

Third Quarter, 2003

## Contractor Investments...Do's and Don'ts

More and more often contractors are offering investment dollars to their clients to obtain a longer term contract. While some of their offers make perfect sense, too often they are designed specifically to protect a very profitable deal and lengthen the contract term beyond what is usual and reasonable.

We've recently seen some unbelievable deals out there. Some clients are signing ten to twenty year deals to make the contractor investment numbers "work". In effect the institution is mortgaging their future program quality to obtain an investment that may have a useful life of 5 - 7 years maximum. What will happen 5 years down the road when additional renovations are needed? Your program will suffer, or you'll have to come up with the renovation funds.

### \$ Do's \$

- Critically review the contractor's motivation for making the investment. There is no free lunch.
- Always ask your contractor to propose the annual budget with and without the investment.
- Run the numbers, what is the "real" cost of the investment in higher prices over the contract term.
- Always answer the following questions when considering investments. What is the contractor's cost of capital? If your institution has ready access to capital cheaper, why use the contractor's money?
- Make the contractor start amortizing the investment, when the deal starts. It can sometime take over a year for a contractor to "close the books" and finalized the investment. This means that your "5 year" amortization can legally take 6 years or longer to be written off.

### Don'ts

- Never allow a contractor to amortize an investment longer than the useful life of the asset purchased.
- Most renovations have a realistic useful life of 5 years or less. Never allow for a longer amortization, unless the contractor is funding a building for you.
- Don't allow your contractor to use an investment as a hook that prevents you from changing contractors. Contract companies are merging and changing ownership often in today's environment. The people that you made the deal with today, may not be there tomorrow.
- Accept any terms that make you pay back interest or any other penalty, should you terminate the agreement prior to the investment being fully amortized.

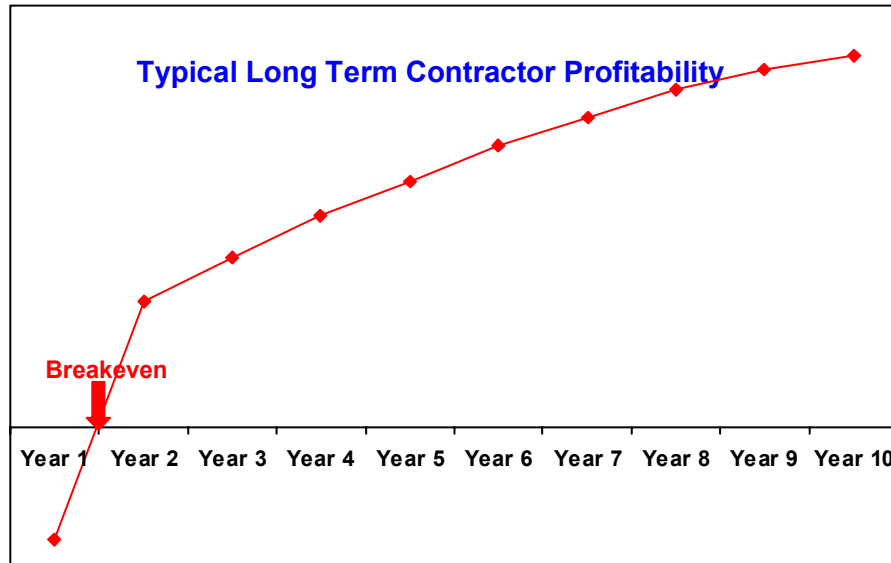
#### Recent Client

#### Quote:

***"SSG saved us \$1,000,000 by re-negotiating a new five year contract with our existing contractor, without going through a RFP process..."***  
**- Business Manager**

## Why will a contractor do almost anything to get a longer term contract?

The reason is simple. The graph below shows the typical profitability curve for a long term contract management agreement.



Contractors almost always lose money in the first year of the contract. Their profit margins increase rapidly over the first several contract years. Due to their focus on operating efficiencies, their margins will continue to increase year after year.

Allowing a contractor to use investment dollars to "hook" you with an agreement longer than 5 years will always cost you money in the long term.

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