10years at 20%. 12% of the respondents had less than 3years in the industry while 12% had been in the industry for more than 15years.

In the open ended questions there were common responses which were mentioned by a majority of the respondents the arithmetic mean was used to find the appropriate weighting, and they were as follows:

Cause	Weight per %	Rank
<i>Not enough work</i>	32%	1
<i>Lack of finance</i>	24%	2
<i>Managerial skills &amp; financial mismanagement</i>	20%	3
<i>Lack of experience in the industry</i>	16%	4
<i>Lack of skilled people</i>	8%	5

Table 1. The main causes of small contractors to fail

When asked about the challenges they encountered in the open ended questions, most respondents reported that *not getting work* was the greatest contributor to causes of contractors to fail, and 32% of the respondents correlated in that statement, 24% of the respondents said that *lack of finances*, 20% said *managerial skills and financial management* whereby the owners of the companies would use substantial amounts for personal usage. 16% of the respondents said *lack of experience* in the industry, and 8% said that *lack of skilled people* contributed to the main causes of small contractors to fail.

In the *likert scale* of 1 - 5 the researcher developed an index Challenge & Problem Index (CPI) to analyze the responses in a statistical method in question 17, it is explained as follows:

$$CPI = \frac{(1\alpha_1) + (2\alpha_2) + (3\alpha_3) + (4\alpha_4) + (5\alpha_5)}{\sum \alpha}$$

(1) = To no extent, (2) = To small extent, (3) = Moderate, (4) = To large extent, (5) = To very large extent.

$\alpha$  = Number of responses

$\Sigma_{\alpha}$  = Total responses per variable

	Weight	Rank
Finance	4.38	1
Lack of skilled people	4.29	4
Lack of marketing	4.19	3
Lack of cash flow	3.62	4
Lack of business management	3.52	5
Lack of estimating	3.38	6
Tendering	3.24	7
Lack of delegation	3.10	8
Lack of communication	2.86	9
Lack of project administration	2.71	10
Lack of project planning	2.57	11
Lack of implementation of Health and safety issues	2.24	12
Contract documentation	1.90	13
Lack of inventory management	1.71	14

Table 2. The Challenge & Problem Index (CPI)

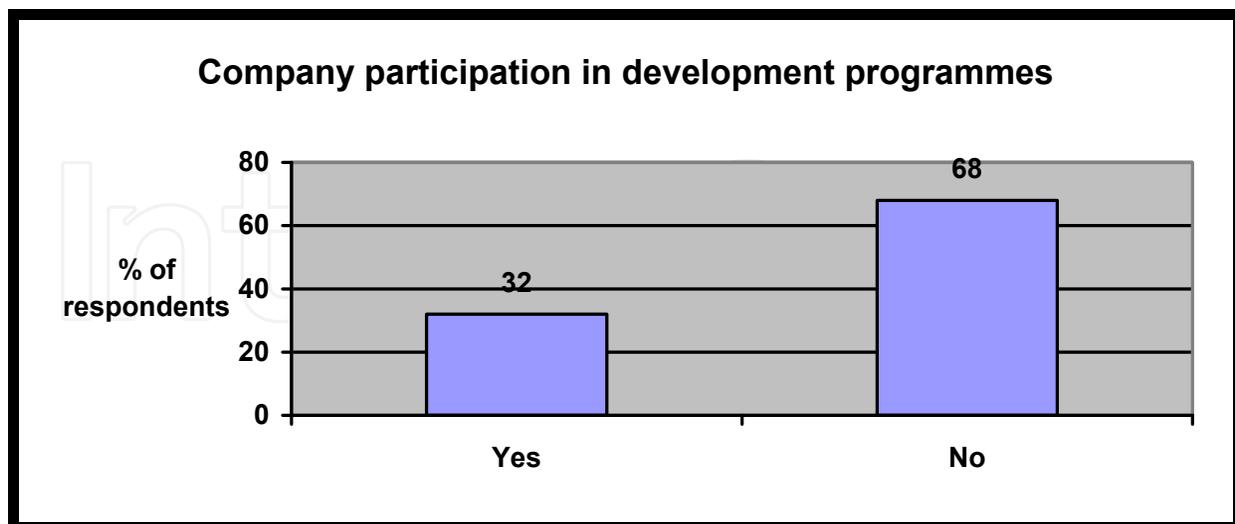


Fig. 4. The companies that participated in development programmes

The second objective "to investigate what strategies are employed by small and medium contractors in countering the challenges that they face" it was found in the open-ended questions in the questionnaire, that the challenges that were encountered can be overcome by participating

in development programmes and courses that will enhance their skills as well as expediting payments from clients.

Contractors in the Northern Free State region mentioned that they were not exposed to development programmes like in other provinces and that is why 68% of them said they did not participate in any development programmes and 32% did participate.

The responses below were the common solutions which were described by the respondents and they thought should be implemented.

Challenges and Problems	Weight per %	Rank
<i>By participating in development programmes &amp; courses</i>	48%	1
<i>By expediting payments from clients</i>	32%	2
<i>By marketing the company and tender for private jobs and not only government jobs</i>	16%	3
<i>By negotiating better project prices &amp; plant hire prices</i>	4%	4

