2007 Surety Market

Construction expansion has been strong and is now moving into its third year. Can contractors maintain the pace? Is the surety industry prepared to continue supporting this expansion?

Looking back to August 2006, nonresidential construction spending was up 17.1 percent, according to the U.S. Census. Four months later, nonresidential construction spending rose 12.7 percent, and by May 2007, it increased 15.4 percent. In July 2007, nonresidential construction spending was still up 13.9 percent.

Surety industry executives have a unique vantage point, and from where they sit, no slowdown is in sight.

CONSTRUCTION ECONOMY

The lodging, office, commercial, health care, education, public safety, transportation, communication, power, and conservation and development sectors all enjoyed double-digit gains in July 2007 compared to the previous year, according to the U.S. Census.

"It is difficult to find a segment of the nonresidential construction industry that is not experiencing growth in both public and private sectors. We see this trend continuing at least for the next 24 to 30 months," says Terry Lukow, executive vice president of Travelers Bond, Construction Services. "The only hesitation is that a major event would not structurally change the economic environment that we're in now."

Doug Hinkle, chief underwriting officer of CNA Surety, concurs. "Over the past two years, we have seen extraordinary construction activity across the country with contractors running at capacity or near capacity," he says. "Fortunately, because of favorable supply and demand relationships, the increased construction activity is often coming with increased profit margins, which makes it easier for sureties to respond favorably to growth in a contractor's bond program."

Some industry executives believe the strong construction economy may last even longer. "With exception to the slumping residential market, we see the construction boom continuing well into 2009," says Michael J. Cusack, senior vice president, managing director and operations board member of Aon Construction Services Group.

With the exception of the upper Midwest—particularly Michigan, which is affected by the struggling auto industry—the strong growth across most regions may reflect the considerable need for public infrastructure projects and for community schools, hospitals and other facilities.

And, given the tragic Interstate 35 bridge collapse in Minneapolis, the focus on infrastructure inadequacies may direct attention to long overdue improvements.

