

In a tight but improving surety market...

HOW CAN CONTRACTORS IMPROVE THEIR BONDING CAPACITY?

Construction contractors, even while project owners are requiring more bonds for more projects, continue to confront a surety industry made conservative by several straight unprofitable years.

The insurance industry endured unprecedented challenges in the opening years of this decade, with a sweeping effect on surety policies. (Although surety bonds aren't insurance, they're often issued by insurance companies, and 80 percent are reinsured.)

A sharp rise in construction failures, a \$40 billion bill for the 9/11 attacks, and the spectacular bankruptcies of Enron, K-mart, WorldCom and other companies all combined for a heavy toll on insurers and sureties. Bond underwriters overall lost money every year between 2000 and 2004.

One result of these costly events was a sharp consolidation in the reinsurance and surety markets. Another was a new strictness in the way surety providers look at construction companies and classify bond requests. Essentially, the sureties' definition of acceptable risk narrowed.

But now surety losses are shrinking, and signs of a turnaround are mounting. The overall direct loss rate — the total amount the sureties paid out in losses as a percentage of the premiums they collected — declined to 37 percent by early 2005 after soaring to 83 percent in 2000. If the trend continues, contractors can expect to see surety companies easing their requirements somewhat. One early sign of such leniency is the increase in the number of secondary surety companies offering more flexible terms and conditions than the larger players.

A softer surety market will affect construction companies differently. Some contractors who have found it hard to obtain sufficient bonding may see new flexibility on the part of sureties. If such firms can stabilize their businesses through better practices, smarter allocation of resources and more accurate measurements, they should be able to obtain higher bonding limits and compete for more bonded work.

On the other hand, when bonding becomes more accessible, bonding capacity will provide less of a competitive edge than it presently does. A well-run firm that can obtain adequate bonding today should make full use of this temporary advantage.

KEY INDICATORS SURETIES WATCH

Contractors face widespread bonding requirements today. Not long ago, only the federal government required construction bonds; today, around a third of privately owned projects do so. With tighter budgets governing projects everywhere, owners want stronger protection against contractor default.

Some construction companies face the challenge of establishing a surety line from scratch, while others seek to maintain or increase their limits. Regardless, every contractor should be aware of the main indicators that interest surety companies.

Profitability

With so many construction companies doing well today, why should a surety risk a bond for an unprofitable one? One bad year can sometimes be explained, but a construction company that loses money two years running, even if its net worth is respectable, raises a red flag in today's surety market. Build up a sizeable reserve fund in the event of a bad year or a bad job.

One step a contractor can take to improve profitability is to decrease bonuses and control overhead costs. In turn, improved profitability increases stockholders' equity, and the larger a company's stockholders' equity, the easier it is to obtain bonding capacity and potentially less expensive bonds.

Net worth and working capital

Surety companies take a hard look at a bond applicant's net worth. They generally discount assets that include risk, like aged receivables and inventory.

Sureties also look at how assets are allocated. A contractor may show a strong bottom line, but if its capital consists almost entirely of equipment and fixed assets, can it really fund a job? If such a company's cash and credit line were to dry up, it couldn't simply sell equipment to pay wages and other job costs, because then it couldn't do the job at all.

That's why a surety company likes to see contractors with strong working capital (defined as current assets minus current liabilities). Current assets include cash, receivables under 90 days and some inventory — assets that can likely be turned into cash within a year — as opposed to property, plant, equipment and other long-term resources.

Working capital gauges a firm's ability to finance its operations and indicates the level of protection creditors and surety companies can expect when they underwrite the firm's operations.

ARE YOU BOND-WORTHY? CAN YOU PROVE IT?

Before a surety company agrees to write a construction bond, it pre-qualifies the contractor. After it writes a bond, the surety monitors the contractor's performance. Here are some of the main documents surety underwriters use to measure a construction firm's strength.

Financial information

- Annual financial statements prepared by an accountant who understands construction. These financial statements must include your balance sheet, statements of income and cash flows, equity reconciliation, accounts receivable and payable, and overhead expenses. Also include schedules of completed contracts and projects in progress.
- Current tax returns.
- Schedule of equipment.
- Personal financial statements for company owners. Financial interactions with the company are particularly important to detail.

