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[NOVEMBER 2010]

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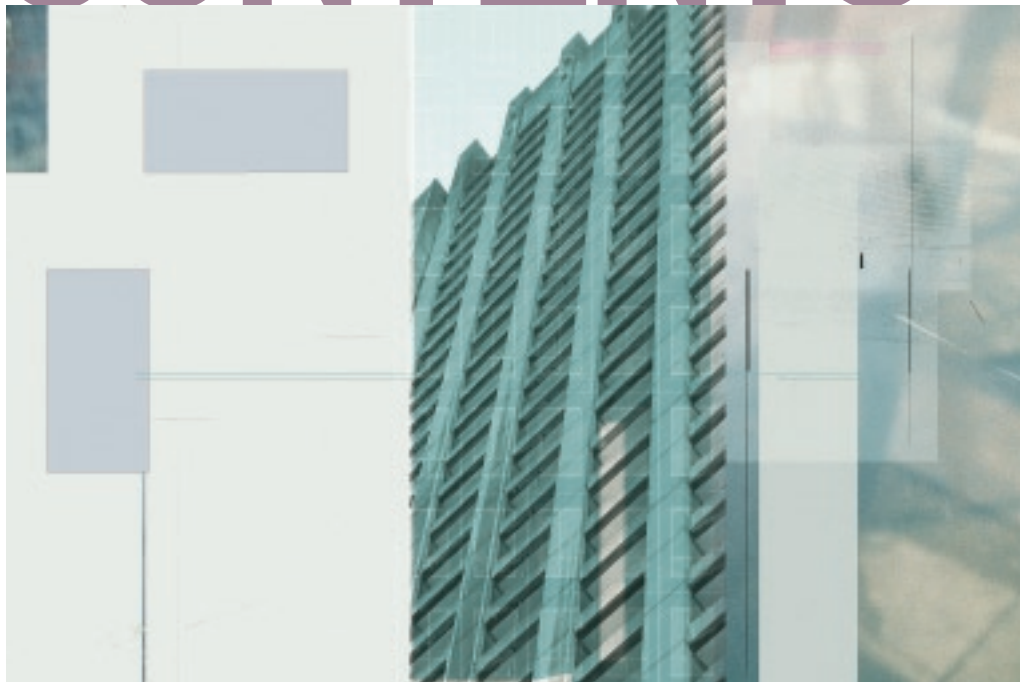
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TABLE OF CONTENTS



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- S4** 2010 Surety Market Report
- S10** Executive Insights
- S18** Managing Surety Credit in a Down Cycle
- S20** P3 Opportunities: New Roles Demand Strong Surety Support
- S22** Secrets to Survival
- S26** Accounting Proposal Alters Contractors' Financial Statements
- S30** Gaining a Competitive Edge through Surety Credit
- S34** Year in Review: Economy and Fiscal Issues Top 2010 Agenda
- S38** Diversity Partnership Moves Ahead
- S44** 2011 Directory of Surety Bond Producers

2010

BY MARC RAMSEY

Today's difficult economic environment has spared few industries or geographic areas. When facing challenges, construction business leaders need to fight the instinct to manage on their own. Instead, they should engage all of their stakeholders on the critical issues facing their business and clearly articulate cogent strategies designed to see them through tough times. Construction firms should tap into the breadth of resources with which they have surrounded themselves, including their surety company and professional surety bond producer.



**Drawing the Line Between
Average and Extraordinary
Construction Firms**

"One of the key ways in which construction executives can manage through the tough times is by increasing communication to all those connected to the construction business," says Tom Kunkel, chairman of the board of The Surety & Fidelity Association of America (SFAA), and president of Travelers Bond & Financial Products.

The economic downturn has affected contractors' balance sheets by increasing the number of slow receivables and the value of some under-billings. Some contractors experienced sizable profit and loss events simply as a result of recording so many severance payments in a compressed period of time. It is important for contractors to make every effort to preserve liquidity. Place a greater emphasis on cash management and collection of receivables, and perform ongoing, real-time assessments of manpower allocation.

"Tough decisions must be made to keep overhead expense aligned with forecasted revenue," says Michael J. Cusack, senior

vice president—managing director/contract surety for Aon Construction Services Group.

At the most basic level, sureties want strong balance sheets and experienced management teams. Beyond these factors, underwriters and bond producers focus on forging lasting relationships with contractors that transcend fluctuating markets and economic cycles. It is more important than ever for contractors to meet regularly with their underwriter and bond producer, review business plans and openly discuss areas of concern.

In today's marketplace, surety bonding is a valuable financial resource. Only well-managed, well-capitalized firms can access significant bonding capacity. The ability to bond work in a tighter credit cycle confirms that a contractor has the financial and personnel resources needed to complete a project successfully. That surety affirmation remains one of the clear lines of demarcation between the weakest and strongest firms in the construction industry.

SURETY MARKET

New construction opportunities vary by type of work, region and private versus public spending trends. Generally, utilization of bonding capacity is down across the board, but small and middle-market contractors are being more adversely affected. Private commercial construction spending is low relative to the past five years, and is expected to remain low for one to two more years. Education spending is slowing as universities experience lower endowments due to volatile investments. Health care spending remains flat and is one of a few positive areas. Construction unemployment is expected to remain extremely high.


Government-bonded construction spending also is low relative to prior years, and is expected to remain low due to high state deficits and reduced tax receipts. As Americans drive less, reduced gas tax revenue will negatively affect road and bridge construction. Most discretionary government construction spending is drying up, with state and local government spending experiencing the largest declines. Federal highway and military spending remains reasonable. Overall, the limited government construction spending is focused on fewer larger projects.

Small and middle-sized contractors are experiencing fewer job bidding opportunities and substantially increased competition on bids. "Contractor backlogs are shrinking, and backlogs are being replaced with less profitable work, possibly outside contractors' comfort zones," says J. Spencer Miller, president of the National Association of Surety Bond Producers (NASBP) and Schwartz Brothers Insurance Agency Inc.

SURETY MARKET REPORT



FUSE/PUNCHSTOCK



Uncertainty regarding the lines of responsibility between design and construction that are not adequately dealt with in the contract can create added risk to both contractor and surety.

—DOUG HINKLE

Larger contractors also are seeing less work, but they require fewer jobs to survive. “Generally, an ongoing shift to larger projects is benefiting the largest contractors—allowing them enough work to support their core operations,” says Rod Williams, executive vice president and chief underwriting officer of Liberty Mutual Surety.

Reduced government revenues often prompt new and innovative ways of stretching limited funding resources, such as gap financing and public-private partnerships. (See related article, p. 20.) The extent of their use, however, depends on the type of project and urgency to build it. Requiring gap financing limits competition, as few contractors have the resources necessary to pursue such projects.

The use of building information modeling (BIM) within alternative project delivery methods has been an effective tool for the construction industry. The more collaboration between the owner, architect and contractor, especially at an early stage of the process, the more likely a project will have a successful outcome. Today, most BIM projects are design-build, where the risk of the architect and engineers are

brought into the bonded obligations.

The use of BIM can bring into question the traditional roles and responsibilities of contractors, owners and design professionals. “Uncertainty regarding the lines of responsibility between design and construction that are not adequately dealt with in the contract can create added risk to both contractor and surety,” says Doug Hinkle, chief underwriting officer of CNA Surety. “To date, however, our experience has been very positive.”

Adds Liberty Mutual’s Williams: “Underwriters want to understand how risk is being managed among a contractor’s building partners. One way the surety bonding risk can be quantified is for a contractor to obtain the engineer sign-offs at all relevant stages of construction. Also, contractors should ensure that the architects control the design software so there is a clear delineation of roles and responsibilities, and that all parties execute within their areas of expertise.”

David Finkelstein, executive vice president of surety for Arch Insurance Group, agrees. “BIM has had, and should continue to have, a positive effect on sureties because the application—when properly employed—

reduces conflicts between the architect, general contractor and subcontractors.”

In all market sizes, capacity and availability remain for qualified accounts. However, some contractors are finding the lack of work has caused their working capital and net worth to drop to levels that make it difficult to secure the desired surety support. “Contractors that have adjusted the scale of their operations to match the marketplace realities generally continue to find acceptable levels of support from their surety,” says David Hewett, executive vice president of Zurich North America Surety, Credit and Political Risk.

Underwriting has stayed consistent, but companies are requiring more in-depth information on a more time-sensitive basis. Working capital bank lenders are being underwritten as well. “Requests for future forecasts are becoming more frequent, particularly as current financial situations are showing stress,” says NASBP’s Miller. “Project financing is being scrutinized for project adequacy and viability.”

Small (Under \$10 million)

Surety availability abounds in the small market as new sureties enter the marketplace and provide additional capacity. However, barriers to entry remain high for contractors seeking the support of a surety partner. Price and terms are very competitive due to the pressure of reduced writings as a result of the economic downturn and favorable financial performance of surety companies.

Without reasonable levels of committed capital, surety companies have been unwilling to extend credit based on projected earnings and prospective growth of the balance sheet. “Small firms must demonstrate a certain level of experience and sophistication, and have access to capital, in order to obtain surety credit,” notes Aon’s Cusack.

The Small Business Administration’s Surety Bond Guarantee Program is expanding, and the SFAA’s Model Contractor Development Program has been implemented in several states and localities, as well as federally through the U.S. Department of Transportation. Already, these programs are having a positive effect on small and emerging contractors’ ability to access surety bonding. (See related articles, p. 30 and 38.)

Top 10 Writers of Surety Bonds—2009*

Companies	Direct Premium Written (Millions \$)
Travelers Bond	\$924.2
Liberty Mutual Insurance Group	\$723.2
Zurich Insurance Group	\$486.8
CNA Insurance Group	\$406.1
Chubb & Son Inc. Group	\$277.0
Hartford Fire & Casualty Group	\$181.0
HCC Surety Group	\$165.2
International Fidelity Insurance Co.	\$147.1
ACE Ltd. Group	\$109.0
The Hanover Insurance Group	\$100.2

*Includes contract and commercial surety

Source: The Surety & Fidelity Association of America (SFAA), "Top 100 Writers of Surety Bonds—United States & Territories, Canada & Aggregate Other Alien," 2009 (Final). Additional information and reports are available for purchase from the SFAA website, www.surety.org. See Statistical Services, then List of Statistical Reports.

