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11 STRATEGIES FOR BUILDING & MAINTAINING SURETY RELATIONSHIPS IN AN UNCERTAIN MARKET

This has been one of the most difficult surety markets since the Great Depression. Driven by the over exuberance of the late '90s, corporate malfeasance, and soft economic conditions, surety industry losses during the past four years have exceeded $7 billion.

Since 1995, at least eleven sureties have left the business or been acquired by other surety companies.

BY JAMES L. BLY & DAVID C. MOYLAN

The combination of these events has dramatically affected the construction industry. In the current surety environment, many contractors face:

- Changing underwriter relationships, and a shift in underwriting philosophies caused by attrition and consolidation.
- Co-surety relationships and the challenge of working with them.
- Back-to-basics underwriting that requires more cash and capital from contractors.
- Capacity constraints for large contractors with bond programs greater than $150 million.

Some segments of the construction industry, notably well financed small- and middle-market contractors, may have seen increased competition for their business. This results from an almost universal focus among national and regional sureties on bond programs and capacities that are less than $150 million.

As depicted in Exhibit 1, the surety in-dustry is a cyclical business. The contract surety business has experienced four consecutive losing years, and underwriters continue to deal conservatively with many contractors.

The Surety Association of America's mid-year results suggest that 2004 will be another losing year, which indicates that difficult conditions may continue for some time.

However, no matter what the contractor segment or how tight the market, the 11 strategies outlined here will assist in arranging, maintaining, or building surety relationships and capacity.

Strategy 1: Financial Reporting

Use a CPA firm that knows the construction business. Accounting rules are changing in the aftermath of Enron and the wave of other financial scandals; so, work with construction-oriented CPAs who: **1)** are current on disclosure issues, **2)** provide a product that meets the needs of banks and sureties, and **3)** have a reputation as a quality firm in the industry.

Maintaining Standards

Ask your CPA about the financial reporting implications of these and other new financial reporting standards affecting your company:

FIN 46

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51* (FIN 46) has new financial reporting rules for companies with multiple entities affiliated under common ownership that could include the requirement to consolidate these entities for financial reporting purposes as early as 2005.

At a minimum, increased footnote disclosure relating to the relationship and financial risks between the affiliates is required in 2004. (See "FIN 46: What Does It Mean for Contractors?" by Larry W. Filener in the May/June 2004 issue.)

SAS 99

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* (SAS 99) includes added auditing standards aimed at financial reporting fraud. (See "Contractor Fraud Alert" by Larry D. Van Horn and Jerry T. Henderson in the September/October 2004 issue.)

FAS 150

While the implementation of Statement of Financial Accounting Standard No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150) has been delayed for nonpublic companies, contractors may need to review their buy-sell agreements if FAS 150 becomes effective.

FAS 150 requires contractors with entity purchase buy-sell agreements to record the company's future liability to buy the stock under a buy-sell agreement without allowing future life insurance proceeds to fund the obligation as an asset. (See "FAS 150: Implications for Contractors" by Eric P. Wallace and Larry D. Van Horn in the November/ December 2003 issue.)

Quality Financial Statements

Surety companies prefer financial statements prepared by construction-oriented CPAs that include comparative year reporting, open and closed job schedules that reconcile to the income statement, a comparative schedule of SG&A expenses, and complete footnote disclosure. Ideally, footnotes relating to receivables include a breakdown of open and closed job A/R, retainages, and an aged A/R summary.

Banking arrangements should be fully explained, including the bank security and required guarantees, summary of financial covenants, and future maturity of debt beyond the current operating cycle.

Footnotes relating to claims and unapproved change orders need to provide as much detail as possible about the nature of these items, management's reporting of these items, and updates on the resolution of these matters during the time between the fiscal year-end and the issuance of the financial statements.

Sureties prefer internally prepared financial statements that include the same classifications and quality as the year-end statement to allow for accurate comparison to year-end reports. Internal reports that include budget projections and year-over-year results are also preferred. *Bonus points* are earned for reconciling job schedules as well as A/R and A/P aging reports with each internal financial statement.

Surety companies continue to see (and accept) financial statements of varying quality. However, the sophistication of the surety underwriting community continues to improve, and it is our opinion that contractors with the best financial presentations will be able to sustain the best surety relationships over time.

Strategy 2: The Balance Sheet

Surety companies base a contractor's surety program for the upcoming year on their evaluations of the contractor's year-end audit. CPA Review Financial Statements may be accepted if the contractor's sales are less than $10 million on average or if the financial statement lacks significant debt and demonstrates a high degree of liquidity.