Company information

- An organizational chart showing employees and responsibilities.
- Resumés of principals and key employees.
- Description of the firm's cost accounting system, showing its integration into general ledger and how the job costing procedures operate.
- Management policies and controls for monitoring job performance.
- A business plan summarizing the firm's specialties, markets and prospects for growth and profitability.
- A business continuation plan, explaining any buy-sell agreements and plans for continuity if the owner dies or becomes disabled.
- References. Minimally, provide contact information for owners, subcontractors, suppliers, architects and engineers on previous projects. Letters of recommendation are even better.
- Completed *Contractor's Questionnaire*, published by the National Association of Surety Bond Producers (NASBP), or *Contractor's Qualification Statement*, published by the American Institute of Architects (AIA).

Banking and insurance information

- Bank letter, showing history of relationship and balances.
- Evidence of a bank line of credit. For a surety, this is the best demonstration of a strong banking relationship with good borrowing ability, especially if it's unsecured or secured only against long-term assets.
- Certificate of liability insurance.

Job information

- Contract.
- Bid results.
- Subcontract or purchase order forms.
- Job history.

In assessing a contractor's working capital, a surety will discount 30 percent to 50 percent of inventory. It won't recognize prepaid expenses or officer or shareholder receivables.

Strong net worth combined with weak working capital is common, particularly for contractors like road builders with heavy investment in equipment. Sureties were once more flexible in bonding such firms, but most now insist on an adequate level of working capital.

While a surety looks for evidence that a contractor can complete a job, it's also preparing for a bad outcome. If the bond is called, the surety intends to recover its losses with claims against the contractor's assets, and it makes sure beforehand that there are assets at the ready.

Cash flow

Maximizing your cash on hand is a key to increasing your bonding capacity. Most surety losses are the result of a contractor's cash-flow failure. Given cash or lending resources, most contractors can finish most jobs, even though they may take a loss. What stops them is a shortfall of cash and credit — in which case the surety must either step in and finish the contractor's work, pay the contractor's subs and suppliers, or both.

Cash flow isn't just money in the bank; it's also borrowing ability, so a strong line of credit with a bank is a plus. But keep in mind that interest-bearing debt — a fixed cost which must be serviced even if the market slows — is an unfavorable liability in a surety's eyes.

A surety may use the following formula to calculate free cash flow: net income plus depreciation, amortization and other non-cash items, less principal payments on debt. If this number is small and the balance sheet shows that the company is highly leveraged, the surety may reduce the bonding capacity of the contractor because of a concern about the entity's ability to fund its debt service.

Work-in-process (WIP) calculations

Surety companies prefer to underwrite contractors who operate with accurate WIP estimates and steady work. Without accurate estimates being reflected in the company's WIP schedule, the contractor will experience repeated gain or fade on job profitability for financial statement purposes. These gains or fades will cause the surety to question the contractor's estimating ability, which could have a negative impact on bonding capacity.

A profit fade means the contractor recognized profit too early and must pay for it later. After a surety company bonds a contractor based on a solid financial statement, it doesn't want to see losses showing up later. In fact, if one project manager has a habit of overly optimistic estimating, with resulting profit fades, a surety will notice his or her presence on a new project and discount the company's bond-worthiness accordingly.

A general contractor might anticipate completing a million-dollar job for \$800,000. If it incurs \$400,000 in costs the first year — 50 percent of the total — it will recognize 50 percent of the total contract price as revenue, or \$500,000. Accordingly, for that year, income minus costs produces a gross profit of \$100,000.

However, what if next year at job's end the contractor's total costs have mounted to \$900,000? Its total profit on the job is now only \$100,000 — which it has already recognized. The originally anticipated profit margin of \$200,000 has now faded to \$100,000, and the company will need to report this profit fade in the second year. Accordingly, the gross profit for year two will be zero, since 100% of the total profits on the job were recognized in the first year. In hindsight, the company should have only recognized revenue of \$444,444 in the first year (\$400,000 divided by \$900,000 times the \$1,000,000 contract amount) and the balance in year two.

Profit gains are less worrisome, and may merely register a firm's conservative projections. But a construction company's ability to accurately estimate work is critical, and steady WIP figures offer evidence of that strength.

A surety looks at charge rates, too. If a company charges a D8 bulldozer at \$125 an hour on one job and \$175 on another, a surety wonders why. The company's WIP figure may be undervalued if it's undercharging for equipment.