Middle (\$10 million–\$100 million)

The middle market remains a competitive segment of the surety industry. The capital structures, reinsurance arrangements and net retention strategies of most underwriting companies support a business plan focused on construction firms with sales below \$100 million. Based on the competition in this space, contractors may experience more underwriting flexibility from

sureties on issues such as bond rates, work programs, minimum capital thresholds and personal guarantees.

Among contractors, competition and margin compression in this segment remains fierce. Contractor backlogs are down 20 percent to 60 percent. "Given the reduced work portfolios, bonding capacity is not a primary concern," Cusack says. "Firms are more focused on expense

management, cash flow and balance sheet preservation."

Rick Ciullo, chief operating officer of Chubb Surety, adds, "While capacity may indeed be plentiful, middle market contractors are wise to choose their surety based on longer term factors, such as financial strength and operating success within the surety industry. The surety industry moves in cycles. Today's too-much-supply in surety capacity will be replaced with tomorrow's too-much-demand, and middle market firms that manage their business for the long term will want to partner with a surety that does so, too."

Large (\$100 million–\$250 million)

While the general conditions mentioned for the small and middle markets also exist in the large market, fewer sureties support this segment (both primary and reinsurers). This segment may be more susceptible to a turn in surety results and a possible restriction of capacity. "Currently, however, this segment remains fairly competitive," says Mike Noe, executive vice president of construction services for Travelers Bond & Financial Products.

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We believe the value provided by professional sureties and strong bond producers is more important than ever to our construction clients as we work to position ourselves for success in this challenging environment.

—DAVID HEWETT

At this point in the cycle, profitable backlogs have been extinguished and all replacement work has been secured with more aggressive margins. Most contractors have adjusted their overhead to compensate for prevailing market conditions involving lower backlogs, less revenue and lower margins. Competition and margin compression in this market segment are intense. Contractor backlogs are down 35 percent to 60 percent.

Mega (Over \$250 million)

"While there seems to be some increase in capacity, this end of the market is highly susceptible to a restriction of capacity in the event of poor surety loss results," Noe says.

Despite the challenging construction environment, mega contractors have remained profitable, but the yields are far lower than those generated during the last five years. Disciplined expense management and maximized resource allocation are critically important in this market, as is identifying the right project opportunities. If the market dictates a lower yield on work, it makes good business sense to focus on securing the right work with more dependable owners.

SURETY OUTLOOK

U.S. construction continues to evolve and adapt to the changing requirements of owners. Surety bonds, within the specific requirements of a surety guarantee, remain an efficient and effective tool for owners to mitigate risk on construction projects. The true value of bonds is best demonstrated during times of economic uncertainty.

Contractors often carry large backlogs into a down construction cycle, while governments take time to trim construction spending once tax revenues decline. This creates a lag between the start of a down cycle and the ensuing increase in contractor defaults. In today's environment, more contractors are seeing red ink or just breaking even.

"The recession that began in December 2007 currently shows little or no sign of receding," says Henry W. Nozko, Jr., president of ACSTAR Insurance Co. "During 2010, total construction put in place will decline for the fourth year in a row. As a consequence, construction pricing is fiercely competitive, resulting in contractors operating on razor-thin margins with no room for error."

Based on recent economic forecasts, 2011 is expected to be another extraordinarily difficult year for contractors. It may be only a matter of time until the extreme economic pressures of tighter margins, longer bid lists, lack of work and shortage of commercial bank credit overwhelm many in the construction industry.

As in prior down cycles, this suggests that both owners and sureties may see an increase in the frequency and severity of defaults. Such a trend is likely to last until construction rebounds. Larger surety companies have developed the scale necessary to sustain small to moderate loss activity, but as long as the recession holds firm, surety executives will be concerned about the frequency of larger losses in the coming years.

"We are hopeful that the underwriting discipline that has been implemented since the last surety loss cycle will prevent loss ratios from rising to unacceptable levels," says Michael P. Foster, executive vice president of Merchants Bonding Company (Mutual). "As an industry, we have attempted to stress the importance of long-term planning, including managing overhead, maintaining estimating discipline, and identifying and addressing onerous

contract provisions. All of these factors put together will help mitigate the negative effects of the economic conditions."

If this cycle develops as predicted, the amount of loss activity will determine how surety companies react. "If severe, it could affect capacity; but at this point, it is not possible to predict whether the industry will experience a soft or hard landing," says Travelers' Noe.

Contractors should expect surety companies to proceed cautiously during the next two years. Underwriters will work hard to protect strong, long-term contractor relationships, and likely will be more skeptical in the underwriting of new accounts. For now, surety industry results as reported by the SFAA continue to be favorable, although the loss ratio for contract surety has increased significantly. "The results continue to be surprisingly positive as we enter the fourth quarter of 2010," says Arch's Finkelstein. "There have been signs of some payment deterioration that serve as early warnings of potentially larger problems, but the frequency and severity of losses have not been realized."

Surety executives expect the surety marketplace to remain competitive in 2010, continuing into 2011. Capacity is available for well-managed accounts as the industry waits for the full impact of the economic recovery. Surety remains profitable, and that bodes well for construction firms that rely on surety support.

"We believe the value provided by professional sureties and strong bond producers is more important than ever to our construction clients as we work to position ourselves for success in this challenging environment," says Zurich's Hewett.

A surety company can be a true partner and a key stakeholder—one with a crucial ability to help a construction business grow and prosper. A quality surety has resources in the legal, financial and accounting areas, and can provide guidance that goes beyond just providing a bond. "It is especially important during tough times to clearly communicate the state of the construction firm's financial health and any unusually difficult financial or technical issue facing the business," Kunkel says.

Marc Ramsey is communications manager for The Surety & Fidelity Association of America. For more information, call (202) 463-0600 or email mramsey@surety.org.



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A Q&A WITH THE NATION'S LEADING SURETY INDUSTRY EXPERTS

EXECUTIVE INSIGHTS

EXPLAIN HOW BALANCE SHEETS HAVE CHANGED IN TODAY'S ECONOMY AND HOW THIS HAS AFFECTED A CONTRACTOR'S BONDABILITY. WHAT STRATEGIES CAN CONTRACTORS USE TO PROTECT THEIR BALANCE SHEETS AND WEATHER THE ECONOMIC STORM?



THOMAS KUNKEL
Chair of the Board
The Surety & Fidelity
Association of America
President
Travelers Bond & Financial
Products



MIKE NOE
Executive Vice President,
Construction Services
Travelers Bond & Financial
Products

The boom times during the past 10 years created a mindset in which taking on debt seemed the best way to grow a business. Many bankruptcies resulted when companies could not meet payments once their cash flow was disrupted. These experiences have brought a new sensitivity to the business world when it comes to debt.

A lesson learned is that construction firms should maximize

liquidity whenever possible. When borrowing is necessary, debt should be paid down as quickly as feasible to preserve flexibility for future projects. Having an available line of credit is important in today's economy, but planning cash flow without reliance on the bank is a much safer bet.

In addition, due to the fact it has become increasingly harder to secure new work at acceptable profit margins, firms need to continue to take a realistic approach to overhead management. The sooner the fat can be trimmed out of an organization, the more adept the firm will be at managing through the downturn. It also will be better prepared and positioned to take advantage of opportunities when the market starts to improve.



ROD WILLIAMS
Executive Vice President
and Chief Underwriting
Officer
Liberty Mutual Surety

The overall economic problems and weak construction market have had varied effects on contractors' balance sheets. Slowing receivables is a common theme, even on public work, as owners operate within stretched budgets. Contractors heavy in private work may

face hung receivables caused by an owner default or loss of project funding.

We also have seen an increase in affirmative owner claims. On the liability side of the balance sheet, contractors that entered the recession with excessive debt are struggling to meet the debt service in light of declining revenues and lower profit margins. A depressed market for construction equipment also makes it difficult to liquidate unproductive equipment.

Contractors still have many options to weather the economic storm. These include managing overhead to appropriate levels relative to declining revenues; reducing debt and culling non-productive real estate, plants and equipment; self-performing more work if expertise is present in the firm; and exercising strong job cost control in project estimating and execution.

A contractor's relationship with the surety is more important than ever. Contractors should engage in open and frequent dialogue with their surety agents and underwriters to ensure transparency and alignment in the underwriting process. It is much easier to address problems and develop solutions with early identification and open dialogue. Economic cycles come and go, and contractors that follow a well-thought-out business plan are better positioned to survive and prosper in the long term.



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DOUG HINKLE

*Chief Underwriting Officer
CNA Surety*

In general, today's weak construction economy is providing far fewer work opportunities at far lower profit margins. Declining revenue can have a significant effect on cash flow, which will vary by type of contractor, but certainly margin deterioration creates added risk for everyone involved in the construction process.

The one strategy that deserves special note in a difficult construction market is organizational cash management—a skill set that can make a significant difference in profitability and ultimate survival. To be effective, it needs to be part of the overall corporate culture and driven by senior management.

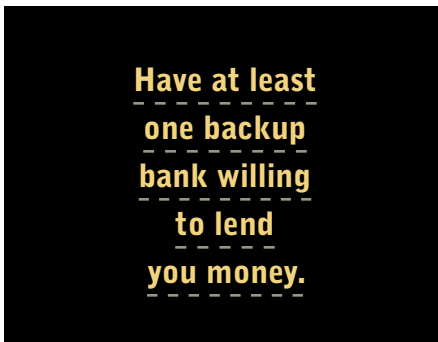
One of the essentials to cash management is forecasting cash flow on a project-by-project basis, as well as for the company as a whole. The projections not only predict profits, but also show whether cash flow is adequate to support day-to-day business operations without additional infusions of cash or financing costs. Constantly focusing on cash flow has many rewards, as it will lead to stronger billing and collection procedures, better project cash production through front-end planning of bidding work, stronger change order management procedures, better decisions relative to fixed asset investments, less bank reliance, greater profitability and a stronger company overall.


RICK CIULLO

*Chief Operating Officer
Chubb Surety*

This turbulent economy and high-risk environment puts additional stress on a contractor's balance sheet. More than ever, a contractor must develop a strategy for managing its balance sheet. Doing so reduces risk to its business and increases the contractor's access to surety credit. The two go hand in hand.

A balance sheet reflects the quality of a company's management. A clean and uncluttered balance sheet generally shows a well-managed company, while a balance sheet complicated by stray investments or accumulated problems indicates a poorly managed company or one under stress.