Interim reports do not impact the surety program as much as the year-end financial statement (increasing or decreasing in capacity), unless there is a negative material change to the financial position. Most surety underwriters recognize the cyclical nature of construction and expect interim results to fluctuate based on the weather and other seasonal factors.

The Year-End Report

Because the year-end report provides the basis for the surety program, many contractors hold a year-end planning meeting to review their balance sheets.

Most contractors attempt to minimize bank debt by: **1)** accelerating receivable collection; **2)** decelerating payable disbursement, while maintaining payment record; and **3)** minimizing balances on officer, employee, or affiliate receivables at year-end.

It is common practice to minimize prepaid expenses by negotiating a premium payment plan, rather than carry a large prepaid item on the balance sheet that will not be allowed as a current asset. Several contractors also defer bonuses or other discretionary expenses.

If insurance premiums are financed, premium finance companies may be willing to include prepaid deductible deposits required for loss-sensitive insurance programs, eliminating the need for letters of credit or large, upfront cash deposits.

Percentage Cases

Working capital and cash are *the royalty* of the surety world. Today, most sureties try to hold GCs to a "5%" case, meaning the analyzed working capital is 5% of the aggregate surety program.

Specialty contractors may require percentage cases of 5-10% based on the cash needs of the operation. Heavy & Highway contractors are normally held to a net worth test of 5-7.5%, with working capital in the 5% range.

Sureties expect net worth for GCs and specialty contractors to be at least 5% of the surety program.

Disallowed Assets

Sureties are likely to disallow or discount the following current assets in their calculation of analyzed working capital:

- Restricted cash
- Receivables in dispute or over 90 days
- Related-party receivables
- Prepaid items
- Costs and Earnings in Excess of Billings that consist of unapproved change orders, disputes, or appear on projects that are substantially complete
- Deferred tax assets

Deferred Tax & Long-Term Liabilities

To cover shareholder tax liabilities, sureties may also impute a Deferred Tax Liability on S corporations that distribute earnings subsequent to the year-end.

Surety companies are not consistent regarding their treatment of revolving bank debt. Sureties may allow a two- or three-year revolver to be treated as a long-term liability, as long as the contractor complies with its bank covenants and the maturity of the revolver is beyond the current operating cycle. (This can be the case even if the only security for the revolver is the contractor's current assets.)

Ask your surety how it analyzes your company's financial statements and be prepared to address any of its concerns.

Strategy 3: Work-In-Progress Report

Surety companies focus on underbillings because of their experiences with contractors reporting significant write downs as a result of inflated profits carried in the financial statements under the Costs and Earnings in Excess of Billings accounts (as recorded under PCM accounting rules).

Profits may be overstated as a result of including unapproved change orders in the contract value, unforeseen profit fade, or overly optimistic cost-to-complete calculations. Review the scenarios below from the surety's perspective:

Scenario 1 – Inflated Underbilling

Contract Price	$1,200,000
Estimated Total Cost	900,000
Estimated Gross Profit	300,000
Cost to Date	450,000
Revenue Earned (50% of Contract Price)	600,000
Billed to Date	500,000
Costs and Earnings in Excess of Billings	$ 100,000

Scenario 2 – Accurate Underbilling

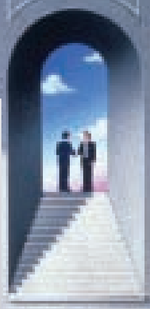
Contract Price	$1,200,000
Estimated Total Cost	1,100,000
Estimated Gross Profit	100,000
Cost to Date	450,000
Revenue Earned (40.9% of Contract Price)	491,000
Billed to Date	500,000
Costs and Earnings in Excess of Billings	$ (9,000)

The scenarios are the same, except job profit is overstated by $200,000 in Scenario 1. The difference in estimated gross profit changes the underbilling status from a $100,000 current asset to a $9,000 overbilling recorded as a current liability. If the contractor's net worth position under Scenario 1 were $400,000, it is reduced to $291,000 under Scenario 2 – a 27% reduction in equity, despite the fact that the job remains profitable overall.

Job Profit Comparisons

Surety companies perform job profit comparisons of WIP reports over time to determine whether there is a trend of profit fade.

