Insurance II – Surety

# The Importance of Surety in the Current Construction Environment

## What's Inside


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# Surety Market Report 2013

**Although the United States'** unemployment rate and the construction unemployment rate both are down from this time last year, recovery in the construction industry is lagging behind the rest of the country. In April 2013, the U.S. unemployment rate was 7.5% (8.2% in April 2012), but the rate for construction was at 13.2% (14.5% in April 2012).

The housing market is recovering, the job market improving, and the stock market surging, which has increased consumer confidence and spending. Unfortunately, government spending at all levels—which drives business for the construction industry and, in turn, the surety industry—is the weakest area of the economy. With more spending cuts to meet the requirements of sequestration, the lack of government activity will continue to have a negative impact on economic growth for the remainder of the year.

The prolonged economic downturn has given way to an increase in surety claims and losses over the last year. Smaller contractors have been hit the hardest and many more probably will be forced out of business. With claims and losses increasing, Tim Mikolajewski, chair of SFAA's Board of Directors and president of Liberty Mutual Surety, says, "Surety companies' claims departments must be properly staffed to match the demand and must respond responsibly to claims and honor their obligations."

Surety executives generally define the current surety market as "competitive." "The increase in capacity comes at a time when the construction economy is still fairly stagnant, creating a supply/demand imbalance as more sureties compete for a shrinking pie," says Gary Rispoli, vice president and U.S. field operations officer for Chubb Surety.

## SMALL

As one would imagine, this segment has been hit the hardest by the continuing tough economic conditions. Many businesses have had to close their doors because not enough work is available at acceptable margins. For those small contractors still active in the market, competition is high. "When it comes to underwriting terms and conditions, there is perhaps more scrutiny on smaller contractors because of their vulnerability to the continuing depressed construction economy," say Rod Williams, executive vice president and chief underwriting officer at Liberty Mutual Surety. Michael J. Herrod, executive vice president and managing director of surety at Aon Construction Services Group, suggested that owners and contractors do research on their surety in this market. "While some of the national surety companies have specialty units looking for business here, it tends to be more dominated by the lesser recognized surety company names," he says.

Large surety companies, though, have taken an interest in smaller contractors, and executives tend to agree that financially sound contractors will find surety credit. "It is clear that the largest surety providers have begun marketing for the small and medium accounts," says Mike Foster, executive vice president of underwriting at Merchants Bonding Company. "Positive results for those traditionally in the small to medium space have improved their surplus and capacity for larger accounts."

"Most sureties' programs for this market are streamlined to make the underwriting process quick and less paper-intensive," says Lawrence McMahon, president of NASBP and executive vice president and surety manager at Alliant Insurance Services, Inc., of San Diego, Calif.

## MEDIUM

"Probably the most sought market in the industry, capacity is freely available with very competitive rates," says Bob Staples, senior vice president of surety at Allied World U.S. Many contractors in this market have suffered due to declines in work opportunities at the state and local levels. Those who were aggressive with cutting overhead at the beginning of the downturn are faring better, but the market is still very competitive. "The small and middle segments are increasingly competitive due to new entrants in these segments, but this has not resulted in lower prices or deteriorating terms and conditions," says Ross Fisher, vice president and general manager of The Hartford Construction Group & Bond.

Middle market contractors also will find that surety underwriters are on the lookout for any information that may be a "red flag" indicating financial problems or other struggles. "Surety underwriting is taking a very close look at middle market clients to make sure they possess sufficient resources to withstand current conditions," says Mike Bond, head of surety for Zurich North America.

## LARGE

This remains a highly competitive market as well. Businesses with strong balance sheet, however, will be able to obtain surety credit. "This market is credit sensitive, whereby the better credits are getting favorable terms and conditions and adequate capacity, which is often more than a contractor can use these days," says Aon's Herrod.

## MEGA

Globalization of construction has had a major impact on this market segment, which is seeing the most activity. "The need for quality surety has not waned, especially among larger multinational contractors who need significant capacity," says David Hewett, president – surety at the XL Group. "Capacity for mega contractors is covered by the top five or six surety companies in the market," says Liberty's Williams. "This has been a desirable segment of the market in recent years because of the generally high credit quality of larger contractors and the increasing number of very large construction projects," he says. Surety companies do not report frequent or significant losses in this segment, but any change in those circumstances definitely will impact surety capacity. "The mega contractors are clearly the most susceptible to a restriction of capacity in the event of sustained surety losses," says Robert Raney, executive vice president of Travelers Bond & Financial Products.

## CONTRACTOR FAILURES

Reduced government funding of and spending on public projects is one of the main reasons for the lingering depressed market for construction. The private sector is slowly showing signs of improvement. Contractors' profit margins are depressed, with the exception of some large contractors with specialized expertise who have remained profitable. The prolonged economic downturn has led to an increase in losses for 2012, but they were not as high as anticipated. SFAA's year-end results for 2012 show an increased loss ratio at 22%, up 8% from last year, which reflects the reporting of claims from contractor failures stemming from the economic downturn. Most of this is taking place at the subcontractor level and among small- and mid-size firms.

Mike Foster, executive vice president of underwriting at Merchants Bonding Company, says he is seeing an uptick in payment bond claims against solvent principals. "The majority of these are ultimately resolved, but it shows that subcontractors and suppliers want their money faster, and it is flowing more slowly. We continue to see suppliers are quick to file a claim to make sure their rights to file a claim are protected," he says. Aon's Herrod says there has been an increased interest in potential sales of businesses that do not have the financial standing to weather the downturn. "Also, we know our general contractors are seeing strain in their subcontractor base and reporting increased 'noise' in the system—not so much failures as other factors such as slow performance, pay disputes, and safety short cuts," he says.

Surety executives say that they expect more failures as the economy picks up, following historical trends. It is critical for contractors to be positioned financially to handle the demands that come along with more work as the economy improves. "We continue to counsel our clients to price their business in a way that supports their overhead costs, especially as work becomes more plentiful," says The Hartford's Fisher. Only time will tell, though, if contractors will be able to sustain their businesses through the recovery. "In past recessionary cycles, the recovery has been much quicker and steeper than we have seen this time," says Liberty's Williams.

## VALUE AND PROTECTION

Given the volatility of the current market and increased subcontractor failures, surety bonds are necessary now more than ever. Surety bonds assure large contractors and private owners that funds and resources are available to complete projects, even in the event of payment or performance failure from lower-tier contractors on the job. "Surety bonds remain the best non-performance risk management tool and, as a result, a primary way to assure that a project is delivered on time and under budget. Owners and general contractors simply take on excessive risk when surety bonds are not utilized," says Zurich's Bond.