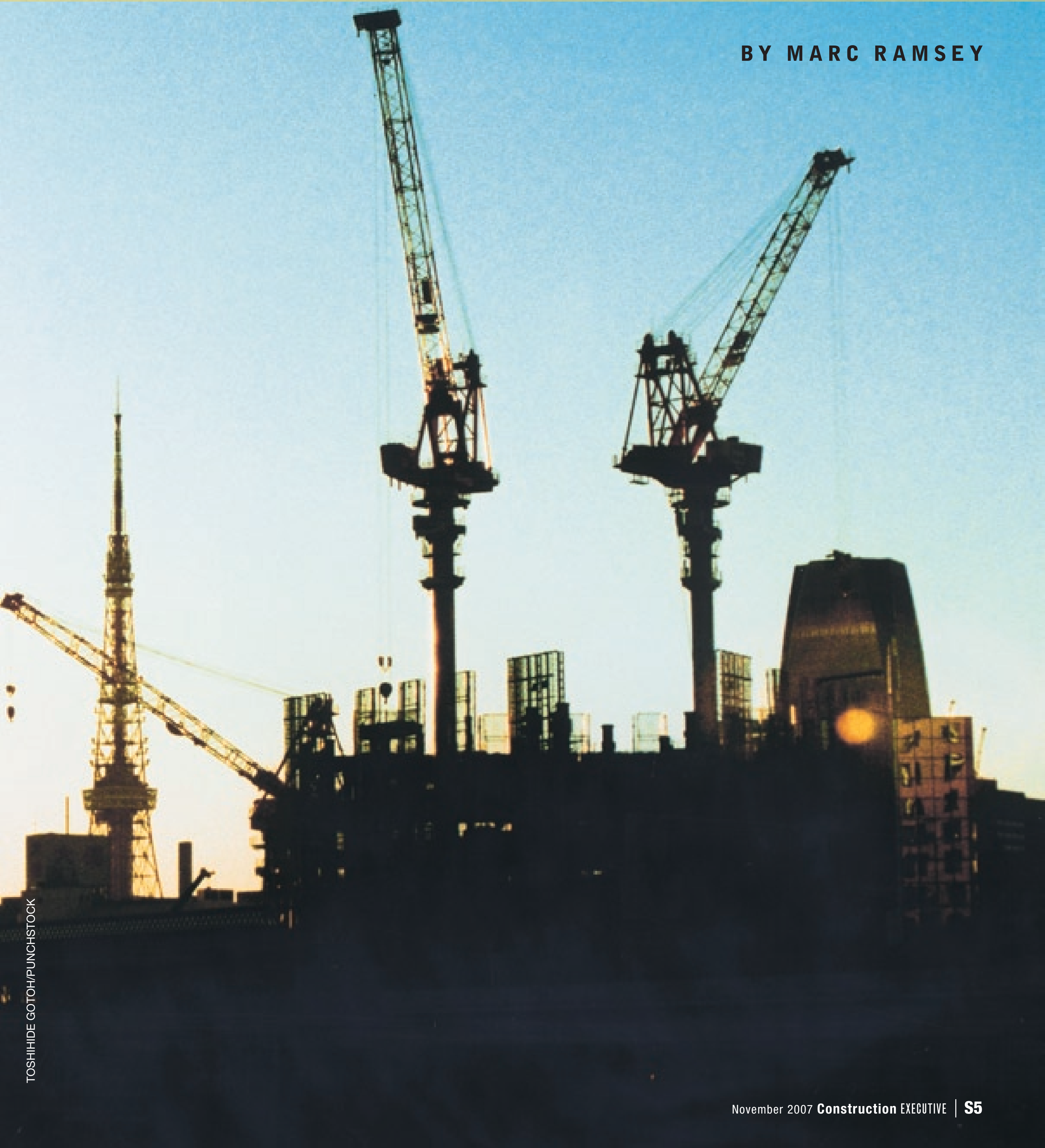
The entire country has more work in the pipeline. Contractors in the Pacific Northwest, for example, are reporting at least a full year of available work, which is stretching the capacity of the construction industry. With all of the opportunities, contractors must choose projects that maximize their return on investment of funds and personnel. Communication with surety executives is especially important to ensure everyone is on the same page with the business plan and future work opportunities.

Successful contractors regularly discuss a clearly defined business plan with their surety and measure all deviations from this plan. They know their costs and, given the strength of financial controls in place, are capable of compiling accurate financial projections. Their actual results also consistently track favorably to the communicated projections.

"The recurring theme here is that the most successful contractors surround themselves with professionals who are capable of supporting the information needs of their planning process and also provide the necessary guidance to accurately quantify risk and the exposures inherent in the construction business," says William A. Marino, chairman and CEO of Allied North America. "The contractors who are most successful with their surety partners are the ones who leave nothing to chance."

OVERVIEW

BY MARC RAMSEY



TOSHIHIDE GOTOH/PUNCHSTOCK

Contractors are becoming better businesspeople, surety executives observe. Systems have improved immensely, and contractors are more educated in the entire process than ever before. "Contractors have just become better managers with their businesses and their money," notes Rick Kinnaird, chair of the board of The Surety & Fidelity Association of America (SFAA), and senior executive, surety, of Westfield Group.

A contractor's bank relationship is also important. "Banks are already tightening consumer loan terms and conditions, and changes to small contractors won't be too far into the future," says Michael F. Greer, vice president, surety and fidelity, of Penn National Insurance Co.

"Contractors really need to make sure their bank relationships are sound. People forget what happened back in the 1980s when bank credit was scarce. If a bank pulls or changes the terms of a bank line of credit and the contractor is extended on its biggest job ever, there could be dire consequences. Contractors who tightly manage their cash flow and collect their receivables will be much better off if credit conditions continue to deteriorate."

CAPACITY AND AVAILABILITY

The No. 1 issue that has emerged from the continued robust construction economy is the lack of human resources. Before extending surety capacity, sureties must be certain a contractor employs enough quality people to carry out its business plan. "Construction companies are developing more programs," says Thomas Kunkel, president and CEO of Travelers Bond. "They're doing everything they can to add value to keep better employees in place."