Contractors will better resonate with a surety and enhance their bondability with a clean, uncluttered balance sheet.

A contractor can protect its balance sheet by knowing who it is working for, diligently collecting owed monies, liquidating unused assets, and only accepting work with margins that will cover its overhead, profit and the risks inherent in its business. If profitable work is not available and a contractor chooses to take on unprofitable projects, it ultimately will destroy its balance sheet and jeopardize its future viability. The contractor's access to surety credit will drop accordingly.

Sureties also expect a contractor to have a business plan to weather periods of economic turbulence. While some decisions are difficult to make, such as reducing overhead to a level that matches income, deciding and executing quickly can be paramount in preserving a company's balance sheet.

By developing a disciplined approach to managing its balance sheet, a contractor will greatly increase its chance of being successful through all phases of market cycles and, as a result, will increase its access to surety credit.


DAVID FINKELSTEIN

*Executive Vice President—
Surety*

Arch Insurance Group

The economic downturn has reduced revenues and job profit margins, resulting in lower net income or outright losses. Contractors' balance sheets are less liquid, and stockholder equity positions are deteriorating, especially if their outside debt burden is high. Sureties generally respond by reducing available credit and applying stricter underwriting conditions.

Contractors should adjust their organizations to match the available revenue and tighter profit margins. Reducing

overhead and selling underutilized fixed assets are two common approaches. When possible, the proceeds should be used to retire debt.

Characteristics of a successful contractor in the current economic environment include strong cash position, low debt levels, disciplined job selection and a diversified customer base. Strong cash and low debt allow operating flexibility. Disciplined job selection should prevent acquiring new work with little or no margins. Underperforming jobs can adversely affect the balance sheet for years to come. A diversified customer base gives the contractor more potential projects and the ability to utilize resources more effectively.

WHAT IS YOUR ADVICE FOR CONTRACTORS GIVEN TODAY'S CHALLENGING CONSTRUCTION ECONOMY?


MICHAEL F. GREER

*Vice President—
Surety & Fidelity*

Penn National Insurance Co.

Debt in any market exposes a contractor to additional risks. These additional risks also are factored into the surety credit equation. A surety is more likely to approve a project for a contractor that does not need to chase work.

Debt and the need for cash push contractors to take work just to generate cash flow. Invariably, something goes wrong, the contractor loses money and its cash flow is squeezed. Rumors about its status start, and the contractor goes to the surety for financing or to court for bankruptcy protection.

Banks are in a very tenuous position. Many have problems and losses that have not come to the forefront. If a contractor's debt-laden bank suddenly decides it doesn't want to lend to contractors anymore, then that contractor has a very short period of time to secure new financing before the sky starts to fall. Many people forget what happened with the savings and loan crisis and the Resolution Trust Company, when a lot of solid viable companies received demand notices from their banks.

My advice to all contractors is to have at least one backup bank willing to lend you money. Agents back up surety relationships all of the time—contractors should do the same thing with their banks.

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WHAT ADVANTAGES DO UNDERWRITERS AND BOND PRODUCERS BRING TO THEIR CONTRACTOR CLIENTS, PARTICULARLY IN TODAY'S ECONOMY?



DAVID HEWETT

Executive Vice President

Zurich North America Surety, Credit and Political Risk

The value of a strong surety and professional surety-oriented producer is more important in challenging times than at other points of the economic cycle. A stable underwriting approach and consistent capacity is vital as contractors strive to find the right projects that will bring a favorable return. Contractors need to take advantage of the total value that a strong surety can bring, including a consistent underwriting approach, necessary capacity, contract language review and claim department input.

Potential problems are the same as always; for example, securing the wrong job for the wrong owner outside of a firm's traditional area of expertise or geography. Strong levels of communication with your surety and broker can identify these issues, as well as ways to capture new opportunities that support and advance your business model.



STEVEN F. COWARD

President

Berkley Surety Group

Contractors are entrenched in a depressed construction market, faced with constrained project funding, a suppressed credit environment and a competitive arena that is causing margin reduction. It is essential that the surety company and bond agent provide the value-added experience, advice and support to ensure the contractor maintains a sense of balance in these unprecedented times. By creating an open dialog among all parties, the surety and agent can provide the assurance contractors need to support an appropriate, well-thought-out business plan.

The harsh reality is that 2011 does not appear to promise the improvement everyone hoped for, so business plans may need to contemplate a myriad of strategies. Proactive communication with the bond producer and tapping the vast market knowledge it holds could be

invaluable, particularly when addressing options as a business owner. Should the contractor consider a merger/acquisition or alternative market, or simply wind the business down? The unthinkable—winding down the business—ultimately may be the best way to protect the equity earned over the years. In this instance, early and constructive communication with the surety could be a significant factor in reducing the exposures.

These are unprecedented times when the choice of business partners, trust and level of communication are paramount considerations for a business owner.



MICHAEL P. FOSTER

Executive Vice President

Merchants Bonding Company (Mutual)

The advantages bond producers and underwriters bring to their contractor clients are the tools necessary to survive tough economic times. Establishing a team of qualified consultants, including a professional surety agent and surety underwriter—as well as a CPA, banker and lawyer who understand and are committed to the long-term goals of the company—is critical to the success of the contractor. Successful contractors allow such a team to help them make good decisions. If they did not make the proper decisions during good times, then they will not survive the bad times.

Contractors should have been making decisions such as growing the company's cash, working capital and equity; constantly attempting to minimize or eliminate institutional debt; maintaining a prudent budget for the acquisition of additional equipment or personnel; and establishing an effective management control system that generates timely and accurate accounting and job cost information. All of these best practices are what good surety producers and underwriters bring to the table, giving their contractors an advantage.



J. SPENCER MILLER

President

National Association of Surety Bond Producers (NASBP)

President

Schwartz Brothers Insurance Agency Inc.

Today, technology offers enhanced capabilities to the underwriter and bond

producer. Surety underwriters have the ability to model accounts and add input into their underwriting processes. They also have the ability to share best-in-class benchmark information with their agents and accounts to assist in business development. New communication capabilities at NASBP give the bond producer more exact and quicker access to information to share with its customers in reference to risk management, bond forms, partnering and local legal issues.

Both surety underwriters and bond producers have benefited from improved software applications that help them with data management and backroom processes. These applications help the bond producer and underwriter make beneficial, timely decisions, and provide advice to their customers. Contractor clients benefit from producers and underwriters that share information and communicate directly with obligees on onerous bond forms and contract requirements.

The role of the professional surety bond producer and its importance to the surety process is emphasized in this difficult business climate. Contractors in this environment need trusted advisors who understand their history, management, business objectives and business cycles. The professional surety bond producer helps contractors gain perspective and directs them to resources that help them remain long-term, viable businesses.



WILLIAM A. MARINO

Vice Chairman

Aon Construction Services Group



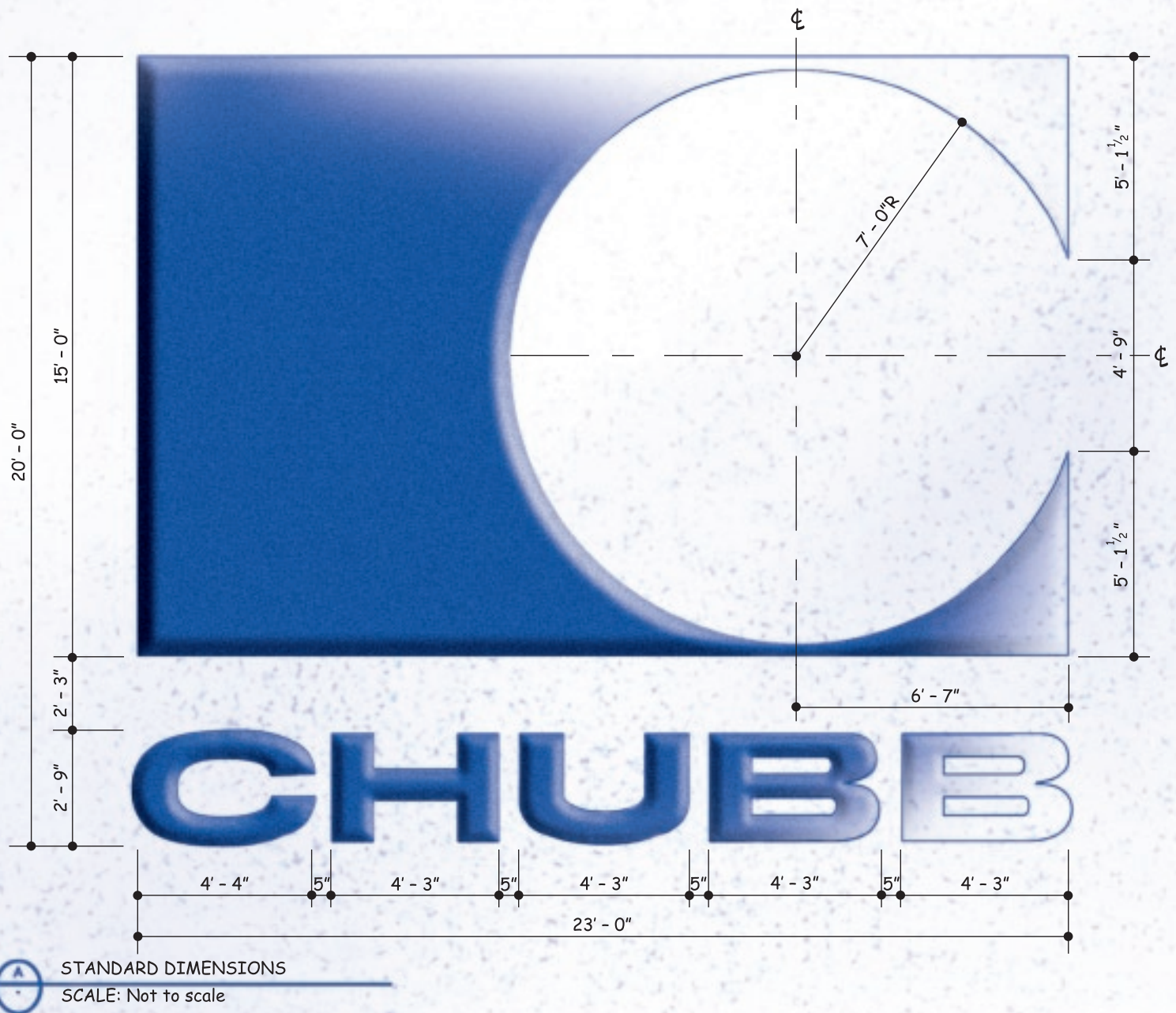
MICHAEL J. CUSACK

**Senior Vice President—
Managing Director/Contract
Surety**

Aon Construction Services Group

The biggest strategic advantage offered by a strong surety bond producer is having broad access to the marketplace. When selecting a bonding agent, contractors need to ask if the prospective broker or producer has access to a wide range of contacts in the industry.