"In recent months, a number of owners and contractors have learned the hard way that neither subcontractor default insurance nor other alternative security measures provide the same degree of protection as 100% performance and payment bonds," says The Hartford's Fisher. The prequalification process performed by a licensed surety company is unmatched, and surety executives say that owners and large contractors put themselves at risk when they try to evaluate contractors' financial standing themselves. "The rigorous and in-depth investigation conducted by the surety of the contractor's overall creditworthiness, financial strength, and past and future ability to perform the project under consideration provide much needed peace of mind and defense against contractor default," says Travelers' Raney. "The bond premium is a small price to pay to have an expert assist owners and contractors with the risk mitigation. It is more cost effective than trying to handle it internally and paying the overhead associated with it," says Merchants' Foster.

Some surety companies report an increase in surety bond usage in the private sector as well, as private owners understand the benefit of a surety bond and more lenders require them. XL's Hewett says that surety bonds are being used more on large international projects. "Multinational contractors are finding opportunities all over the world and knowing the benefits of surety here, continue to look for surety as a means to manage their performance risks," he says.

## SURETY OUTLOOK

Insufficient work in both the private and public sectors continues to keep contractors from operating profitably. Those contractors who are hanging on by a thread probably will be forced to exit the marketplace by the end of the year. Surety executives agree that losses will rise. Some say losses will increase in frequency but not severity, and others say they expect losses to get more severe as well. This will be especially true once the economy begins to improve.

"Losses will be more frequent, but I do not see them being more severe, since the industry has done a better job of sticking with its underwriting discipline through this economy. With that said, I do not see this impacting capacity," says Alliant's McMahon, and most surety executives agree. "We do not expect capacity to be reined in, however, we do expect to see sureties re-underwrite what they have, a process that may prune away those firms that do not meet more robust underwriting standards put in place going forward," says Allied World's Staples.

Those who expect an increase in severity of losses say that smaller, regional surety companies will be affected, but the larger, national companies will not. "Barring a transformative event marked by extreme severity that leads sureties to exit the market, there likely will continue to be adequate capacity for qualified contractors," says Chubb's Rispoli.

"The surety industry's challenge will be sustaining its success gained from the five-year construction expansion from 2003 to 2008, which led to the best run the surety industry has seen," says Liberty's Mikolajewski. "When it comes to loss ratio, the question is, are we going where the math and history would tell us we're headed or will the strict underwriting training and other practices from the last few years keep that from happening?" ■

*Stephanie Robichaux is the communications manager at The Surety & Fidelity Association of America. She may be reached at (202) 778-3629 or srobichaux@surety.org.*


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# Executive Perspectives

***Q.** Has a decrease in public funding for infrastructure projects impacted your contractors and the surety industry? What are you seeing with your contractors' financial statements, and are industry financial results trending negatively, positively, or remaining neutral?*

**Michael Bond**
**Head of Surety**
**Zurich North America**

While much of the popular press headlines talk about the increase in construction spending in 2013, the reality is that the amount of public spending, which has a direct impact on surety bond exposures, has actually decreased 5.4% over the prior year according to the AGC. We are seeing that our customers have been negatively impacted by this decrease as the amount of work simply has not been at the same levels as prior years. Many of our customers have planned for the decrease and are performing well in a difficult environment. The risk to sureties has increased, as some small and middle market customers have failed and are presenting some losses to sureties. Clearly we see some continuing uncertainty ahead in 2013 and 2014, so we suggest customers strengthen their surety relationships to manage through this period in an effective way and be in a position to use their surety credit to the best advantage and acquire desirable work that we think will be available in the near term.

**Rod Williams**
**Executive Vice President and Chief Underwriting Officer**
**Liberty Mutual Surety**

The decrease in public construction funding has had a prolonged negative impact on contractors and the surety industry. As the private construction market dried up almost overnight, many contractors who worked exclusively for private clients were forced into the public market to survive. Simultaneously, with lower tax coffers to fund construction projects, public owners were letting much less work. The result was a heightened competition in public construction with greatly reduced profit margins. Many contractors bid work at or below their cost in hopes of riding out the recession. Those contractors who did not or were not able to adjust their business plan accordingly have struggled or failed. In addition to taking work with lower margins, many contractors increased their risk profile by venturing beyond their historical areas of expertise, either by taking on larger jobs, new types of work, or moving to new geographical areas. With lower margins and diminished financial resources, there is little margin for error.

The surety industry is dependent upon public construction which accounts for approximately 85% of surety bonds. As a result, surety industry revenues have dropped about 9% since the recession began. Industry loss ratios are likely to continue to rise over 2013, especially if economic activity begins to pick up at a more rapid pace. Meanwhile, contractor financial results continue to struggle.

**Ross Fisher**
**Vice President and General Manager**
**The Hartford Construction Group & Bond**

Public construction spending, specifically infrastructure spending, has decreased over the last several quarters. This has certainly impacted our contractor clients who work in this space. As less work has been available, bidding has been highly competitive, which has resulted in a deterioration of margins on this work. As a result, some contractors have seen erosion in their gross margins and overall profitability.

Overall, our contractor clients have managed their businesses through these challenging conditions by adapting to changes and right-sizing their overhead costs to remain profitable. We have also seen submissions from some contractors that have not adapted to changing conditions and have been adversely impacted, which may make it challenging for them to secure surety credit in the coming months. Overall, the contractors who have adapted their business strategies to current market conditions are continuing to operate successfully.

**Matt Lubin**
**Senior Vice President and Chief Underwriting Officer**
**Chubb Surety**

The decrease in public funding for infrastructure, estimated at upwards of 30% since its peak in 2007 according to FMI's Construction Outlook 3rd Quarter 2012 Report, has had a pronounced impact

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on both contractors and the surety market. The surety industry's written premiums are down about 10% over the past five years due primarily to a decrease in bonded work, while the direct loss ratio increased by about eight points in 2012 in large part due to the prolonged down cycle, according to The Surety & Fidelity Association of America. Supply has clearly outpaced demand for contractors in the infrastructure space, resulting in a negative impact on key financial metrics such as revenue, profit, liquidity, and work programs. Contractors lacking a diversification of geography, product, or customers have felt the downturn disproportionately.

However, these trends are not universal. Scale matters. Since the start of the recession, a clear bifurcation in the construction market has developed. While local and regional firms have felt the impact of the recession, larger companies have performed fairly well. Large infrastructure contracts are more frequently let on a best value or design-build basis, which has tended to benefit larger players. Curtailed government spending has pushed necessary infrastructure maintenance and new construction off into the future creating fewer opportunities for smaller firms. Evolving delivery models in the U.S., such as public-private partnerships, will continue to put pressure on the smaller end of the construction spectrum. With infrastructure spending expected to gradually improve over the next few years, we'll need to wait and see if such a recovery will benefit the market as a whole or only a small percentage of players based on the changing dynamics of the construction industry.