If a contractor historically reports profits at the beginning of the project that are materially greater than profits at the end,



a surety will recalculate the WIP revenue earned based on the historical completed job margins, which reduces the "allowed" working capital and available surety capacity.

Or, a surety may simply require a higher percentage case for the surety program for contractors with a history of profit fade.

In contrast, a contractor who carries large underbillings and has a history of consistent or increasing margins throughout projects may not encounter any problem with the surety's program analysis if there is a sound explanation for why these items exist.

Examples would include legitimate unapproved change orders, timing differences, the inability to bill for materials in fabrication or for stored materials, and front-loaded costs that are spread throughout the project's billing cycle. Material underbilling balances that exceed 30% of the net worth or appear on projects that are 50% complete or greater are red flags for the surety.

Calculating Surety Capacity

Surety companies also use the WIP report to calculate a contractor's surety capacity. Because the surety's credit decision is based on the financial resources available to finance total backlog, maximum surety capacity is typically based on the contractor's total backlog. Here is a summary of how surety capacity is normally calculated:

	Cost-to-Complete on all bonded and unbonded projects from most recent WIP report	$80,000,000
+	New jobs added since last WIP report	15,000,000
+	Pending bids	7,500,000
–	Runoff since last WIP report	20,000,000
=	Surety capacity used	$82,500,000

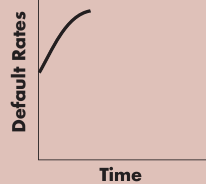
Surety companies will normally exclude T&M projects and Agency CM work from backlog calculations and only include the contractor's share of a joint venture when calculating the surety capacity used.

Sureties may also allow for additional runoff for the time between the bid date and the contract's start date. Sureties will not normally exclude bonded subcontractor cost-to-complete from their calculations; however, they will take comfort and offer flexibility, knowing that a portion of the cost-to-complete is subcontracted and bonded.

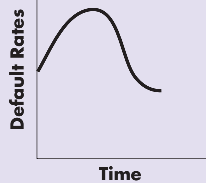
To determine projected profitability during the next 6-12 months, sureties use the WIP report to compare the revenue and remaining gross profit to the annual overhead projection. Sureties will be concerned by contractors who cannot cover more than 6 months of overhead with

Exhibit 1: Stages of the Surety Cycle

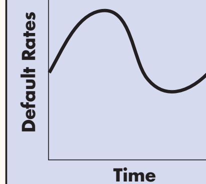
- Sureties are exposed to major credit losses, which often come as a surprise.
- Many sureties reduce or stop bonding.
- The reinsurance market tightens and many underwriters leave the business.



- Macroeconomic trends show clear improvement.
- Bonding policies of most sureties remain "tight."
- Surety results "lag" behind economic recovery by 12-18 months.



- Booming economy leads to good times.
- Sureties start to loosen up their credit underwriting policies.
- Reinsurance rates are reasonable.



- Economic boom comes to an end and leads to an increase in default rates.
- Default rates first rise in the lower-tier accounts and later across-the-board.
- Sophisticated sureties have reduced risk exposure through new risk strategies and increased market share.

their remaining gross profit, unless a game plan exists for the immediate acquisition of work or a reduction in overhead is contemplated in the near future.

Contracts with gross profits significantly above or below historic averages will be under close scrutiny and will require explanations. Sureties may also be concerned if B/C+E on bonded jobs is excessive, since overbillings erode the surety's collateral base if the surety is required to complete any bonded projects.

A Little Communication Goes a Long Way

As we've seen, the WIP report is a key ingredient in the surety underwriting process. Prior to sending any WIP reports to their surety, contractors should earmark projects with large underbillings, claims, profit fades, or slow receivables and prepare explanations for any unusual items. Taking a proactive approach and explaining perceived problems on the WIP report is the best way to instill confidence and trust with your surety broker/agent and carrier.

Strategy 4: Business Plan

A surety often asks a contractor about its business plan. Contractors without formal, written business plans should, at a minimum, be operating from an annual budget that includes revenue, gross profit, and annual overhead projections with a comparison of actual to budgeted amounts for each internal interim financial statement.

Backlog

A surety is also interested in: **1)** how much of the budgeted gross profit is covered from existing backlog and **2)** how much additional work is required to meet budgeted projections. The surety may inquire about the contractor's market for the next 6-12 months, how much work is available, and the contractor's historical hit ratios for obtaining work.