Table 3. How the challenges and problems can be overcome

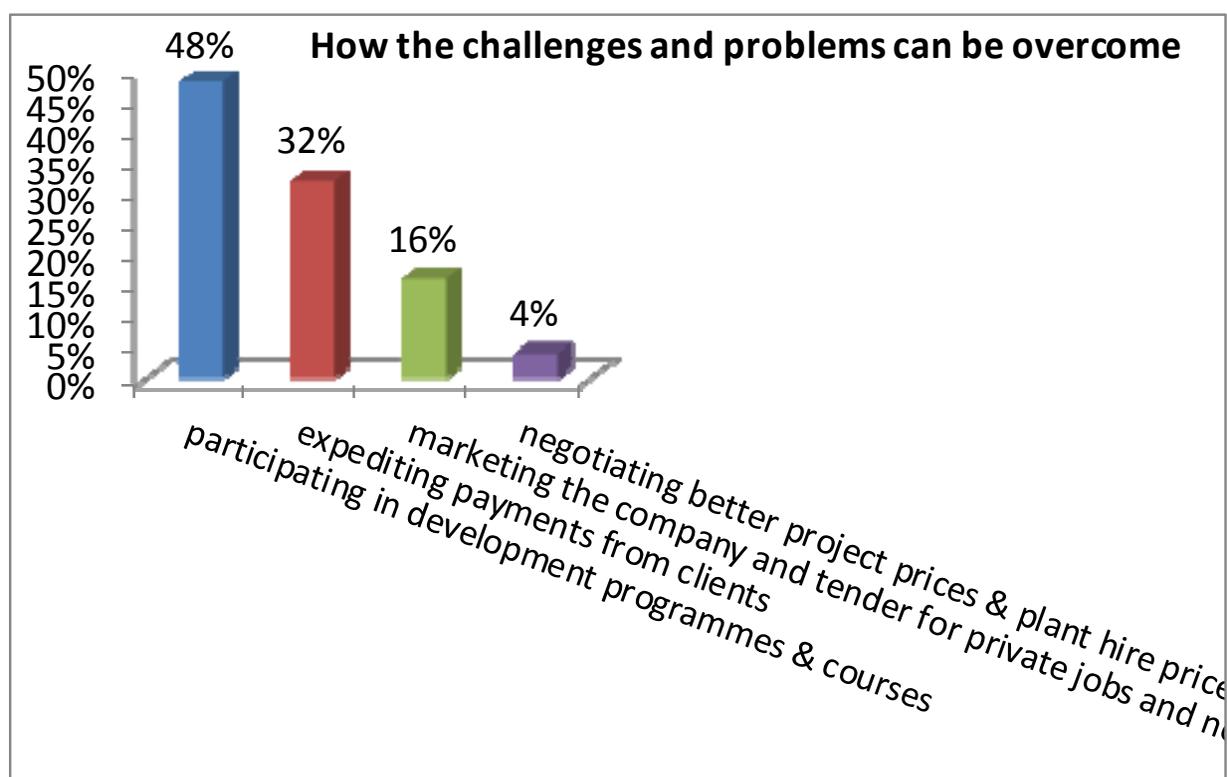


Fig. 5. How challenges and problems can be overcome

48% of the respondents said that the challenges and problems they experienced could be overcome by participating in *development programmes and courses* that will enhance their skills. 32% of the respondents said that *expediting payments from clients* will also tackle their challenges and problems, as long periods waiting for payments are a big problem for small and medium contractors. 16% of the respondents believed that *marketing their companies more*

and tendering in the private sector too will help as they only tendered for government jobs. 4% of the respondents said *negotiating for better project prices and plant hire prices* will help overcome the challenges they faced.

## 12. Recommendations

It is recommended that the following interventions are made:

1. Training and development of small and medium contractors in the Northern Free State ranks as the most important intervention at this stage by the Free State government in particular. The procedure must ensure that these contractors as well as emerging contractors will benefit from these development programmes.
2. The companies must market themselves more and must not only depend on government jobs but must also tender in the private sector.
3. Strict rules and regulations must be put in place for the clients who do not pay the companies in time.
4. The registration of small contractors by the Construction Industry Development Board (CIDB) needs to be attached to the contractors' performance and the skills that are improved.
5. There must be a body that governs and regulates the construction industry for people who want to enter as construction business by screening them and identifying the possible risks to prevent possibilities of business failure.

## 13. Conclusion

The conclusion drawn by the researcher based on the problem statement is that the majority of small and medium construction companies in the Free State Province lack the managerial skills as well as the financial, environmental and expansion factors. These factors have an effect in the failure of a company and they can be improved and changes can be made in some areas.

Indeed it was established that a form of training like the Construction Education and Training Authority (CETA) is offered by the government, but the majority of small and medium contractors in the Free State Province are not exposed to these skills development trainings.

The findings have also revealed that the small and medium contractors in the Northern Free State do not get work regularly and that also contributes to the appropriate function of the companies, however the jobs that they do get are just to keep them surviving till the next job comes along. This means that the current state of many of these companies are not healthy because for a construction company to make a profit they need to participate meaningfully in the available construction job market.

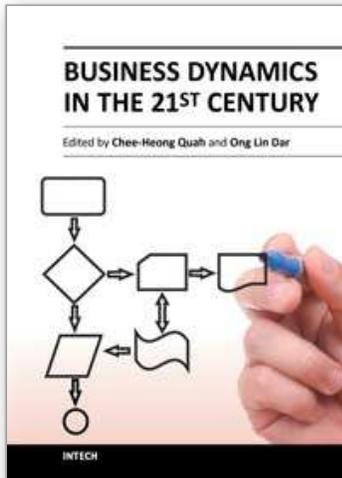
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In this 21st century of opportunity and turbulence, business firms need to equip themselves with new competencies that were never thought of before. For this reason, this book is timely as it introduces new insights into new problems in the aspects of performance and quality improvement, networking and logistics in the interconnected world, as well as developments in monetary and financial environment surrounding private enterprises today. Readers shall find that reading this book is an enlightening and pleasant experience, as the discussions are delivered in a clear, straightforward, and "no-frills" manner - suitable to academics and practitioners. If desired, the book can serve as an additional piece of reference for teaching and research in business and economics.

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