**David Hewett**
**President - Surety**
**XL Group**

The decrease in public funding for infrastructure is having a rippling effect in many areas including many contractors' financial statements. That said, however, this is where surety bonds can make the biggest impact and help eliminate potential default risks. Today's contractors continue, with some hesitancy, to look at various alternative project delivery methods. Sureties are looking at innovative ways to use surety to help in these new project delivery approaches. Some are looking at collaborative solutions using elements of contractor and subcontractor risk analysis to address performance risk on private construction projects. For instance, our surety team is looking at how to provide a flexible risk management product that addresses performance risk securitization. In today's construction market, we cannot just deliver the ordinary. We have to build innovative, creative solutions.

**Doug Hinkle**
**Senior Vice President and**
**Chief Underwriting Officer**
**CNA Surety**

While our nation has ongoing need for major infrastructure investment, the lack of public funding due to reduced revenues and budget constraints continue to undermine infrastructure funding. Nationwide public highway funding was down 4.6%, year over year, at year-end 2012, and funding through April of this year reflects a continued decline.

Reduced funding has led to increased competition and shrinking profit margins. Firms reporting operating losses are occurring with increased frequency. While all sizes of contractors have been impacted, the small to mid-sized contractors, who have less staying power, have been under the greatest pressure.

As with every weak economic cycle, some areas of the country are more negatively affected than other areas. While the overall performance trend line for our heavy civil contractors is mixed, most firms have made the necessary adjustments in their overhead and equipment needs and remain operationally sound. Management is clearly being tested during this difficult business cycle.

*Q. How do individual sureties differ from corporate sureties, and what should concern owners or contractors about the use of bonds from individual sureties?*

**Michael Herrod**
**Executive Vice President/**
**Managing Director - Surety**
**Aon Construction Services**
**Group**

It is imperative that owners and contractors have a clear understanding of the financial wherewithal of the surety companies providing performance and payment bonds on their behalf. Corporate surety companies provide bonds for the vast majority of bonded contracts in the United States with annual premiums in excess of $5.1 billion for the FYE 2012. Performance and payment bonds guarantee that the surety company will complete the work or make payments on behalf of the contractor if the contractor defaults. It is important that the issuer of the surety bonds have the required financial assets and claims capabilities to honor their guarantees in the event of a default.

There are regulations and tracking mechanisms in place regarding the financial assets and claims-paying abilities for corporate sureties that do not exist for individual sureties in most cases. Corporate sureties are generally covered by detailed accounting rules associated with risk-based capital to help ensure their ability to pay claims. The claims-paying ability of an individual surety is closely tied to the quality of the underlying assets backing the issuer. The lack of transparency and the potential inability to quantify these assets should raise red flags prior to the acceptance of surety bonds from an individual surety by an owner or contractor.

**Lawrence McMahon**
**Executive Vice President and Surety Manager**
**Alliant Insurances, Inc.**
**NASBP President**

Individual sureties do not receive the same high level of scrutiny as corporate sureties. Under applicable federal regulations, they are vetted solely by contracting officers, who often are overburdened and under-resourced and are not trained to evaluate surety assets pledged by individuals. Federal regulations do not require individual sureties to possess a certificate of authority as an insurer in any state, despite the fact that states require licensing of anyone issuing a surety bond. They are not required to furnish character information, such as information about criminal convictions, tax liens, bankruptcies, or cease and desist orders. If a contracting officer fails to perform the investigation of the individual surety adequately, and the assets backing the individual surety bond prove non-existent, unpaid subcontractors and suppliers have no payment recourse, and contracting agencies have no performance guarantees. The history of federal procurement offers many examples of harmed small businesses which discovered too late that no real assets backed the individual surety bond furnished to the government. That is why NASBP supports H.R. 776. It offers a straightforward solution to this problem. It requires individual sureties to pledge solely those assets that are public debt obligations unconditionally guaranteed by the U.S. Government, such as U.S. Treasury bills and notes. These assets are placed in the physical custody and control of the federal government, which then has the ability to pay valid claims.

***Q.** What are some reasons why owners and contractors should not use letters of credit or subcontractor default insurance?*

**Robert E. Staples**
**Senior Vice President, Surety**
**Allied World U.S.**

- Surety bonds are price competitive with irrevocable letters of credit (ILOCs) issued by banks, and they provide broader coverage to the project owner against contractor default.
- ILOCs typically have sunset provisions (usually one year) whereas surety bonds are in full force and effect for the duration of the project for which they are written.
- When issued, ILOCs are usually a percentage amount of the contract price. Surety bonds on the other hand are most often issued at the full value of the contract price, thereby giving the project owner 100% performance and payment guarantees for the project as defined in the contract terms.
- Typically, banks that issue ILOCs offset the ILOC face amount against the contractor's working capital line, therefore reducing the contractor's borrowing capacity. Conversely, most surety bonds are issued on an unsecured basis and do not impact the contractor's borrowing capacity with its bank.
- Subcontractor default insurance is similar to an ILOC in that it provides the GC with a financial option to offset subcontractor default. However, the GC must then take it upon himself or herself to complete the defaulted portion of the contract. With a surety bond, contractor default risk is transferred to the surety who in turn handles the business side of the default in conjunction with the GC.

**Mike Foster**
**Executive Vice President, Underwriting**
**Merchants Bonding Company**

Letters of credit and other alternatives to surety bonds come with major pitfalls. Owners and contractors can end up spending significant amounts in legal fees making sure the language in a letter of credit does not undermine the irrevocable and liquid nature of the security. They will also spend money performing due diligence on the financial condition of the bank providing the letter of credit. It makes little sense to accept a guarantee from a bank that's vulnerable to default. A surety has minimum criteria for a bank to meet before accepting an irrevocable letter of credit.

If contractors or owners utilize alternatives to surety bonds, they forego the expertise provided by both the surety underwriting team and a competent claim operation. In deciding whether or not to write a letter of credit, the bank simply determines if the contractor can repay any payment by the bank. There is no evaluation of the contractor's ability to perform the work as a surety undertakes. Sureties also provide claims professionals with the expertise to establish which claims are legitimately covered by the bonds. They know how to administer the claims process to make sure that work is completed and bills are paid. They've been through the process of putting completion work out to bid for the benefit of the owner. Without performance bonds in place, all of these functions will need to be handled by the owner. Plus, it's likely that the owner will incur significant additional legal expenses to administer the claim.

An owner contemplating not bonding a project or considering alternatives to surety bonds would be wise to remember the old saying, "You get what you pay for!"

# What "Recovery Risk" Means to Contractors as the Economy Improves

**By Gerald F. Haley**

**Signs of promise for better** times ahead in the construction economy are now appearing in a variety of areas. Fueled by record low interest rates, reports are that residential real estate prices are firming and rising in many parts of the country. Stock market prices, long seen as a predictor of future economic activity, have recently surpassed historic highs. The nation's crumbling infrastructure is creating a number of large bridge and road projects, some of which are far more significant than was imagined even a few years ago.