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teams of underwriting companies, and a broad understanding of financial and business issues. An experienced bond agent works diligently to become a valued and trusted advisor by his contractor clients. The best bond producers have confidence in their client relationships to allow for candid discussions. These conversations provide sound, long-range advice that may not always coincide with the views of a contractor's management team.



HENRY W. NOZKO JR.
President

ACSTAR Insurance Co.

There is a growing trend for terms and conditions of construction contracts to further expose both prime contractors and subcontractors to expanded liability under prime contract agreements and sub-contract agreements. Escalation of broader and more onerous indemnity and warranty provisions are being woven into many construction contract agreements, creating an unreasonable assumption of risk by the contractor or subcontractor.

Most sureties will assist contractor clients in modifying, removing or renegotiating certain onerous contract terms and conditions. Surety-sponsored or required contract modifications usually can enhance the results of negotiation. No contractor or subcontractor should sign a contract with over-the-top provisions. A bilaterally fair agreement will contribute to overall project success.



BRAD W. GIBSON
Surety Executive

Rutherford

Contractors are finding themselves in the most difficult construction environment of the past 35 years. Business planning, budgeting and adjusting are essential to success and survival in this environment. Every aspect of a construction business must be carefully evaluated, managed and adjusted on a regular basis.

Much like a personal exercise program, construction business owners first must have a formalized business plan and budget, which should be revisited monthly and "exercised" throughout the year to maintain the organization's financial strength. The plan will aid in making adjustments

**Construction-related
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more firms into
the public
works arena.**

to overhead, unallocated expenses, debt, cash requirements and many other components necessary to weather the downturn. Contractors must be diligent in following and adjusting the plan.

An experienced and reputable surety agent helps a contractor with the planning and budgeting processes. The agent should have a level of expertise that allows him to offer significant input and review as a trusted advisor, in addition to other professional services. The agent then communicates with the underwriters to solicit their input and endorsement.

Contractors that regularly evaluate and adjust all aspects of their plan and budget will have the greatest chance of maintaining a sound financial position and preparing their organization for the better times ahead. Surety underwriters place a high value on well-conceived plans, and they associate credibility with those who contribute to the plan.



DWAYNE SHELTON

Vice President

Risk Services of Arkansas

Member

INSURICA Insurance
Management Network

In a strong economic climate or in a downturn, a professional bond producer armed with internal tools and the tools of the surety industry can help insulate the bottom line and the overall health of the balance sheet of contractor clients. Service advancements in two areas are notable.

Modeling and benchmarking have evolved to a point where real-time data mining from active surety accounts form

the basis for a true best-in-class peer group. One of the largest sureties boasts a 6,500-client database with up-to-date comparative data. The advantage is the numbers are not skewed by industry averages, which include contractors that do not or cannot bond work.

In addition, the legal departments of sureties can combine with risk management resources to advise and educate contractors on the changing legal climate to protect their long-term success from both upstream and downstream contractual pitfalls.

The successful contractor-broker relationship collectively will seek the value of these resources and adhere to the lessons learned.



HARRY CROWELL

Chairman

The Insco Dico Group

This year, construction-related entities will need to secure contract bonds as the lack of private work forces more firms into the public works arena. Given the current economy, the selection of a surety is even more critical than at any time during the past three decades. The surety underwriter is responsible for the prequalification of the contractor and must rely on direct input from the surety producer, principals, CPAs and bankers. With the intense competition contractors are experiencing, the prequalification process becomes even more complex, challenging each underwriter to understand more risk factors than ever.

The apparent attempt of owners and obligees to perfect contract and bond language increases the risk factors as well, increasing the due diligence required for responsible prequalification. These risk factors emphasize the need for professional feedback from all the parties, ensuring the contractor principal can fully appreciate the risk it is undertaking and sharing with its surety.

Bond producers must know their customers well, understand the construction business and its challenges, and serve as a true partner.

Compiled by Marc Ramsey, communications manager for The Surety & Fidelity Association of America.

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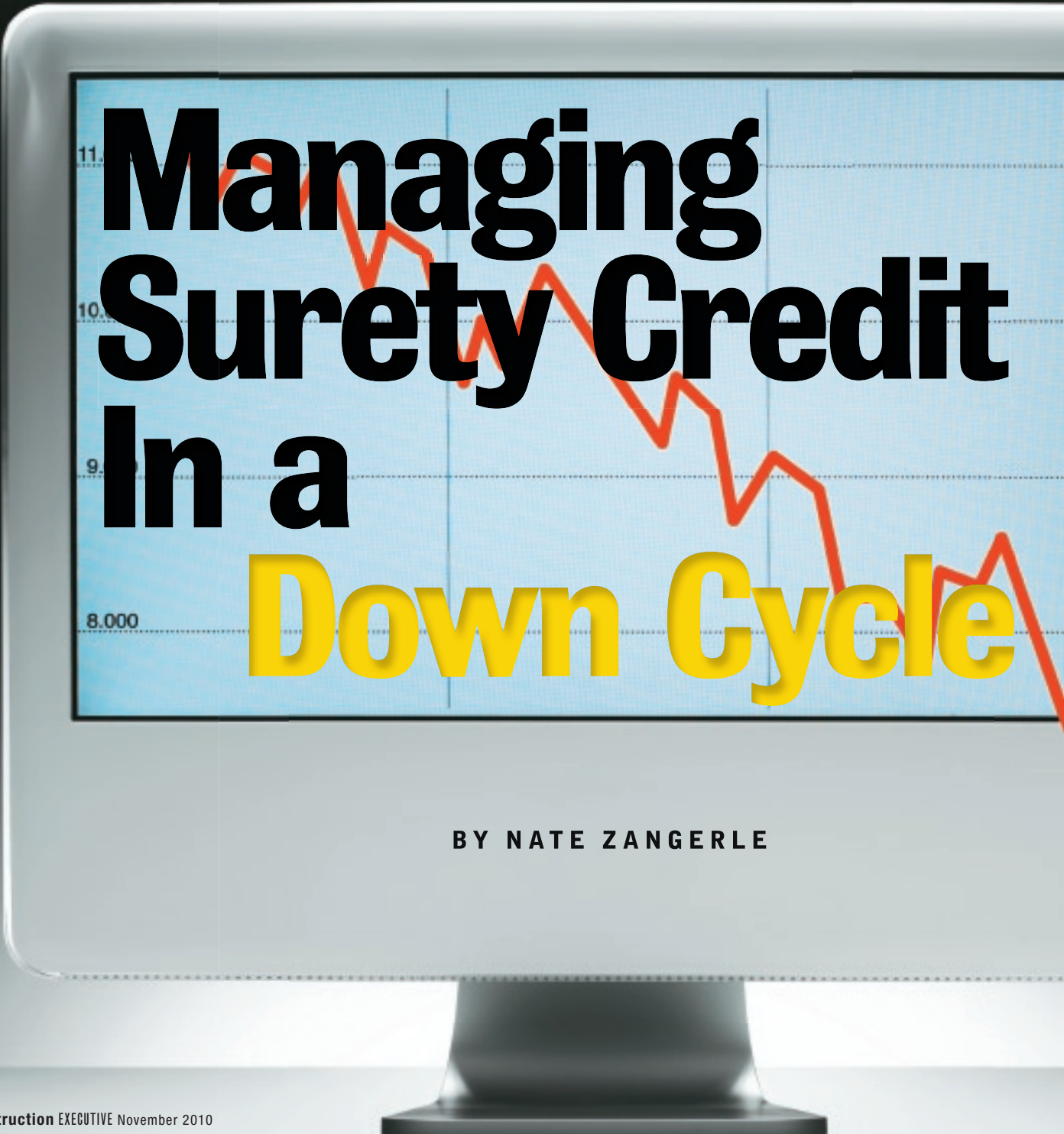
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The tough economic realities facing the construction industry have challenged business operating models. Housing remains depressed, private construction funding is nominal, tax revenues are lagging and government deficits are growing even higher. For contractors exhausting their work programs, the prolonged construction recession translates to fewer project opportunities, lower margins on awarded projects and greater competition overall. Given all this, do contractors also need to worry about their surety credit lines?



Managing Surety Credit In a Down Cycle

BY NATE ZANGERLE

Unlike the banking industry, which is restructuring in the face of subprime and real estate losses, the property and casualty insurance industry (including surety) remains financially sound and well capitalized. Surety industry capacity is stable and sufficient to meet market needs for worthy contractors.

Surety credit underwriting is based on three basic ideas. The contractor should have a stable financial condition, including

appropriate net worth and strong liquidity relative to operational needs; the necessary people, facilities and equipment to perform; and a sound character and reputation. Contractors also should focus on establishing strong internal controls, building a track record of project profitability and executing a comprehensive business plan that allows them to adapt quickly to changing construction cycles.

A sound financial condition is characterized by strong liquidity and manageable debt. Contractors should focus on building positive cash flow and conserving cash. Contractors that avoid amassing slow-moving assets and depending on working capital lines of credit are better positioned to manage a problematic job or survive a contract payment dispute.

Working capital without liquidity also can present risk. A contractor can have good working capital but low liquidity, which may be evidence of poor cash flow from operations.

Contractors are in the business of leveraging assets to make profits. Depending on economic conditions, an important aspect of leveraging assets is knowing when to assume debt and how to manage it for both the short and long term. Maintaining a low debt-to-net-worth ratio indicates a contractor can withstand declining revenue. Creditors also perceive a contractor that holds significant off-balance-sheet debt or over-invests in equipment relative to operational needs as having a higher potential default risk.