For instance, if a contractor needs an additional $20 million of work to cover its annual overhead and has a hit ratio of 20%, then the contractor may need to bid or make sales presentations for $100 million in new work. If this amount of new work is not available or achievable, then the contractor may need to adjust its overhead accordingly.

Future Plans

Contractors should also be prepared to discuss their competitive advantage in the market and explain why they will be able to sustain their hit ratios at their projected gross margins. When contractors consider an expansion into new territory, the surety will want to review a plan that includes a sound rationale for the expansion.

A surety is more likely to support such an expansion if it accommodates the construction needs of a familiar customer or GC in a new territory. When entering a new market through a joint venture with a local contractor, complete knowledge of the labor market and use of familiar subs or the bonding of subs will make a surety more comfortable with the expansion.

Strategy 5: Continuity Plans

Many surety obligations extend up to four years or more. (Bonds on projects with a two-year duration may include a two-year period to file suit for faulty workmanship or materials.) For this reason, sureties want detailed plans in the event of the death or disability of the owners or key company personnel.

The surety will ask to review details of the buy-sell agreements, including provisions for funding the agreements, employment contracts with key personnel, and the qualifications of the management team being groomed to replace key contributors in the future.

Strategy 6: Project Review & Risk Analysis

Contractors should perform a complete assessment of the risks involved with large, unusual, or unique projects, and communicate the assessment results to your surety early in the process. Exhibit 2 shows many of the risks contractors need to analyze.

This is also recommended for joint ventures, which have added layers of complication in this market. Most surety companies have a list of acceptable co-sureties; but, be aware that the list of acceptable sureties, or the level of credit/capacity they can accept, can change.

In addition, contractors should plan for more *lead time* than in the past. Both local and home office surety underwriters are being required to review more information and provide more detailed analyses to obtain appropriate approvals.

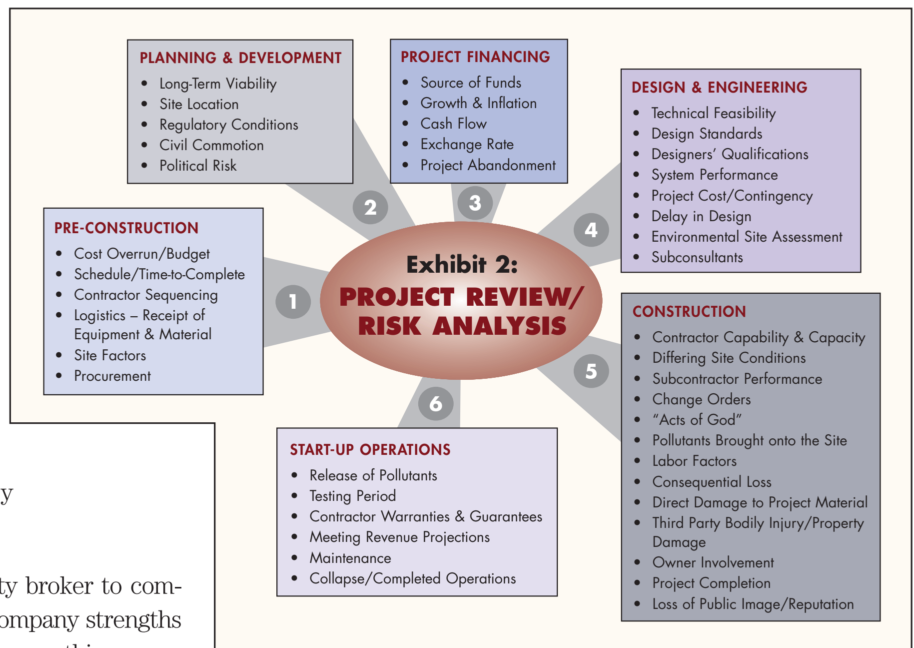
Strategy 7: Use Your Professional Surety Team

Use all of your resources (CPA, banker, legal advisor, and surety broker) to resolve surety issues and plan successfully. Remember, in the surety transaction, your surety broker is both your consultant and your advisor (assisting with problem solving and developing solutions), as well as your advocate with the surety markets. Therefore, it pays to ensure you have the right broker working on your company's behalf.

This is even more important when you have multiple sureties. Managing co-surety relationships takes experience, and inadequate representation can have a dramatic affect on your surety facility, so ensure you have the right team and resources.

Strategy 8: Benchmarking & Pre-Qualification

Benchmark your company's financial performance against peer companies to determine points of comparable strengths and weaknesses. Understand the key ratios and financial criteria on which surety companies focus.