As a result construction companies all across North America that have faced difficult times since 2008 as a result of the economic crisis are eagerly eyeing new opportunities to replenish their backlogs and refurbish their balance sheets. From 2008 through 2012 new work was difficult to acquire, and many firms accepted razor-thin margins with the idea of managing through the crisis until better opportunities arose. Contractors managed through the crisis by reducing their workforce, cutting overhead, selling equipment, and scaling back their operations in efforts to stay afloat and achieve profitable operating levels.

Construction firms of all sizes report much greater optimism and enthusiasm about these positive signs. Contractors need to conduct a strategic assessment to make sure they are ready for the rebound and in a position to prosper rather than fall victim to recovery risk. To many observers it is counterintuitive, but surety companies have long observed that historically many more contractor customers fail as the economy recovers when compared to other times in the economic cycle. Hence the term "recovery risk."

Why is there an increased risk of failure at this part of the cycle? Intuition would say that more work and expanding opportunities would be good for all, following the old expression "rising tides raise all ships." The harsh reality is that many construction firms have less financial strength coming out of the recent five-year down construction economy.

As a major surety we have the opportunity to study the financial statements of a large number of privately and publicly held construction companies. What we see at this time is that many firms have financial statements that are less vibrant than five years ago. This makes sense when you think of the work that was accepted and performed at margins significantly less than traditional profit margins. These projects and the low profit margins have worked through to the balance sheet. Also many firms that seldom used their bank lines have needed that liquidity to stay afloat. All in all many construction companies realistically have less financial cushion now than five or six years ago.

Make no mistake about it, an improving construction economy is a very good thing. Since construction is a high-risk business, well-managed firms must recognize that this time in the cycle creates an even greater risk. A strategic self-assessment is required to reduce the recovery risk and includes the following areas:

## 1. Management

Does the construction firm have the capacity to handle the new projects that will arise and all that comes with it? Most firms greatly reduced staff in recent years, and with it went some capacity to direct and manage projects. In other words, even well-managed firms eliminated some of their capabilities so now they must recognize exactly what they can effectively handle. Management failures remain a leading cause of contractor failure, so contractors need to be honest to determine if they have the management capabilities to successfully manage a growth mode. Select only projects that fit within proven management and staffing capacity.

## 2. Subcontractor Risk

Does the work an organization is contemplating require the use of subcontractors? Many subcontractors, even those with historically strong reputations, have been financially battered by the construction recession, so the risk of subcontractor default can prove to be the downfall of an otherwise viable contractor who hires the subcontractor. Make your subcontractor selection based on more than a subcontractor's past reputation. Conduct the necessary due diligence to make certain subcontractor partners can deliver so that your project is delivered on time and on budget.

## 3. Territory

Is the work that is available in the recovery actually within a geographic area that fits a firm's capabilities? Sureties continue to find that some contractors have failed because they took work in another geographic territory, sometimes only 150 miles away, but the business norms, owners, contract terms, and suppliers are significantly different. Those differences are often large enough to cause a contractor to default.

## 4. Surety Credit

If a construction company has downsized by a significant percentage, as many firms have, does that firm have the surety bonding capacity for new work based on current financial statements? Many firms think of themselves as the size they were and having the financial strength they had a few years ago, but today their actual financial strength is very different. It is always a good idea to maintain a strong, transparent relationship with your surety and the surety agent. As the economy recovers, effective surety relationships can mean the difference between success and failure. ■

*Jerry Haley is senior vice president for Zurich Surety and can be reached at Gerald.haley@zurichna.com and www.zurichna.com/surety*

# Balance Sheets in Stress

**By Fran McGrath and Joe Ruch**

**Prolonged economic challenges** in the construction industry continue to wreak havoc on once strong contractor balance sheets. Over the last four years, balance sheet stress has been driven by reduced construction spending, fewer projects, and depressed profit margins to cover overhead. This scenario has many contractors reevaluating their strategy and/or considering exiting the market altogether. Balance sheet stress has also created difficulty for sureties that rely on a contractor's financial and operational wherewithal to support work programs with surety credit.

Sureties assess a contractor's financial strength in several different ways with liquidity being a significant element. Liquidity is a measure of how readily available assets can be converted to cash relative to how soon liabilities require payment or satisfaction. The balance sheet provides a measure of long-term viability or solvency by assessing the entity's ability to fund payments on long-term debt, generate cash flow to meet production goals, and provide an adequate return on capital to owners. Typical surety ratio analyses look to working capital and net worth figures in comparison to the work program for a measure of financial strength. Additionally, sureties analyze other ratios, including liquidity and underbillings to working capital and debt and interest-bearing debt to net worth, as well as other financial metrics.

The asset classification labeled "underbillings" is unique to the construction industry. This figure represents the amount of costs and earnings in excess of billings a contractor may or may not be entitled to collect. Even though the line item appears as a current asset, it typically means one of three things in the absence of a contractual change order. First and most importantly, it may represent costs that will not be passed on to the owner and, therefore, represents profit fade or unrecognized losses. If this is the case, it is not an asset, but will eventually fall to the income statement and reduce net income.

Two other common causes for an underbilling may be contract terms that do not allow the contractor to bill for all costs when expended and issues with the contractor not billing in a timely matter. If one of these is the reason for the underbillings, the current asset treatment is proper, but the underbillings may cause cash flow difficulties. If such underbillings exist on multiple projects, they could render the contractor in default on payment obligations. Project cash flow analysis and projections during the estimating process are critical to minimizing underbilling potential. Late stage unberbillings raise concern for a surety as they may indicate potential claim activity or profit fade.

The statement of cash flows provides an excellent vehicle to measure the entity's ability to generate cash from core operations. It further indicates the sources and uses of cash from investing and financing activities. It is imperative that contractors understand and reconcile the relationship between balance sheet entries and the impact on the cash flow statement.

At first glance, a positive figure for the cash flow from operations section would be indicative of success, but additional analysis is needed. For example, an increase in accounts payable would be a source of cash and contribute to generating positive cash flow; however, this may also be an indication of a contractor not paying subcontractors, vendors, and suppliers. This event increases the stress in the balance sheet. Also, an increasing spread between accounts receivable and payable, along with higher accounts receivable and payable turnover ratios, may serve as leading indicators of stress.

Equipment-intensive companies derive benefit from depreciation expense on the cash flow statement due to its "non-cash" impact. However, there is a constant requirement for the company to purchase new equipment, and this is reflected through the line item titled "Capital Expenditures" (CAPEX) located in the investing activities section of the cash flow statement. The stress on the balance sheet of equipment-intensive entities typically develops as a result of poor CAPEX decisions. Fleet utilization data should drive procurement decisions. Balance sheet leverage is added with the decision to purchase with cash or debt.