Operationally, people are a contractor's most important asset. The challenge in a construction recession is maintaining the core expertise and value-added services of good employees so the contractor is properly staffed during the recovery. Similarly, contractors need to prioritize and manage facilities and equipment effectively. Maintaining a plan to periodically assess operational needs to minimize the carrying costs of non-productive facilities and equipment is important. By the time the down cycle comes, it often is too late to cost-effectively shed non-productive equipment.

Construction is a long-term business, and creditors seek long-term relationships. Contractors that develop a consistent track record and positive reputation by performing and delivering on promises to owners, subcontractors and vendors demonstrate stability and present better risk to

creditors. Moreover, establishing candid relationships with creditors is key to preventing surprises and changes in surety or borrowing capacity.

A critical success factor is the quality of internal controls. Contractors should demonstrate strong job costing, change order and revised cost-to-complete procedures. Contractors that know their costs and can adjust accordingly are more likely to survive an economic downturn. Having a vigorous bidding process is critical to long-term success, as it allows a contractor to focus on projects that best meet its organizational strengths.

Job selection also is critical. Contractors that operate within a proven geographic territory and project type are more likely to be successful. Consistent operating profits remain a leading indicator of long-term performance.

**Establishing candid
relationships with creditors
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For the long term, contractors should establish and follow a comprehensive business plan. Because economic conditions change fast, a viable business plan must allow for both expansion and contraction. A solid business plan lays out the need for people, facilities and equipment, and outlines the optimal combination of project type and geographic territory selection. Further, a plan must focus on management of general and administrative expenses, when and how to downsize, and how to minimize expense creep relative to revenue growth.

Good surety companies underwrite consistently in both good and bad economic cycles. Working through a professional surety bond producer, contractors should encourage open and direct dialogue with their underwriters to foster a sustainable surety line of credit.

Nate Zangerle is senior vice president of underwriting for Liberty Mutual Surety. For more information, call (610) 832-8240 or visit www.libertymutual.com.

SABINE SCHECKEL/GETTY IMAGES

P3 Opportunities: New Roles Demand



BY GEOFF DELISIO

Public-private partnerships (P3s) represent a fundamental change in the project procurement process for U.S. contractors and those who serve the contracting community. While this procurement method is common in various parts of the world, especially in the United Kingdom, broad use in the United States has been limited to the Armed Forces for the upgrade and construction of military housing.

Proponents of P3s believe a government agency can engage the talents of the private sector to bring new assets into use for the public's benefit, as well as operate existing assets in a way that gives the agency greater flexibility with its budgets and certainty with its expenses.

structure typically involves the governmental body providing the concessionaire a lease to an existing asset or to the land upon which a new asset will be built. In turn, the concessionaire (generally a single-purpose entity with potentially several owners) contracts with multiple parties that serve specific roles within the project,

revenue begin to flow. This scenario places a premium on competent contractors that can partner with the concessionaire in providing a world-class project.

A surety bond can play a key role in the construction phase of a P3. Typically, construction is let as part of a design-build contract from the concessionaire. During

Strong Surety Support

THE BASICS

Broadly speaking, P3s refer to a procurement process by which the talents and capital of the private sector are used to perform tasks that historically have been the responsibility of the public sector. This support can include providing short- or long-term project financing, contributing design and construction services, and operating and maintaining an existing or a newly built asset.

The underlying theme of the P3 process is value for money: The public is provided something of value for the additional money the private sector is being paid. By connecting all of the responsibilities related to an asset together over time, the end result should be a better performing asset at an overall lower life cycle cost.

If a private company is required to operate and maintain the asset for a long period, it will seek a design that makes the asset more efficient to run. Likewise, if a private entity is responsible for paying to maintain a roadway for 50 years, it will try to ensure the design, construction methods and materials can lower maintenance costs over time.

The marketplace generally refers to two main categories of P3s: greenfields and brownfields. A greenfield project refers to a newly constructed asset being brought into public use. In contrast, brownfield projects refer to existing assets for which the ongoing operations and maintenance are transferred to the private sector. In either situation, the underlying agreement between the public and private sector tends to be long term (30 to 50 years), with the asset returning to public care at the end of the term.

The private entity that enters into a contract with the public entity usually is called a concessionaire. The contractual

such as design, financing, construction, operation and maintenance.

Third-party financing is combined with an equity piece from the concessionaire to fund the transaction. The concessionaire is paid a fee based on the availability of the asset, and in some cases the fee is based on the public's use of the asset. The concessionaire uses these fees to pay off the debt incurred to fund the original purchase of the existing asset, or to pay construction costs for a new asset with a return to the investors.

NEW ROLES

Parties involved in a P3 take on new roles compared to a traditional public agency-driven procurement. The governmental body is no longer the "owner" in the traditional sense of the word. Rather, the public entity serves in an advisory role as a steward of public assets, while the concessionaire services the public in a market-driven fashion. Government leaders are guided by the desire to implement strong public policy and at the same time safeguard the public's investments.

The concessionaire becomes the "owner" in the new framework. A diverse group of companies—lenders, contractors and suppliers—can have ownership in the concessionaire.

Contractors and suppliers are being asked to bring significant value and expertise to the project as team members. Generally, these projects are undertaken on a zero change order basis. Once the financing has been secured, no additional funds are available to the concessionaire.

A key in the overall project is getting the asset to fully function as soon as possible; only then does the concessionaire see

the prequalification process, concessionaires often look for contractors that qualify for a performance and payment bond from the surety. In a construction project where completion time and operational performance are key, having a performance and payment bond covering the design-build contract benefits all involved.

The payment bond can give subcontractors and suppliers peace of mind that they will be paid for services and materials provided to the project, which is not always clear given the public-private structure of P3s.

NEW OPPORTUNITIES

Because the roles of the major players within a P3 do not follow the traditional scheme, all are confronted with new opportunities that need to be managed carefully to ensure success. For contractors with the talent to provide value-added insight as a member of a broader team, P3s present a significant potential. Unlike a low bid procurement process, neither the price of construction nor the contractor's fee is the material factor in determining who wins the job.

While P3s offer an opportunity for qualified contractors, the risks involved demand support from a surety with experience solving customers' problems and reducing their risk. A performance and payment bond provides tremendous benefit to all, whether supporting the design-build aspect of the project or separate design and construction portions of the contract.

Geoff Delisio is vice president of Zurich Surety Credit and Political Risk, Owings Mills, Md. For more information, call (410) 559-8720 or email geoff.delisio@zurichna.com.



Secrets to Survival

As the construction industry continues to struggle in a difficult economy, it is not all gloom and doom. Across the United States, many contractors are surviving using a combination of proven business practices and new strategies to keep the work flowing.

BY THERESE WIELAGE

Jason Chambers, president of Tri-Sure Corp., an underground utility contractor in Auburndale, Fla., has been called on to finish work that was started by failing companies. "I keep my nose to the grindstone and turn over every rock to look for business to keep us going," Chambers says. When the downturn started, Chambers recalls vowing that his company would be "the proverbial last man standing."



While the future of the construction industry remains uncertain, a sampling of successful contractors around the country shows that tough challenges can be met. Key points drawn from several business testimonials include:

- Stay out of debt or keep it low.
- Network with past and present business contacts to find new work.
- Keep overhead low and maintain a strong financial statement.
- Develop company leaders to chart a successful course.
- Develop and maintain strong relationships with a professional surety bond producer and underwriter, as well as a construction accountant.
- Get involved in community activities. Be a good corporate citizen and take advantage of side benefits, such as raising company awareness and networking to find new business.



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Using various combinations of these strategies, several contractors have been able to avoid cutting staff. In Florida, Service Painting Corporation set a goal of keeping its entire workforce employed. "Salary reductions, hourly reductions and division cost procedures were implemented across the board equally and were supported unanimously," says Paul Weigel, the company's president. "Creating shared reductions by all, rather than the wholesale firing of a few, can strengthen the company's morale and attitude to succeed as a team."

DEBT

Kevin Henter, president of Gator Excavating, Grimes, Iowa, says his father taught him that debt is a four-letter word—something to be avoided as much as possible. Gator performs site grading work and road building, and installs underground utilities such as storm and sanitary sewers. "Maintaining a very low debt structure has been my policy from day one," Henter says.

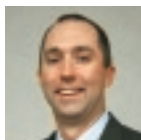
He tries to buy equipment with cash from company profits rather than going into debt to pay for the machinery. "If the economy comes to a halt and a company is riddled with debt, it's going to get in trouble," Henter says. "It's not rocket science."

When many Florida companies decided to grow during the construction boom, Chambers held back, using company profits to buy and pay off new equipment to replace old machinery, rather than expanding his lineup of machines.

CONTACTS

Keeping in touch with past and present business contacts is important to cultivate new opportunities. "We have used our experiences with our existing clientele as a platform to launch ourselves into multiple contracts with new agencies," says J.R. Durazo, president of Durazo Construction, a commercial general contractor in Tucson, Ariz.

Dusty Barrick, president of Diversified Interiors of Amarillo, Texas, credits what he calls a "cousin company" in El Paso, Texas,



Without effective, positive leadership in this industry, it is difficult to succeed.

with helping his commercial subcontracting firm find new business in the military sector. The two companies aren't related financially, but have had a long association.

"Really, they were kind of the spark that got us going," Barrick says. "They introduced us to the right people. We owe them a lot."

Barrick also credits his company's success to innovation. The company is more involved in early stages of projects, providing input on design issues and ways the work can be done better, faster and cheaper. That dramatically raises the company's chances of getting a job, Barrick says.

Diversified Interiors also consults with suppliers, employees, material manufacturers and even friends to find better ways of doing things. "The more people we can involve who have specific skill sets, the better," Barrick says. "I honestly think the smartest move we ever made was to figure out that we weren't that smart."

OVERHEAD

Keeping overhead costs low is important to maintaining a viable business. "We keep a real sharp eye on overhead and keep a real sharp point on the pencil," Henter says.

Gator operates with a lean staff. "With the amount of work we do, we could justify another project manager, but the increased costs would go directly to overhead," Henter adds. "We all just have to work a little harder."

Durazo also emphasizes keeping overhead low. "Even though we've experienced growth in the last several years, we have continued to maintain relatively low

overhead by limiting the upgrading of our equipment and resources," he says.