Use your CPA and surety broker to compile a report assessing company strengths and weaknesses, and discuss this assessment with your surety.

GCs should also closely evaluate project owners and pre-qualify their subs. In turn, subs should pre-qualify their GCs. Doing business with the right people leads to success!

Strategy 9: Assess Your Surety

During meetings with your surety, ask about its bottom line results, reserve adequacy, and any legacy issues remaining on the books. The surety should explain its type of reinsurance program (pro-rata share, excess of loss, or combination of the two), and where your program fits into its current and future strategy.

Discuss acquisition plans, issues with rating agencies, and (if applicable) acceptable co-sureties. If concerns develop after these meetings, consider a backup surety relationship.

Strategy 10: Communicate & Build Your Relationship

The surety business is a relationship business. Surety underwriting is based on an objective analysis of your company and a subjective view of the organization and the people running it. So, it is imperative that you:

- *Meet regularly.* And, occasionally, vary the location: the surety, your home office, and the jobsite.
- *Communicate frequently.* Don't assume the surety understands your business, the issues your company faces, and/or the reasons for its successes or failures.
- *Avoid surprises.* Tell your surety about problems before your broker learns of it from other sources.
- *Use your surety carrier as a source of information.* It sees many contractors, and may have a solution to an issue that faces your company.

Your surety broker should play an active role in communication. Building this type of relationship takes time, but is worth the investment.

Strategy 11: Solve Tough Surety Placements

We estimate that as many as 30% of all contractors have lost bonding capacity during the last three years. With a restriction in surety capacity, many contractors find they are not able to bid bonded work under the same terms as in the past (or under any condition) because of tighter underwriting standards. A few strategies follow on how to gain approval on a challenging surety placement.

Provide Expanded Job Details

Include a breakdown of labor, material, subs, contingencies, buy outs, gross profit, job cash flow, and the impact the project will have on backlog and annual revenues. If necessary, prepare a projected backlog runoff schedule by project that reflects the revenues and gross profit expected from each job (including the new project) over the next two years.

If this projection keeps revenues within the business plan parameters, and there are such favorable factors as a prior relationship with the owner and a good fit between the nature of the work and the contractor's

expertise, the surety may support the request even if the project is substantially larger than any project completed in the past. However, any "stretch" project requires a thorough review of project risks and an analysis of the steps necessary to minimize those risks.

Work with the Owner

Ask the owner to buy the materials direct and reduce the contract price to an amount that fits within the surety program. The owner may also be willing to break the project into phases that can be bonded with separate bonds.

Another alternative: Ask the owner to accept a reduced bond amount if a substantial portion of the work is subcontracted and bonded. While a reduced bond amount will not reduce the surety bond cost (contract surety rates are usually based on the contract price, not the bond amount), an approval for a smaller bond penalty may be more easily attained from the surety.

Think Creatively

Here are another dozen potential solutions to a tough surety placement:

- *Get specific job collateral* (e.g., Irrevocable Letters of Credit) on a percent of the contract price.
- *Acquire specific job indemnity* from a third party (partial or limited dollar indemnity).
- *Consider funds administration* where the surety restricts the flow of funds on a project through a third-party administrator.
- *Investigate open or silent joint ventures*, which add indemnity, financial strength, and operating abilities to reduce the risk of default for the contractor and surety.

  Silent joint ventures normally allow an indemnitor to realize a share of the gross profit in return for the agreement to indemnify the surety.

  These types of arrangements are structured so that the indemnitor has access to books and records, control of funds, and takeover rights in the event of a default.
- *Bond subcontractors or purchase contractor default insurance* to minimize the risk of subcontractor failure.
- *Open a project specific line of credit* as a dedicated funding source for the project.
- *Capitalize a new company to perform bonded work* to eliminate legacy issues.
- *Improve working capital* through a loan and subordination, additional capitalization, or an increase in LTD.
- *Subordinate existing debt* to the surety.
- *Offer a UCC* to the surety on specific assets.
- *Structure an inter-creditor agreement* between the surety and banks to equitably share the collateral base.
- *Ring-fence the assets of a profitable subsidiary* so that any distributions or dividends trigger additional indemnity rights for the surety.

Summary

We believe the market is in the recovery stage. If the construction economy continues to improve, then we may see a softening of the market in late 2005. In any event, implementing the strategies previously discussed will allow your company to maintain and grow this very important credit source. BP

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