A significant portion of net worth should be in the form of retained earnings from completed projects. The capital structure of the entity also contains initial capital contributions and paid in capital. Paid in capital amounts provide infusion of cash to increase net worth. However, additional paid in capital amounts may signal balance sheet stress because they are needed to offset losses on projects and excess distributions. A contractor's net worth needs to be liquid to fund operations.

Balance sheet line items typically move in tandem with income statement accounts (i.e. accounts receivable and sales). The movement in sales on a percentage basis should reconcile to a corresponding increase or decrease in receivables, inventory, and underbillings. Financial stress is higher in companies where sales have experienced a decrease, yet we observe increases in the aforementioned accounts.

In the absence of a robust construction economy with high profit margins, contractors should add focus on their ability to be liquid and generate positive cash flow from operations to avoid additional balance sheet stress. ■

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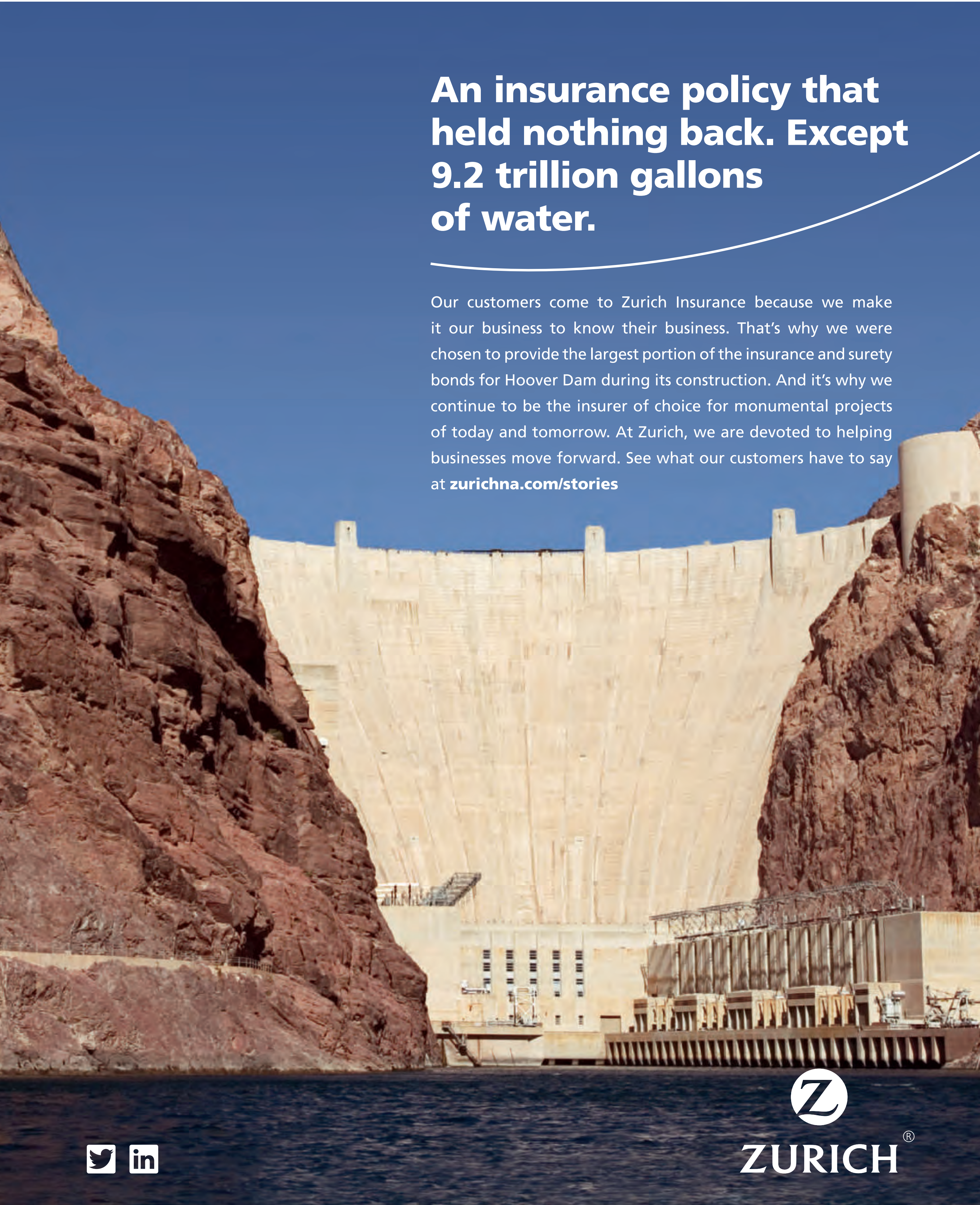
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# More Than a Surety Bond

**By Gary Rispoli**

**The relationship between** a contractor and its surety is more than a few pieces of paper attached to a construction contract. For today's sophisticated contractors and their corporate surety providers, the surety bond guarantee can be just the beginning of a win-win relationship for those contractors that want to take advantage of what their surety has to offer.

Contractors with a strong surety relationship have effectively added a valuable professional resource to their management team, as corporate surety providers can bring a broad base of knowledge to their contractor partnerships.

Major surety providers are continuously underwriting hundreds of contractors and thousands of projects at a time, year after year, through all types of market conditions and challenges. While information on any specific firm must always be kept completely confidential, the wisdom and expertise accumulated by sureties over time is a tremendously powerful resource.

Consulting with a surety provider should never take the place of vital services provided by other professionals such as attorneys, accountants, and surety producers. However, major sureties have a breadth of scope—national and international—and a depth of experience that can often be used to supplement the work of other professionals. It's a risk management tool that a savvy contractor might use again and again.

For instance, corporate sureties spend a good deal of time reviewing construction contracts in the normal course of underwriting. This is an area where sureties may have a wealth of resources, often including in-house counsel with extensive archives that could prove to be a valuable asset for a contractor. Consulting with a surety on potentially onerous contract language such as "actual damages" or "efficiency guarantees" could be very helpful. Since both the contractor and the surety are "on-the-hook" for the performance of the bonded contract, it's in the interest of both parties to get it right from the very beginning.

Another area where consulting with the surety is often beneficial is in the creation and implementation of business plans. This is particularly true when they involve major changes, such as geographic expansion. Entering into a new geographic territory could present some daunting challenges such as working with new owners and subcontractors, unfamiliar terms and conditions, adhering to a new set of laws and building codes, etc. What may be different or even unknown, and therefore represent greater risk for the contractor, may actually be very well known to the corporate surety. Information from a surety can help the contractor develop a plan to mitigate the potential risk of expansion.

Major surety markets also have extensive experience in evaluating cost controls and can be very helpful with subcontractor bonding, selecting joint venture partners and establishing co-surety relationships when appropriate.