FINANCIAL STATEMENT

Anticipating a downturn in the industry, Service Painting Corporation, which employs about 250 people in Tampa, Orlando and Sarasota, Fla., began making preparations more than two years ago with a defined cost-control program. An important element in the company's success is the fact that Weigel and his three partners—Todd Monroe, Steve Tyer and Bob Parker—are all directly involved in the company's operation. Service Painting has five divisions that specialize in industrial and commercial painting, nursing home renovation, and restoration and waterproofing of buildings and parking garages.

The firm has worked hard to maintain a strong financial statement secured by significant retained earnings and a line of credit in place with a highly rated bank, Weigel says. Additionally, maintaining a \$10 million to \$15 million bonding capability confirms the company's stature for larger projects.

LEADERSHIP

Marv Selge, president of Selge Construction, Niles, Mich., credits the company's leadership with helping it weather the construction downturn. Selge's company performs heavy earth excavation, concrete highway paving and directional boring, and installs sanitary and storm sewers.

Three years ago, a leadership training academy taught the firm's top nine executives how to knock down communication barriers, get to the heart of subjects harmoniously and stay focused as a group. Now, the company relies on its core leaders to get jobs done more productively.

"The leadership is everything," Selge says. "Without effective, positive leadership in this industry, it is difficult to succeed. With that type of leadership, your company can flourish even in challenging times."



Therese Wielage is vice president of marketing for Merchants Bonding Company. For more information, call (800) 678-8171 or email twielage@merchantsbonding.com.



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Accounting Proposal Alters Contractors' FINANCIAL STATEMENTS

In underwriting a contractor to determine whether to provide performance and payment bonds for a given project, the surety evaluates the three Cs—character, capacity and capital. Because capital involves determining the contractor's ability to support the project and its entire operation, the financial statement is a crucial evaluation tool for sureties.

On June 24, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board proposed revised accounting standards regarding how revenue from contracts is recognized. If the proposed standard takes effect, the content, meaning and usefulness of the financial statement will change significantly.

Since 1981, U.S. Generally Accepted Accounting Principles (GAAP) have required that revenue from construction contracts be recognized on the percentage of completion method. Under this method, the contractor recognizes revenue and profits from a construction contract to the extent of progress toward completion for that given financial accounting period. Progress typically is measured by the costs incurred to date by the contractor.

The U.S. GAAP Codification of Accounting Standards, Subtopic 605-35 (and its predecessor, Statement of Position 81-1) recognized the unique characteristics of and challenges involved in accounting for construction contracts. Construction accounting requires “measuring the results of relatively long-term events and allocating those results to relatively short-term accounting periods.” In addition, the revenue generation of a construction contract involves “considerable use of estimates in determining revenues, costs and profits.”

For almost three decades, GAAP recog-

BY ROBERT DUKE

nized that the best way to account for the unique nature of construction accounting and the best way to reflect the “economic substance of an entity’s transactions” was to recognize construction contract revenue and profit by using the percentage of completion method. The proposed accounting standard changes this position.

NEW CONTRACT REQUIREMENTS

Generally, sureties have found the percentage of completion method to be a reliable and accurate approach to accounting for contracts. The financial statement should depict the economic reality of the transaction, including the following characteristics:

- The construction contract is the source from which revenues and profits are generated.
- As a user of financial statements, the surety is interested in how the contractor performs with respect to each contract, in its entirety. The measure of performance is the amount of profit generated by the contract and the ability of the contractor to produce the profit that was estimated at the contract’s inception.
- A project owner pays the contractor as work progresses, and profits from a construction contract are generated by the contractor’s activity on the project.



Costs are an objective and reliable way to account for the contractor's progress and activities.

The proposed standard breaks from these characteristics in that the construction contract is no longer the profit center. Under the proposed standard, revenue is recognized when a contractor satisfies a “performance obligation.” Conceivably, a single contract could have multiple performance obligations, each with its own profit margin. The proposed process for recognizing revenue strays from what the surety wants (i.e., a measure of profitability of the whole construction contract as it progresses) and involves a high degree of judgment and subjectivity.

The proposed standard sets forth the following steps to recognize revenue:

- identify the contract with the customer;
- identify the separate performance obligations in the contract;
- determine the transaction price;
- allocate the transaction price to the separate performance obligations; and
- recognize revenue when the entity satisfies the performance obligation.

Under the proposed standard, an accountant would review each contract and determine whether it involves single or multiple performance obligations—introducing greater subjectivity and judgment in the process. A performance obligation provides “distinct” goods or services;



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paragraph 23 of the proposed guidance explains the criteria for determining what makes a good or service distinct.

Determining whether a performance obligation is satisfied (and when revenue is recognized) also involves a great deal of judgment. The proposed standard states that a performance obligation is satisfied when the good or service is transferred to the customer. Transfer occurs when the customer obtains control (the ability to direct the use of, and benefit from, the good or service, according to paragraphs 25 and 26 of the guidance). Determining when the

project owner has control involves more analysis and subjectivity than determining the costs incurred to date.

IMPACT ON SURETY

If implemented, the proposed standard could have several adverse effects from the perspective of the surety as a user of the financial statement. First, the usefulness of the financial information is diminished. The surety is looking to the financial statement to answer the question: How did the contractor perform on this contract? By moving the focus away from the whole

contract to a performance obligation, the financial statement is answering a different question: How did the contractor perform on this performance obligation?

Second, the reliability and credibility of the financial statement is diminished. The long-held view has been that the percentage of completion method of accounting (recognizing revenue as costs are incurred) is the most reliable and accurate depiction of the transaction. The proposed standard will result in recognition of revenue only when the entire contract has been completed (i.e., the completed contract method), assuming the owner obtains control of the work only at completion.

The proposed standard will still allow for recognition similar to the percentage of completion for projects in which the owner controls the work in process as it is performed. However, this means the revenue of some contracts may be recognized per the percentage of completion method and the revenue of other contracts will be recognized per the completed contract method.

Another hit to the reliability and credibility of the financial statement is caused by the introduction of subjectivity and judgment to the revenue recognition determination. What constitutes a performance obligation and whether the performance obligation has been satisfied could be viewed differently by different accountants looking at the same contract.

To address the diminished usefulness, reliability and credibility of the financial statements, sureties likely will require additional information to combine the multiple performance obligations into a single contract. In addition, sureties likely will require schedules regarding the billings and costs for each contract to determine the performance and profitability of each contract in its entirety.

Because the proposed standard does not meet the surety's needs, contractors may face additional costs for the analysis and review of financial statements, and for compiling the accounting information needed to view the contracts under the percentage of completion method.

Robert Duke is director of underwriting and assistant counsel for The Surety & Fidelity Association of America. For more information, call (202) 778-3630 or email rduke@surety.org.



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John F. Welch, CEO

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TO FOLLOW ARE JUST A FEW OF THE WAYS CNA SURETY DEMONSTRATES HOW WE'RE ON SOLID GROUND:

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customer-focused solutions to bonding requirements. What really sets CNA Surety Corporation apart from the competition is our underwriting consistency and working closely with our accounts to help them meet their goals.

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CNA Corporate Office in Chicago, IL

impressive customer base. As a result of working with a wide range of customers, we have developed a sophisticated benchmarking report that allows us to compare one client to their peers and we share that data with our clients.

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GAINING A COMPETITIVE EDGE

Through Surety Credit

With an increasing number of bidders on construction projects, many small and emerging contractors are exploring ways to gain an edge over their competitors. Being bondable is one way a company can set itself apart.

"Most of the work coming out right now is government work, so it's important to be bondable," says Joshua Etemadi, a producer at Construction Bonds Inc., a division of Murray Risk Management and Insurance, Fairfax, Va. "Once contractors get their first bond, they are part of a group of contractors that has been independently verified, vetted and qualified to compete on bonded projects."

Lawrence McMahon, senior vice president/surety manager of Alliant Insurance Services, Inc., San Diego, agrees. "Most of the private work has dried up and the available work is public works and military," he says. "Without a bond, contractors cannot access this work."

Many contractors cognizant of this situation are considering obtaining surety



BY KATHY HOFFMAN AND
VANESSA STEVENS

credit for the first time to prequalify for work on public projects.

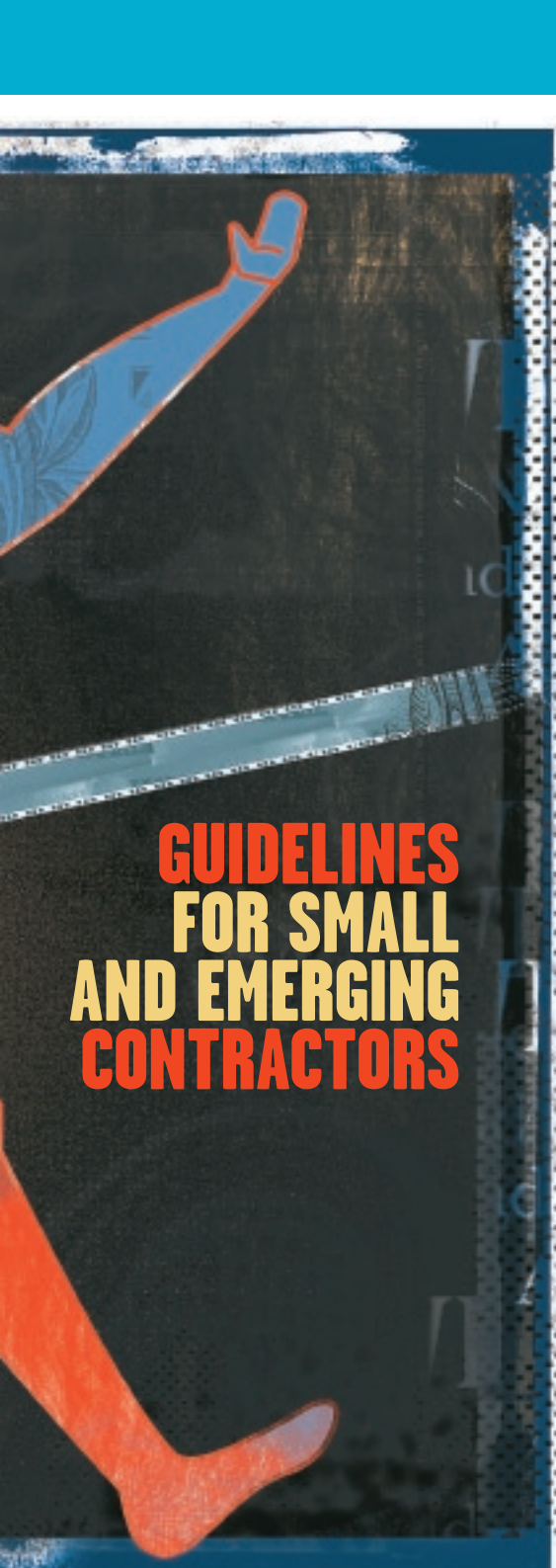
COMMIT TO THE PROCESS

William Maroney, senior vice president of City Underwriting Agency, Inc., Lake Success, N.Y., says small, emerging contractors seeking to become bonded for the first time need to commit to the process.