Work programs are another issue. Sureties may challenge acceptable levels if too much work develops too quickly. Sureties are looking for respectable profit margins from their contractors with full work programs. "Project selection is paramount in this scenario where there is strong construction funding and numerous projects coming out for bid," Kinnaird of SFAA explains.

The size of single projects today also presents challenges. "It is staggering," says William Cheatham, president of Zurich North America Surety. "We are seeing bigger and bigger projects, and the biggest concern is surety capacity. There doesn't appear to be the capital influx necessary to expand capacity for high limits of surety credit. Occasionally, capacity has been managed to date by owners requiring bonds at less than 100 percent of contract price."

Small Market (Under $10 Million)

Surety executives emphasize that while fewer sureties may be willing to write small market contractors, plenty of competitors have the capacity to support bonding needs under $1 million and up to $10 million. Underwriting may be more stringent than for other markets, and indemnity is required in most situations.

"There is adequate capacity for small and emerging contractors in terms of being able to get bonds," says Henry W. Nozko, Jr., president of ACSTAR Insurance Co. "The difference is the terms and conditions are usually less flexible than for the other groups."

While some executives say capacity and availability have not materially changed for this market, others indicate the marketplace is expanding as underwriters move down to the smaller contractor arena, improving availability.

Smaller contractors should demonstrate a certain level of experience and sophistication and have access to capital to improve their ability to obtain surety support. Without reasonable levels of committed capital, sureties tend to be less willing to extend credit based on projected earnings and prospective growth of the balance sheet.

In addition, smaller contractors should look for a surety company that is dedicated to this segment of the market and has the ability to grow with the contractor. "Small contractors that are interested in growing can benefit greatly from choosing a surety that has the experience and capacity to understand their unique needs and can provide dedicated support for their business development at all stages," says Lloyd Geary, vice president of Ohio Casualty Bond, a division of Liberty Mutual Group.

For contractors that may not be able to obtain bonding through traditional means, SFAA's Model Contractor Development Program can help. Many states and project owners have embraced this program to encourage contractor development.

Working closely with a professional surety bond producer and surety underwriter is particularly important to get construction companies off on the right foot. It is a critical time for construction companies to gain knowledge about standard underwriting requirements needed to grow their organizations. With the surety bond producer's and underwriter's strategic partnership, many of these contractors have the potential to become the next generation of movers and shakers in the construction industry. Some sureties are attracted to smaller construction companies precisely for this reason.

Middle Market (Around $50 Million)

The middle market remains the most competitive, and is the level at which most surety companies want to participate. Capacity is readily available to handle qualified contractors with surety needs in this range, surety executives say.

"Many surety companies that kept their market focus in small business now have moved up into the core middle market business," Lukow says. "As competition increases—and there is no question it has in this area—we are seeing deterioration in underwriting standards."

Contractors at this level normally have strong relationships with business partners, including bankers, lawyers, surety bond producers and surety underwriters. They have frequent interaction with surety decision-makers.

At this level, sureties look for greater sophistication in estimating, recordkeeping and quality audited financial reports, strong senior leadership, project and field management, and well-developed business succession plans. Contractors also must have proper debt-to-equity and backlog ratios.

Large Market (Around $100 Million)

The upper end of the middle market and the large market will remain competitive segments of the surety industry.

"Contractors in the $100 million and up segment are growing at a faster rate than those in the small to middle market segments," says Dennis Perler, president of Liberty Mutual Surety. "As they expand, contractors often stair-step their backlogs, outpacing their financial balance sheets and stressing their leverage ratios until job profits are realized. As this occurs, contractors need to consider balancing financial strength improvement with backlog capacity growth. Contractors that can rationally demonstrate their capabilities to assume larger programs to their sureties, however, should find adequate capacity is available

Top 10 Writers of Surety Bonds—2006

Company	Direct Premium Written (Millions $)
Travelers Bond	$941
Zurich Insurance Group	$444
CNA Insurance Group	$418
Safeco Insurance Group	$360
Chubb & Son Inc.	$276
Liberty Mutual Insurance Group	$260
Hartford Fire & Casualty Group	$206
Arch Capital Group	$142
HCC Surety Group	$131
American International Group	$121

*Includes contract and commercial surety

Source: The Surety & Fidelity Association of America, "Top 100 Writers of Surety Bonds—United States & Territories & Canada," 2006 (Preliminary)

to meet their needs and to work through these stretch periods."