Business continuity is another challenge for some contractors, but they can benefit from the wisdom accumulated by corporate sureties. Surety companies have worked with thousands of private contractors, often family businesses, to help facilitate an orderly transfer of ownership from one generation to the next or from one ownership structure to a new model. In many cases, maintaining robust surety credit capacity throughout the transition is absolutely critical for the contractor. Most private construction companies may need to work through an ownership transfer only once or twice in the history of their company. Most major corporate sureties are working with client continuity issues every day. It might be a mistake to fail to tap into their accumulated expertise.

Perhaps the most crucial collaboration between surety and contractor can take place when a contractor runs into serious financial trouble. The difference between survival and termination is often slim, but reaching out to a surety partner in a timely fashion for support may help tip the balance in the contractor's favor. Major surety providers frequently have extensive, in-house expertise in working through potential contractor defaults. They may be able to help identify and engage industry experts to facilitate "work-out" arrangements. Or the surety may be able to help the contractor address temporary cash flow issues by participating in discussions with the contractor's bank to maintain a credit facility. In some cases, they may be able to facilitate additional investors or joint venture partners. The key to success in many of these difficult situations is to fully engage the surety partner as soon as possible...before it's too late.

In a volatile economy, the best contractors use all of their available resources to maintain consistent and profitable results. The right surety will employ a depth of experience and a collaborative approach that can give the contractor a competitive advantage in any environment. By seeking out a surety provider that has a long, stable history in the industry, a contractor can tap into those years of experience and use that expertise to strengthen his or her own business. A surety bond guarantees fulfillment of a contract. A contractor's surety provider, with years of business acumen, can provide much more than just a surety bond. ■

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# A Lesson in ERM: Establishing Subcontract Scope for Major Equipment or System Purchases

**By Martha Gaines and Greg Daily**

**The construction industry** appears to be on a path of recovery and much better positioned for growth than it has been in years. Challenges still exist though. For general contractors planning to take advantage of new business opportunities, keeping those challenges under control—especially the risks that threaten today's narrow profit margins—needs to be an important part of their plan, their Enterprise Risk Management (ERM) plan.

ERM is a broad-based, detailed approach to managing a contractor's risks. This means not only examining the nitty gritty of their own operations, but their subcontractor's practices, scope of work, and who bears what risks in the delivery of a project. A careful analysis of who bears certain major risks—especially as they impact on-time and on-budget performance—is an integral practice in ERM. It allows contractors, along with their insurers and surety providers, to hone in on exposures that can create problems along the way.

One area where general contractors are advised to take extra precautions is the subcontractors' scope of work including determining who pays for needed systems and equipment for a project. With increasing frequency, general contractors are adjusting key subcontract scopes of work to eliminate (or manage) the purchase of systems and/or other high value equipment. The reasons for this trend are complex and varied but include:

- Achieving cost savings by eliminating the subcontractor's mark-up of the system or equipment;
- The desire to have greater control over the purchase of the system or equipment; or
- The reduction in the size of the subcontract to address restraints the subcontractor may have in its bonding capacity.

Whatever the reason, there are issues that both the general contractor and the subcontractor should consider in the structure of the transaction. Transparency is one. Does the supplier have a contract with the general contractor or the subcontractor who will install the system or equipment? For many reasons, when contractors and subcontractors are purchasing a major operating system or equipment necessary to complete the project, they should be clear who enters into the contract with the supplier, and certain terms and conditions should be properly outlined to define who bears key risks.

First, the general contractor and the subcontractor should be clear as to who controls payment to the supplier. The right and obligation of payment to the supplier is pivotal when demanding performance and, in turn, mitigating any potential damages that may arise. Therefore, whoever bears the obligation to pay—GC or sub—is the one who has the power to most persuasively control performance. The contract documents, therefore, need to determine whether the general contractor or the subcontractor has the authority to demand performance from the supplier and declare a default if the supplier fails to perform. Whoever controls payment then is in the best position to bear the risk of performance. That's why before entering into an equipment or system purchase agreement the parties should carefully assess the risks of shifting a supplier's performance risk to a subcontractor who does not control payment.

Both the general contractor and the subcontractor need to clearly understand who bears the risk of timely delivery of the system or the equipment. If a piece of equipment is needed to complete the project and it is not delivered in a timely manner, it can throw off the whole project. So in such a situation, who has the power to demand timely performance and, if necessary, declare a breach of contract if there is a failure? If the general contractor has assumed the obligation to purchase the equipment, then the subcontractor should make certain that he or she is protected by the subcontract from delays associated with late delivery of the system or equipment. Any obligation of the subcontractor to manage, coordinate, or direct the work of the supplier should be carefully tailored in the GC's contract if the subcontractor does not also control payment. As a practical matter, anyone who does not have control over payment cannot effectively control performance and, therefore, should not assume such a risk.

Now consider a design-build project. In this situation, both the GC and subcontractor will want to clearly define who bears the responsibility for the design or specification of the system or equipment and make sure that the supplier has assumed coextensive design liability to protect the firm that bears design responsibility. Both the GC and subcontractor will also want to review and carefully consider who bears the risk if the system or equipment does not perform. Has this risk been properly allocated, or excluded, in the subcontract? Another consideration is to determine who is responsible for obtaining and delivering guarantees and warranties.

Contract documents need to work together in a cohesive fashion. Delegating responsibility for risk to someone who is not able to best manage it from both a coordination and payment perspective carries its own risks. In the event of a project delay or a failure of performance, these contract details become critical to understanding and evaluating the cause and responsibility for project delays. Allocating risk appropriately is an important strategy for keeping a project on track. ■

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# Some of the Risks Involved in Expanding to New Areas

**By Michael Foster**

**The recent economic downturn** has forced many of us to review our goals, business plans, and core company philosophies. At Merchants, our philosophy has always been to stick to what we do best. Have we changed over the years? While I can assure that we are constantly changing, our core commitment to underwriting and service has never wavered. In an ideal world we would hope to see a similar philosophy in our contractor clients. In most cases this is accurate; however, the declining construction market has forced many contractors to seek new revenue streams. One significant change we have seen over the past few years is in the number of contractors who are travelling farther to secure work.

We are not a proponent of contractors travelling outside of their geographical region of expertise to obtain work. However, we understand that contractors are being forced to do this. When one of our customers expresses a desire to work in a new area, we try to get an understanding of why it makes sense for him or her to do this and how he or she plans to manage the work in the new location.

## Managing the Work

Among the important issues to consider are the plans to manage the work. The options are to send existing personnel to manage the project or hire someone who is familiar with the new area. We have seen successes and failures with both approaches. If contractors send existing staff they could be at a disadvantage because they are not familiar with local subcontractors, building inspectors and codes, and local competition. It is challenging to work in a new environment. If the contractor chooses to hire someone who is familiar with the new area, the new hire will not be familiar with how the company operates. It will be important for them to quickly learn procedures for job costing, change order procedures, documentation, and overall company culture to manage the work successfully.