"First, ask yourself if you are committed to being a solid businessperson in the

construction community," Maroney says. "If so, then utilize set-aside programs to help build credit, such as the U.S. Small Business Administration (SBA) and others in your community. View these programs as stepping stones, not crutches. Your goal is to establish yourself as a qualified, capable construction company. Also, surround yourself with solid professionals familiar with the construction industry, such as accountants and bankers."

LAUGHING STOCK/CORBIS



GUIDELINES FOR SMALL AND EMERGING CONTRACTORS

(The National Association of Surety Bond Producers can help find these professionals and guide contractors through the entire process. A directory of bond producers is available at www.nasbp.org.)

After 20 years of working with groups that help small and emerging businesses in his community, such as the New York State Small Business Development Center at Farmington State College and the Model Contractor Development Program

created by The Surety & Fidelity Association of America, Maroney is familiar with the characteristics of successful business owners. "I'll walk into a seminar with 15 people in the audience, and two will come up to talk with me afterward to ask for specific details," he says. "They're the people who have the best potential for reaching their goal. It may take time, but if they commit, they can do it."

Adds Etemadi: "We frequently tell our clients that although we're providing a piece of paper, we're really providing an opportunity for the contractor to bid on projects that they haven't been able to bid on in the past."

David Castillo, first vice president of Alliant Insurance Services, Inc., Las Vegas, emphasizes the importance of taking the time to prepare complete financial documentation for surety credit. "I equate it to the construction process," Castillo says. "Contractors wouldn't try to bid on a project without the blueprints and specifications. Submitting complete financial paperwork about your company is critical to obtaining surety credit."

Seek help preparing this documentation from professionals in the surety industry, such as bond producers and construction-oriented accountants and bankers.

Thomas Padilla, vice president of Manuel Lujan Agencies, Albuquerque, explains that while working capital and net worth are important, they are not the only considerations. "In today's economy, we must consider many other factors, including the level of debt (and its relationship to net worth), the level of overhead a contractor carries and the existence of a well thought-out plan (including contingencies) for the future," Padilla says. "The first two are critical, as they will have a direct bearing on the contractor's ability to adjust to the changing economy and survive with less work and lower gross margins. The third shows me the contractor has spent time analyzing its operation and the market as it relates to the company, rather than just bidding and hoping for the best."

Etemadi suggests contractors obtain a copy of their credit report immediately. "If you've never attempted to get a bond before, you want to know what your credit looks like before anyone else does," he says. "Do this before you put time and effort into a bid."

HIRE A CONSTRUCTION CPA

John Naso, vice president of surety services for The Horton Group, Orland Park, Ill., recommends contractors partner with a quality certified public accounting firm that knows the construction industry. Also, the CPA should understand the terminology of a construction company's financial documentation, and the proper presentation and disclosure that banks and sureties expect, such as work in progress and completed construction schedules.

Naso encourages contractors to seek recommendations of CPAs from various sources, such as bankers, bond producers and local chambers of commerce. He suggests choosing a CPA firm that is nearby so the accountant can review the company's accounting software and perform quarterly documentation in person.

"Interview several accounting firms to determine which one is the best fit for your team of professionals and who will help you obtain surety credit," he says.

(Construction-oriented CPA firms can be found in the Associate Directory at www.nasbp.org, or by contacting the Construction Industry CPAs/Consultants Association, www.cicpac.com.)

"CPA-prepared financial statements are not cheap, but usually the cost of a statement is immediately offset by the difference in your bond rate or in your increased bonding capacity," Etemadi says.

GROW THE COMPANY

Contractors should take steps to increase their line of surety credit over time. "The best thing about growing through increased bond capacity is that the growth is overseen by multiple parties," Etemadi explains. "When a surety company approves a contractor, the underwriter frequently makes recommendations for continued growth, like securing a line of credit with a bank or securing a CPA-prepared financial statement. The contractor builds a 'circle of trust' with several outside professionals who all want to see the contractor succeed."

"As they take these steps, they continue to have that oversight to ensure they are growing the right way," Etemadi says. "For example, the CPA's financial statement for the firm contains job schedules showing the projects that are in progress and those that have been completed. Based on this information, the surety could approve

a larger project because the paperwork demonstrated the contractor's success. Consequently, the banker may increase the contractor's line of credit."

COMMUNICATE REGULARLY

Carl Dohn, president of Dohn & Associates, Palatine, Ill., emphasizes that contractors must maintain open, honest communication with the team. "Do not misrepresent anything. Do not overstate anything," he says. "The only way an experienced producer can accurately represent a contractor's ability to a surety underwriter is if it really

knows what is going on at the contractor's operation."

"It's important," Padilla adds, "for a contractor to communicate bad or potentially bad news quickly and accurately. In turn, producers and sureties need to share good and bad news with contractors to be true advisors. With today's technology, it's tempting to use only email and assume we're all on the same page, but nothing surpasses personal communication. If contractors want their producers and sureties to stay with them through tough times, they need to communicate their plans for the

future and what adjustments have been or will be made to ensure the continued survival of the firm."

McMahon notes that another key to good relationships is an open dialog and a commitment to meet with the surety regularly to build that relationship.

BECOME A SUCCESS STORY

The SBA's Bond Guarantee Program helps contractors secure bonding that may not meet the requirements of the standard market. For example, Construction Bonds, Inc. helped a mechanical contractor that had



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It's important for a contractor to communicate bad or potentially bad news quickly and accurately.

worked as a subcontractor for three years secure a bond through the SBA in order to pursue prime contracting opportunities.

"Within one month of working with him, the client won his first contract, and the agency bonded it through the SBA for approximately \$500,000," Etemadi says.

After helping the client bond two projects through the SBA, Construction Bonds Inc. graduated the firm into the standard market by helping the firm obtain a CPA-prepared financial statement that was vital in securing a line of credit with a bank.

Ultimately, Padilla adds, "small firms are not that different from larger ones. The key is that all parties listen and cooperate."

Kathy Hoffman is communications director and Vanessa Stevens is grassroots/communications coordinator for the National Association of Surety Bond Producers. For more information, visit www.nasbp.org.



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YEAR



BY LENORE MAREMA AND LARRY LeCLAIR

The surety community, represented by The Surety & Fidelity Association of America (SFAA) and the National Association of Surety Bond Producers (NASBP), is pursuing legislative and regulatory changes that will benefit the contractor community and potentially undo the damage of recent, ill-advised decision-making in Washington, D.C.

FEDERAL ACTIVITY AFFECTING CONTRACTORS

Earlier this year, the Federal Acquisition Regulatory (FAR) Council increased the performance bond threshold in the federal Miller Act from \$100,000 to \$150,000. This change implements a 2006 law under which all thresholds in the federal procurement law must be increased periodically to reflect changes in the Consumer Price Index. This dramatic increase, mandated under Title 41 (Public Contracts), will expose contractors, subcontractors and suppliers to greater risk of nonpayment. It also allows contractors that may not qualify for bonding to bid on and obtain federal procurement projects—leaving taxpayers, subcontractors and suppliers unprotected.

The surety industry submitted comments to the General Services Administration opposing the FAR proposal. The industry also has been working with Congress to exclude the Miller Act from this automatic threshold increase, similar to how Congress exempted the Davis-Bacon Act to protect the payment of wages to laborers on federal projects. New legislation will be required to prevent this type of increase in the future.

The U.S. Small Business Administration's (SBA) Surety Bond Guarantee Program is designed to benefit contractors that otherwise would be unable to obtain surety credit in the standard market. A few enhancements were made to the program in the economic stimulus package to



ROY SCOTT/IMAGES.COM

REVIEW

ECONOMY AND FISCAL ISSUES TOP 2010 AGENDA

increase the contract size guaranteed by the SBA from \$2 million to \$5 million, and to give the SBA more flexibility in settling claims under its bond guarantees. While these recent changes were set to expire Sept. 30, efforts are under way to make these reforms permanent through a small business bill the Senate is expected to consider soon. The surety community has alerted its members to provide grassroots in support of this effort.

The surety industry has a more comprehensive package of legislative amendments to the SBA Bond Guarantee Program that would make it work better for contractors, sureties and agents alike. Again, the economy has been a factor in getting these amendments into a bill in Congress.

Small and emerging contractors also should be aware of pending legislation (H.R. 3771) that would give them a greater opportunity to compete in the construction industry. The bill would amend the SBA Act to create grants up to \$15,000 for women-, minority- and veteran-owned construction firms to obtain funds to hire professional legal, accounting and other services. It also would establish a freestanding educational program to provide grant funds to colleges, universities, vocational/technical schools, community colleges and business leagues or not-for-profit entities to develop and administer a small business construction executive business and risk management curriculum in conjunction with local professionals, such as accountants, attorneys, risk management experts, financial experts/bankers, surety bond producers, and local professional and trade associations.

The surety industry continues to advocate for additional support for H.R. 3771, as it will benefit small business owners who may lack the formal training, knowledge and resources needed to run a successful construction company. Programs such as

this, which require new expenditures, are being met with opposition in Congress due to fiscal concerns.

STATE ACTIVITY AFFECTING CONTRACTORS

For the second year in a row, state legislatures were focused on addressing budget deficits. States struggled to make ends meet with revenues still below pre-recession levels and costs increasing for state functions and services. Much of the surety legislation that affects contractors was related to state budget woes.

Bond threshold increases and bond waivers were key issues for contractors and their sureties in 2010. Two highly visible bills were a bond threshold increase in North Carolina and a bond waiver issue with the Mass Transit Authority (MTA) in New York.

The North Carolina bill started out as legislation to increase the bond threshold from \$300,000 to \$500,000 for construction at the University of North Carolina. The bill was amended to apply to public projects of state departments and agencies as well. The final bill requires projects that are let without a performance bond or payment bond to be monitored to determine the number of defaults on those projects, the cost to complete the defaulted projects and each project's contract price.