Overbillings and underbillings

The percentage-of-completion method for recognizing income is required for most construction companies. This calculation determines whether a contractor has overbilled or underbilled on a project.

Overbilling has advantages when a job is going well. An overbilled contractor is either managing cash well — working on the owner's capital instead of its own, saving money on interest — or building profit in the job that will show up as gain. But when a contractor is struggling, overbilling can indicate “job borrow” — using cash from one job to fund losses on another, which will show up eventually, too.

An underbilling means that a contractor has not billed the owner or general contractor enough based on the percentage of completion as reflected by the actual costs to date compared to the total estimated costs for the job. This could be a result of the billing cut-off as outlined in the contract. It may be an indicator that a job is less profitable than projected and that the gross profit could be overstated. Either way, underbillings can be a potential sign of poor cash management.

Whatever the cause, underbillings that reach 25 percent of working capital raise a warning to sureties, and the construction company should always be prepared to explain what caused them.

Accounting for change orders and claims

A change order that adds \$100,000 to a job can cause a contractor to recognize substantially more revenue. If the order was verbal, issued in the field in the rush to complete a job, and then the owner says it was never approved, the contractor may have recognized too much revenue, resulting in a profit fade.

Claims can raise concerns, too, particularly when a contractor approaches a new bonding agent. No surety is looking to pick up another surety's problems.

Claims are standard in construction, of course, and surety companies look at a company's experience over time. Still, a high number of claims going out or coming in may signal that a contractor has a history of problems with owners or suppliers. Generally, contractors shouldn't recognize revenue from their own claims against an owner until the claim is won. As for claims against the contractor, they represent liabilities that can reduce profit on the job.

Joint venture partners

When a contractor can't find sufficient bonding, it should keep working on the issues that are holding things up. Meanwhile, it might consider a joint venture.

Some contractors can increase their effective surety limits by leveraging the strength of another firm, usually a larger one, in a joint venture. A company with untapped bonding capacity has something of value to trade with a smaller company that's willing to pay fees or a share of profits for the opportunity to bid profitable work.

MAINTAINING THE BONDING RELATIONSHIP

Because the surety relationship is so critically important to the growth and development of your company, maintain a close relationship with your bonding company whether you seek to establish, grow or maintain your bonding capacity.

Get to know the surety company

What ratios and figures does it consider most important? What kinds of companies does it underwrite? Some mainly serve large contractors, while others specialize in new or smaller firms. You will establish a stronger relationship with a bonding company that tends to serve your type of company.

And get to know the surety's home office as well. A local underwriter may understand your underbilling strategy, but if the home office only sees figures on paper, and not the capable, trustworthy company that stands behind the figures, it may discount your worth.

Be a communicator

Schedule regular meetings — right after your yearly financial report is a good time — and keep up a flow of clear, well-presented financial information and job status reports.

Surety companies know that problems arise in construction projects; what they want is accurate and detailed information. So don't surprise a surety with bad news late in the game. If you see trouble brewing, bring your surety into the loop immediately.

Also, notify your bonding company of changes in your company, such as shifts in ownership or top management and forays into new markets or specialties.

Communication is a two-way process. While you're telling an underwriter about your business, listen closely. Surety companies want contractors to succeed on projects, and if a surety believes your firm might not succeed, understand why and address those issues in your business. The surety has real-world experience, and its reluctance to write a bond indicates real problems.

Ensure utmost integrity

A surety wants complete confidence in a contractor's integrity. Unjustified bonuses, questionable loans, powerboats on company accounts and well-paid relatives with vague responsibilities are all danger signs.

Also, no bond applicant should ever try to hide assets. If the worst happens, the surety will find those assets and take them, and bill you for the effort.

And remember, bonding companies don't just look at your bonded work. They view your entire backlog as potential risk. If you're losing money on a \$20-million unbonded project, why will you do any better on a bonded \$10-million job?

CONCLUSION

Preparing a company for bonding success is complicated — like the construction industry itself — and it requires a strong team. Seek help from a banker, a lawyer and an accountant who know the terrain, maintain close ties with the surety industry and know what the underwriters want.

Advisors like this will not only give you good advice, they'll also build the surety's confidence in dealing with your construction firm and smooth the way considerably.

Our accounting firm has extensive experience in helping construction companies increase their bonding capacity. We can work smoothly with your existing team or help you build a new one. If you'd like to discuss the surety environment and review your own situation, please contact us.