## Subcontractor Selection Process

The subcontractor selection process is key to successful project management. A contractor must carefully evaluate the qualifications of the subcontractors they hire. And there are other considerations, such as how to get favorable quotes from subcontractors who have been working with the local general contractors for many years. Also, if you go to a new area you may need to adjust your subcontractor bonding policy.

## Legal, Insurance, and Regulatory Issues

Contractors travelling outside of their usual work territory are often confronted with new legal, insurance, and regulatory issues. Some of the questions we encourage contractors to ask are:

1. Are there protective policies in place for local contractors?
2. Are there special local or state licensing or insurance requirements?
3. Are there more stringent safety requirements?
4. Are there any local union issues to address?
5. Are there best practices for working with the local inspectors?
6. Are you working for a municipality with funding issues?
7. Are there prompt payment requirements in place?

## Geography

The new geography itself can present challenges to a contractor who has not worked in the area before. For example, an underground contractor will have to be prepared for different soil conditions, rock, and water availability. Travelling long distances might mean different temperatures, shorter days, or more rain. If the area is isolated, it may be difficult to obtain materials and supplies on a timely basis.

## Contractual Issues

Understanding contracts and statutes in the new area is important. There may be different policies for what constitutes a change order and how you can pursue a change order. Permitting issues might delay the ability to start work. Dispute resolution procedures should be clarified. There may be different maintenance or warranty obligations. Contractors need to be aware of excessive liquidated or even consequential damages. Contractors will also need to know if "pay when paid" clauses hold up.

Several of our customers have learned that the grass is not always greener on the other side. But, if a contractor must travel to a new area, we recommend that they start in a conservative fashion with smaller projects until they gain a better understanding of the area. It is usually difficult to beat local contractors on hard bid work. We prefer to see our clients travelling to new areas at the request of a familiar owner. Construction can be a very risky business with an extremely high failure rate. Before taking on additional risk, contractors should consider these issues and consult their team of professional supporters including their attorney, banker, CPA, surety agent, and surety underwriter. ■

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# Government Spending and the Impact on Surety Premiums and Construction

**By Patrick McGrail-Peasly**

**Since the Miller Act** mandates performance bonds on most federal projects, total federal spending on construction projects has a direct impact on surety premiums. The "Little Miller Acts," which apply to state and local spending, has a similar effect. So as budgets are reduced at the federal, state, and municipal levels, it has an impact on contractors' revenue and, in turn, the surety industry.

When the recession was just beginning, it was private sector work that suffered due to reduced demand. Banks were tightening lending standards, reducing the availability of capital. At the same time, public works projects were benefiting from increased stimulus spending. This rise in public work also helped many private contractors, as they could shift their focus to the public sector.

As federal, state, and municipal budgets continue to shrink, government entities are looking for ways to stretch their limited funds. Federal dollars are being targeted for larger, high-profile projects, crowding out smaller but necessary construction and maintenance work.

Small or middle-sized contractors who may not have the resources to qualify for larger projects now have less public construction projects available to them. This exclusion puts these contractors in a difficult position. Reduced revenues and lower profit margins can be especially difficult for bridge, highway, and other infrastructure contractors who often have fixed assets that need to be deployed to cover the maintenance and carrying costs.

Until there is improved funding for public works, construction firms must operate in some very challenging market conditions. Fortunately, a large majority of these contractors has been able to manage their overhead to support these lower revenues. Also, many firms had built up their balance sheets through the boom years, allowing them to take a "wait it out" approach. However, this defensive posture cannot be sustained for too long.

The continuing challenge for contractors and the surety industry is to manage risk as public funding for construction shrinks or stagnates. According to U.S. Census data, the value of public construction put in place peaked in 2009 and has steadily declined

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since, with surety premium following a similar trajectory.

More troubling for the surety industry is that losses on public work have steadily grown year over year since hitting a low in 2006, according to The Surety & Fidelity Association of America. This trend is indicative of the twin problem facing contractors: reduced revenues and lower gross profit margins.

The lack of adequate public funding for construction has led some states and municipalities to look to alternative forms of project finance. Examples of this include GAP financing and Public-Private Partnerships (PPP). Both of these options potentially shift to the contractor financial and other attendant risks that they are not used to encountering on traditional public works contracts. As an example, in the case of GAP financing, the contractor may need to use his or her bank line of credit to finance the project's payment "gap." This can tie up a significant amount of their available credit for years after the completion of the job.

Despite the many challenges, most construction firms have proven to be resilient. They have adapted to the downturn by aggressively cutting costs and streamlining operations. Although government funding has been severely strained, the eventual rebound in business activity will allow slow but steady replenishment of revenues and a refocusing on the many delayed but much needed infrastructure improvements across the country. At that point, contractors who have thoughtfully planned and managed their businesses should be in position to grow profitably. Governments will put more work out to bid, contractors will expand backlogs, and surety premiums will rise accordingly. ■

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# What Can Contractors Do To Promote Construction and Bonds?

**By Robert E. Staples**

**It is in every contractor's** best interest that surety bonds remain a requirement for all public work and, to the extent possible, for private contract work as well. The reasoning is as follows:

- The surety prequalification process removes inadequate contractors from the overall pool of contractors bidding on a project, greatly increasing the chances of a successful project.
- Prequalified contractors raise the bar for project owners to expect properly completed projects within the given time frame and contract price. Surety bonds transfer the risk of contractor default to the surety company, thus eliminating the primary cause for project delay and cost overruns for the project owner.
- Contractors who work in partnership with their sureties typically operate successful business enterprises that are better able to stand the economic business cycles of contracting. For these reasons, all contractors should seek a surety line of credit for their own merit and encourage others to do the same.

So what can contractors do to promote surety bonds? Firstly, stay current with federal and state regulations having to do with the Miller Act. There has been ongoing discussion at the state and federal levels of repealing or amending Miller Act regulations both as a cost saving measure and also to encourage competition on smaller contracts. Eliminating or reducing surety bonds from public work will only increase the potential for inadequate contractors—those not prequalified by sureties—to win work which in turn creates the potential for contractor default with unpaid subcontractors and suppliers. It is also very much in the public interest for the Miller Act to remain a guiding force in the industry, as its existence protects against defaulted/uncompleted projects, thus saving taxpayer money.

Secondly, contractors should encourage bonds be made an integral part of private construction projects. Although surety bonds are mandated by law on public works projects, the use of surety bonds on privately owned construction projects is at the owner's discretion. Owners need to be aware that alternative forms of financial security such as letters of credit and self-insurance do not provide the 100% performance protection and 100% payment protection of surety bonds, nor do they assure a competent contractor. With surety bonds the risks of project completion are shifted from the owner to the surety company. When compared to the project risk assumed by the private owner, should a contractor default without bonds as a part of the contract, the premium cost is small indeed.