Raising the bond threshold to \$300,000 several years ago did not have the intended result of increasing small business participation, and neither will the increase to \$500,000. When the issue arises again, the surety industry expects to have quantitative data to demonstrate that the threshold

increase unduly exposes contractors to the risk of nonpayment and taxpayers to greater costs to complete public construction projects.

Similar legislation to increase the bond threshold for New York universities was removed from the state budget bill and did not pass as a standalone bill either.

As originally drafted, the MTA legislation in New York would have allowed the transit agency to waive a number of requirements for public contracts including the bid, payment and performance bond requirements of the state's Little Miller Act for small contractors that participate in its mentoring program. The bond waivers were removed from the bill before it passed, so the MTA will provide "bonding assistance" to small and emerging contractors. The devil will be in the details for whatever "assistance" program the MTA develops.

Highly successful models already are in place in the state: The New York Bonding Initiative is responsible for more than \$67 million in new bonding or increased bonding capacity for small and emerging contractors, and the New York Dormitory Authority has a new bonding education program for small contractors. The New York Bonding Initiative was implemented through SFAA's Model Contractor Development Program (MCDP), and the Dormitory Authority program contains key elements and concepts from the MCDP.

Legislation to increase the state bond thresholds in Hawaii, New York, Oklahoma and Tennessee failed to pass. A late-session bill introduced in New York would have increased the bond threshold from \$100,000 to \$150,000 for contracts subject

to the Wicks Act, and from \$100,000 to \$300,000 for contracts not subject to the Wicks Act. The New York and Tennessee bills would have required periodic increases in the bond thresholds for inflation. The bond threshold already is set to increase in Wisconsin due to a law requiring bonds to be subject to indexing every two years in relation to changes in construction costs.

If the federal bond threshold law is not amended, expect more state legislation to increase state bond thresholds periodically with the Consumer Price Index. A carry-over bill in South Carolina to increase the bond threshold failed last year and did not move this year. A bill in Oklahoma that would have permitted waivers of bid bonds also did not pass.

Regarding construction projects, Mississippi allows rental and lease equipment dealers to make claims under the payment bond. Similar legislation failed to pass in Louisiana, but can be expected to gain approval in other states in the near future.

Florida, Kansas and Oklahoma limited retainage in public contracts to not more than 5 percent; a similar measure failed to pass in Kentucky. In Arizona and Kansas,

bills failed to pass that contained provisions under which no retainage would be withheld if payment and performance bonds were in place. The Arizona bill would have limited retainage to 3 percent.

Retainage in private contracts surfaced as an issue, as states that currently regulate such contracts sought to reduce the amounts required to be withheld. Such legislation could spill over into retainage on public contracts. Connecticut lowered retainage in commercial contracts from 7.5 percent to 5 percent. Legislation failed in Colorado that would have mandated the release of retainage on public and private contracts based on early substantial completion or occupancy.

Legislation permitting public-private partnerships (PPPs) peaked last year, but interest continued into 2010 as state budget problems persisted. As in the past, such legislation raised issues of less than 100 percent bonding and use of other forms of security. A new Maine law requires the construction portion of any PPP to be bonded. A PPP bill passed in Illinois for the construction of one specific highway. However, PPP legislation failed to pass in Florida, Hawaii, South Carolina and

Tennessee, and a PPP bill still is pending in Michigan that would allow a letter of credit in lieu of bonding.

More PPP legislation is expected in 2011 as states struggle to find funding to undertake needed infrastructure projects. (See related article, p. 20.)

States ran out of money for state bond guarantee and technical assistance programs this year. A technical assistance bill was vetoed in Hawaii, and bills to create a state bond guarantee program in South Carolina and Tennessee failed to pass. A state bond guarantee fund bill is pending, but not likely to be enacted, in Pennsylvania due to a \$5 million appropriation it contains.

There is renewed interest in immigration legislation with the passage of the Arizona bill; however, bills failed in Indiana, Virginia and Wisconsin that would have required contractors to verify the information of newly hired employees through the federal E-Verify system.

No comprehensive immigration solution is in sight from Congress. Contractors and their sureties will have to monitor any legislation for Draconian penalties. Terminating a financially sound and well-performing contractor does not benefit the state or its taxpayers. More reasonable penalties can achieve the purpose of this legislation.

Finally, a significant number of bills addressed bid preferences for either local contractors or small and emerging contractors. In some cases, these bills were intended to get federal stimulus money to local contractors and to otherwise benefit the local job market. Kentucky gave resident contractors a preference this year, and Michigan did the same for service-disabled veteran-owned contractors. Legislation failed in Hawaii, Idaho, Illinois, Indiana and Rhode Island for resident contractors, and similar legislation for service-disabled veterans failed in Indiana. Bills are still pending in California, New Jersey and Pennsylvania.

Lenore Marema is vice president of government affairs for The Surety & Fidelity Association of America. For more information, call (202) 778-3637 or email lmarema@surety.org. Larry LeClair is director of government relations for the National Association of Surety Bond Producers. For more information, call (202) 686-3700 or email lleclair@nasbp.org.

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Diversity Partnership Moves Ahead

BY SAM CARRADINE

**SURETY INDUSTRY AND U.S. DOT
INCREASE ACCESS TO BONDING FOR
TRANSPORTATION PROJECTS**

In March, The Surety & Fidelity Association of America (SFAA) and the U.S. Department of Transportation (DOT) Office of Small and Disadvantaged Business Utilization entered into a memorandum of agreement to assist the DOT in designing, developing and implementing a Bonding Education Program (BEP) for small and emerging contractors specializing in the maintenance, rehabilitation, improvement or revitalization of the nation's various modes of transportation.

Based on the SFAA's Model Contractor Development Program (MCDP), the BEP provides bonding education, technical assistance and placement to small and disadvantaged businesses that are competing for, or have been awarded, transportation-related contracts.

The BEP has two major components. The educational workshops offer an introduction to intake and logistics, construction accounting, estimating and project management. Each workshop is designed to provide information that will improve contractors' operations and make it easier to be bonded or increase bonding capacity. A closing workshop focuses on networking and next steps.

The bond readiness component consists of one-on-one interactions with surety bond producers, underwriters and other professionals who work with the contractors on a case-by-case basis to assemble the materials necessary for a complete bond application, conduct bond readiness assessments, and develop tailored prescriptive measures to address any omissions or deficiencies that might deter the successful underwriting of a bond.

The SFAA has received commitments of participation from several of its member surety companies, which are instructing their regional offices and appointed brokers/agents to aggressively identify, support and ultimately underwrite participants in the BEP. In addition, these underwriters and brokers/agents are voluntarily participating in the educational workshops and bond readiness activities. In addition to contacting individual member companies, the SFAA is coordinating volunteer outreach activities with the National Association of Surety Bond Producers and is working with local surety associations in three pilot locales.

To participate in the BEP, a contractor must be a small, disadvantaged, and/or women-owned business within the definition established by the federal or state DOT (and certified as such by the state); must have been in business for a minimum of two years; and must be interested in securing initial bonding or a bonding limit increase. In addition, the business owner must demonstrate commitment to follow through with the entire initiative, including attending the education and training workshops and assembling the documentation needed for a bond readiness assessment.

The BEP is offering the educational workshops and bond readiness activities in a pilot effort utilizing the DOT network of Small Business Transportation Resource Centers (SBTRCs). The DOT enters into cooperative

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agreements with community-based organizations, transportation-related trade associations, colleges and universities, and chambers of commerce to establish SBTRCs on a regional basis. The SBTRC offers a comprehensive delivery system of business training, technical assistance and dissemination of information targeting transportation-related small business enterprises in each region.

Three pilot initiatives were launched this year in Chicago, Dallas and Atlanta. Currently, more than 50 contractors at these locations are engaged in educational

workshops and one-on-one counseling sessions with volunteer surety industry professionals.

The pilot locations were selected, in part, because of upcoming contracting opportunities. For example, in Chicago, the SFAA is partnering with the Great Lakes Small Business Transportation Resource Center, which is run by the Hispanic-American Construction Industry Association. Chicago is in the early stages of a \$3 billion Chicago Region Environmental and Transportation Efficiency Program, for which a significant portion of work

will go to small and emerging contractors that can demonstrate the requisite levels of experience, financing and bonding.

The Dallas/Ft. Worth area expects to undertake several billion dollars of light rail, intermodal and highway work during the next five years. SFAA's partner in Dallas is the Gulf Region SBTRC, run by the Greater Dallas Hispanic Chamber of Commerce. In addition, the Texas Business Opportunity Development Program at Cedar Valley College is providing 30 continuing education credits to contractors that complete the program's educational workshops. At the conclusion of the first round of workshops, 21 certificates of completion were awarded and several of the contractors are awaiting approval of bonding applications made under the program.

In Atlanta, the city began the \$2.8 billion Belt Line project, a 22-mile rapid transit loop that will connect the downtown area with all of its surrounding suburbs. SFAA's SBTRC partner in Atlanta is the Mid-South Atlantic Small Business Resource Center, run by the Greater Atlanta Economic Alliance.

During the past several years, the SFAA has played an active role in diversity nationwide by educating small, minority and women-owned contractors on how to obtain surety bonding or increase their bonding capacity, and by providing technical assistance and program resources to state and local governments in the areas of contractor development and bonding support. The SFAA MCDP has been implemented in several state and local jurisdictions throughout the country, where it has been highly successful in qualifying contractors to participate in the public construction bidding process.

In addition to the DOT BEP effort in the pilot cities, major SFAA-sponsored bonding assistance initiatives are under way in New York, Mississippi, Texas, Rhode Island, New Jersey, Ohio, Maryland and the District of Columbia. To date, several hundred contractors have participated in these programs, and more than \$120 million in bonding can be attributed directly to these MCDP initiatives.

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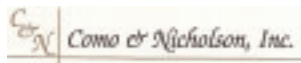
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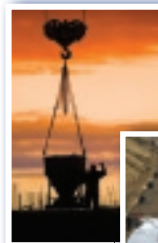
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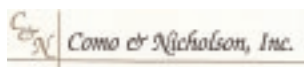
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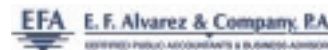
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