The capital structures, reinsurance arrangements and net retention strategies of most underwriting companies dictate a business plan that is focused on developing relationships with construction firms with sales in the $50 million to $150 million range. "Based on the broader competition in this space," Cusack notes, "contractors may see more underwriting flexibility from sureties on issues such as surety rates, work programs, minimum capital thresholds and personal guarantees."

Mega Market (Exceeding $250 Million)

Projects in this market present a wide range of risk from contractual, duration, funding, capital and organizational strain. A loss occurring at this level could be detrimental to many sureties continuing in the surety and construction markets. Understandably, underwriting standards are at the highest level, and financial wherewithal is more of a driving factor in the decision-making process. However, most surety executives are confident the sureties in this market can handle the program needs of contractors that require capacity in this range.

While the competitive pool of sureties willing to take risks gets smaller as project sizes move up the spectrum, little doubt exists that there is more than enough capacity to handle the needs for construction companies with the right balance sheet, strategic business plan and human resources talent.

"Whereas increased contractor financial and management sophistication in communicating information with sureties is important in the $100 million-plus segment, it is even more beneficial for jumbo contractors to proactively engage their surety partners due to the substantial exposures taken on by the sureties," Perler says.

The surety industry has been responsive to providing 100 percent performance and payment bonds for the right project and team of contractors on projects costing near $750 million. "Although no new players or capital has come into the surety industry, existing markets have marginally increased their support for the qualified contractor or consortium under responsible contract terms and conditions," says Terrence Cavanaugh, senior vice president and managing director of Chubb & Son Inc., and chief operating officer of Chubb Surety.

In the current construction environment, mega-contractors are experiencing strong operating results. Consequently, balance sheets are expanding quickly, which allows growing firms to qualify for more surety capacity. "While the surety industry is trying to meet the credit needs of larger contractors, we find that the industry's flexibility is challenged when the bond needs for any one firm spike beyond $3 billion," Cusack says.

The trend toward shorter bid lists and higher margins will continue into 2009. The efficient management of human capital remains critical to maximizing profitability. Tight surety credit conditions may continue, but more efficiently managed contracting firms with sufficient scale will benefit from the confluence of a strong construction economy and disciplined surety underwriting.

SURETY OUTLOOK

The robust construction economy is keeping some contractors' heads above water, but the elasticity of organizational pressure and cash flow buoyancy might be masking problems down the road.

"Adherence to underwriting discipline is what strengthened the positive surety results over the last few years," Cavanaugh says, "and any deviation from that discipline invites a slide back to unfavorable results. The market remains fragile in that one loss, merger, acquisition or scale-back by any player could tighten the market."

Adds Sarah Finn, president of the National Association of Surety Bond Producers, and national surety vice president of IMA of Colorado: "Many sureties, no doubt, appreciate the lessons learned in the early years of this decade when they were suffering significant losses. With competition comes the need to remind ourselves about avoiding the mistakes that produced the last down cycle for sureties."

While the construction economy has been good and has helped mitigate losses, overextension could become a problem if work stays too plentiful. "This is where the surety industry has to keep its discipline and not let contractors take on more work than they can adequately handle," Greer advises. "We are seeing a number of contractors with ample backlogs."

Furthermore, the growth of contractors' backlogs may be outpacing the growth in their balance sheets. "As a result," explains Timothy Mikolajewski, senior vice president of Safeco Surety, "there has been more discussion about ways to enhance the balance sheet with such things as personal indemnity or capital infusions. These discussions are much more typical in today's market."

Fortunately, contractors are carrying record profits along with these record backlogs. "Most contractors have the financial ability to weather some level of financial downturn without the need for their surety to get involved," Mikolajewski says.

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