Thirdly, contractors should consider requiring their subcontractors to provide surety bonds. While many contractors have successfully completed projects without bonding their subcontractors, even one or two subcontractor defaults within a contractor's uncompleted work program can put extreme pressure on overall profit margins, with the potential to cause prime contractor default. At a minimum, prime contractors should evaluate their subcontractor trades for some of the key risk elements that can impact successful project completion and require bonds for those riskier subcontractors.

A last suggestion is for contractors to work with independent insurance brokers who specialize in surety bonding or have an established subset of individuals within the brokerage who dedicate themselves to surety. Surety broker specialists are the best business sources for contractors looking to obtain bonding with surety companies best geared to that particular contractor's needs and business development. Contractors can start with listings from broker trade organizations, such as the National Association of Surety Bond Producers, The Surety & Fidelity Association of America, or the Surety Information Office.

It's also important to remember that surety bonds are risk transfer mechanisms, where the surety company assures the project owner (or prime contractor in the case of subcontractor bonds) that the contractor will perform a contract in accordance with the contract documents. How one evaluates and manages risk on construction projects and makes fiscally responsible decisions to ensure timely project completion is paramount to successful completion of projects within the time frame established and within budget. To gamble on a contractor whose standing is uncertain or who could become bankrupt halfway through the job can be a costly decision for project owners.

How will public agencies, which use the low-bid system in awarding public works contracts, be able to be sure the lowest bidder is dependable? How can private sector construction project owners manage the risk of contractor failure? How can prime contractors manage subcontractor default risk? Answer: By all parties involved within the contracting process taking steps to mitigate performance and payment risk. Surety bonds are a wise investment—protecting public owners, private owners, lenders, and prime contractors from the potentially devastating expense of contractor and subcontractor failure. And it should not be lost upon contractors that they can often be the best source of educating others as to the value of surety bonds. ■

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## Why a Regulated Market is a Safe Market

**By Robert Duke and Mark McCallum**

**A surety bond is** a three-party agreement by which the surety secures the obligation that is owed by one party (the bond principal) to another party (the obligee). A performance bond secures the obligation for the contractor (bond principal) that is owed to the project owner (obligee) to perform the contract fully. A payment bond secures the contractor's obligation to pay its subcontractors and suppliers. As a form of insurance, a surety bond is a risk transfer mechanism. The project owner faces the risk that the contractor will fail or become insolvent and leave the owner with the financial burden of the excess costs of completion. The surety is the deep pocket that bears this risk. A surety first seeks to avoid a default by providing bonds only to those contractors it has determined, based on a detailed underwriting process, are qualified to perform the work. In the event of a contractor default, a surety steps in to provide financial protection to the project owner. The surety bond is a three-party agreement, and different from traditional two-party insurance policies. The contractor ultimately is responsible to the surety for losses that the surety pays out on its behalf, but the fundamental principal remains—the risk of contractor default is transferred from the project owner to the surety.

Because they engage in the business of insurance, sureties are regulated by state insurance departments and must be licensed in the state where the surety writes bonds. The surety is subject to the regulation of the state insurance department, which includes minimum capital and surplus requirements, financial reporting, and periodic on-site financial exams and market conduct examinations, among many other types of regulation. For example, under Texas law, an insurance company is subject to examination every five years (VTCA Ins. Code § 401.052) and must have a minimum surplus and capital of $2.5 million (VTCA Ins. Code §§861.251 and 822.054). In addition, state regulation requires that the surety's premium rates are reasonable and not excessive.

Reasonable regulation of sureties is an essential safeguard for those who purchase bonds or seek their benefits. It has been long recognized that the business of insurance is tied closely to the public interest that must be protected through regulation. Insurance, and particularly surety, can be quite complex where the value of the product includes "future performance of various contingent obligations." Regulation of insurers, including sureties, ensures the buyer of the product that it is obtaining protection at a reasonable price from a well-capitalized entity capable of paying claims. Requiring that the surety furnishing the bond is licensed by the state insurance department is the primary way to ensure that there is a solvent surety standing behind the bonds.

The licensing requirement and the regulation that goes with that is not restricted to sureties that are corporations. Except in very few instances, an individual who desires to write surety bonds personally would need to seek licensure from the state insurance department. Far too frequently, however, individuals have written bonds without a license. In addition to evading the statutory requirement to have a license, the absence of regulations means that the buyer of bonds is not getting the benefit of regulatory oversight. The buyer cannot be assured that a solvent and well capitalized surety is backing the bonds. The buyer does not have the benefit that the price he or she is being charged is reasonable. The buyer also may not have the option of the regulator intervening in situations of improper conduct by an unregulated surety.

Unlicensed sureties have caused harm and continue to cause harm to those persons and entities that depend on bond protections. For example, an individual surety named Morris Sears, operating under the trade name of ABBA Bonding, was issued a cease and desist by a number of states, including Florida and North Carolina, for writing surety business without a license. According to the North Carolina order dated December 9, 2009, Sears had written over $4 million in bonds in North Carolina. In March 2009, Sears filed for bankruptcy (ultimately a Chapter 7 liquidation). To those accepting Sears' bonds, all outward indications were that Sears and ABBA were well capitalized, as Sears furnished parties with documents indicating substantial assets. In one instance, Sears submitted bonds on a federal project in Colorado that were supported by a sworn affidavit that Sears had a net worth of over $126 million. Not surprisingly, Sears operated in a manner to avoid regulatory oversight, so his financial statements were not thoroughly scrutinized and no regulator would be in position to assess whether the $126 million truly existed and was available to pay claims.

George Douglas Black, Sr., an individual surety doing business as Infinity Surety, was arrested and charged by the U.S. Department of Justice with mail fraud for allegedly selling more than $100 million of worthless construction bonds to 150 different construction companies on local, state, and federal public works projects, while receiving $2.8 million in fees. Among Black's alleged victims were the U.S. Navy, the Beaumont Independent School District of Texas, and the Monroe Airport in Monroe, Louisiana. It is alleged that Black repeatedly pledged the same small piece of real property to insure multi-million dollar private, state, and federal construction contracts.

As reported in the February 25 issue of ENR, an individual surety named Robert Joe Hanson received cease and desist orders from at least 10 states for writing surety bonds without a license. Last year, Montana regulators accused him of selling fraudulent surety bonds to Native American contractors.

Unfortunately, these are not isolated examples, and worthless bonds issued by unlicensed sureties continue to be found in the current construction marketplace. Project owners and contractors should never purchase bonds from unlicensed sureties, or they risk throwing premium dollars away on worthless bonds. Moreover, project owners and contractors may be left without any adequate recourse in such situations.

Reasonable insurance regulations protect buyers of bonds and facilitate a safer and orderly surety market. Buyers must avoid being duped. Project owners and contractors should always do business with licensed sureties and consult with the insurance department in the state of the location of the project to find out if the surety is licensed. By placing quick phone calls to state insurance departments, project owners and contractors can easily determine if bonds are issued by legitimate sureties committed to fulfill their bond obligations. ■

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