2006 SURETY MARKET OVERVIEW

SURETY INDUSTRY EMBRACES 21ST CENTURY CONSTRUCTION BOOM

BY MARC RAMSEY

In the late 1800s, "boom" described cattle towns that sprung up overnight along railroad routes. Today, the term boom is thrown around more readily. The Internet boom. A boom market. A booming economy. Baby boomers.

Is today's current construction industry really booming? Is a modern day Gold Rush taking place? Surety executives say they see an explosion in today's construction environment. And some believe "boom" may be an understatement.

Executives who work in all regions and construction markets across the country say the industry has been in a boom for at least six months, and it's likely to continue for some time.

CONSTRUCTION ENVIRONMENT

"The marketplace from a primary construction standpoint is growing faster than I've seen in my 33-year career in the surety industry," says Terry Lukow, executive vice president, Travelers Bond, Construction Services. "On average, our construction clients' backlogs are growing 20 to 25 percent, and that's across all disciplines in the marketplace."

Health care, manufacturing, power, lodging, office, amusement and recreation, highway and street, transportation, government-funded infrastructure—the entire construction marketplace is booming. Factor in the rebuilding of the Gulf Coast region and school, retail and environmental construction, and contractors see tremendous opportunities. "In our view, it is unrivaled by past economic performance by the industry," Lukow says.

Stephen Cory, president of the National Association of Surety Bond Producers (NASBP) and president of Cory, Tucker, & Larrowe Inc., adds, "When you look at the Gulf Coast and the overall health of the economy, there absolutely is a boom in the making. There's more to come. The only cautious point is overextension."

availability continuing to drive owners to look at all conceivable methods to control costs including labor.

"There are so many large projects and so much work available," says William Cheatham, president, Zurich North America Surety, "but that doesn't make the surety or construction markets easier. It changes the risk factors. There's a real balance trying to manage a commercial construction economic cycle that's booming."

So, how long will this construction boom last? Surety executives say at least a year and possibly as long as 24 to 30 months. "The read we get from our contractors is they are confident that their opportunities in the next 12 months will be similar to what they have acquired in the current year," says Dennis Perler, president, Liberty Mutual Surety.

CAPACITY AND AVAILABILITY

Surety executives agree plenty of surety capacity is available to handle the construction boom. Henry Nozko Jr., president, ACSTAR Insurance Co., says, "Most sureties are probably using less than their capacity. The sureties are being careful how they dole out that capacity."

For example, sureties are looking more closely at contract terms and conditions, such as onerous language, consequential damages, delay damages and hold-harmless obligations. "If owners and/or prime contractors have those provisions in the contract," Nozko says, "it will be a tough contract to

Construction activity has been strong so far this year. Many contractors are running at or near full capacity. The U.S. Census Bureau of the Department of Commerce reported that through August, the value of non-single family residential construction put in place was up 17.1 percent.

"There should be some additional questions regarding labor, supervision and commodity prices, such as fuel, copper and cement," says NASBP's Cory. "All will play into construction in the future as inflation creeps in."

According to James Lee, president and CEO, Old Republic Surety Company, open shop contractors will remain a strong force in the construction equation, especially with cost escalation due to materials bond. If they have a fair contract with fair conditions, they will have no problem drawing plenty of capacity."

Sureties continue to employ disciplined underwriting because the industry is still recovering from record losses. Michael Greer, vice president, surety, Pennsylvania National Mutual Casualty Insurance Co., says, "Surety industry losses from several years ago were due in part to contractors obtaining too much surety capacity relative to their financial strength and organizational capability."

The surety industry returned to profitability in 2005 and should be profitable this year. The key for the industry's long-term health, though, will be whether the industry as a whole can sustain the discipline to maintain profitability over time.

Contractors with strong, established backlogs have ample profits to cover overhead, so prudent expansion of well-run operations will be supported through 2007, Liberty Mutual's Perler says.

However, growing too fast, as well as supervisory and labor shortages, are bigger concerns for contractors than capacity. "The real weakness is contractors need skilled professional support around them to grow the business," Zurich's Cheatham says. "Contractors need to pick their surety not for the short term, but for the long term, just like they select skilled professionals."

Because the marketplace is so robust, any commercial contractor can grow. Contractors should look for a surety that can help them grow in a disciplined manner. A professional surety bond producer and underwriter are strategic advisers in today's marketplace when it comes to risk and risk management.

Michael Cusack, senior vice president and managing director of surety, Aon Construction Services Group, says, "As contractors position their firms in this boom era, surety capacity decisions—beyond balance sheet analysis—will be based on the surety's comfort level with contractors' experience, project management capabilities, tolerance and management of contractual risk, and subcontractor procurement/risk management. As additional capacity is extended to support larger work programs, bonding companies will expect contractors to drive margins and improve profitability in this vibrant market."

Mary Jeanne Anderson, vice president, Arch Insurance Group, adds, "Profitability is the hallmark of a successful contractor. The job progress and trends reflected in the work-in-progress schedule provide a glance at the past, present and future profitability of a contractor, and this is a key component in the underwriting process."

The availability of timely and accurate financial information is often as important as the financial data itself. "It can be the difference between a well-run company and one that really does not know where it stands financially," she says.

SMALL-MARKET CONTRACTORS

Expect solid opportunities for the small construction segment—under $10 million—to obtain work at reasonable profits. The key for these contractors, surety executives say, is to accept only work for which they have good managers.

Opinions vary on surety availability for small contractors. Most say more than enough capacity exists to satisfy the demand in this marketplace, while some say underwriting for this segment is easing. Others indicate smaller or emerging contractors may continue to have difficulties entering the surety market and point to more frequent loss activity involving these contractors.

"Fundamental underwriting characteristics in this sector, such as capital adequacy in relation to the work program, will become more stringent," Aon's Cusack says.

Some executives suggest the surety industry will demand smaller contractors become more sophisticated and produce higher quality information on a timely basis. This means using a construction-oriented CPA firm that can prepare a percentage-of-completion financial statement for year-end, and having well thought-out business plans and continuity agreements funded by life insurance.

"Surety companies will insist on having upscale submissions with an overall tendency to shy away from in-house financial statements when considering bonding capacity," says Karen Barbour, president, The Barbour Group.

Bonding assistance and support programs are available to emerging contractors as part of the surety industry's commitment to this segment. "Because bonds are generally a product of statutory requirements, a contractor's ability to bid public work is severely hindered if it can't secure bonds," Old Republic's Lee says. "Our agents assist contractors in providing counsel and advice to enable them to approach markets that will consider bonding."

"Small and emerging contractors of today are the large and successful contractors of tomorrow," adds Gary T. Dunbar, chair, The Surety & Fidelity Association of America (SFAA), and divisional president, Bond Division, Great American Insurance Companies, Cincinnati, Ohio. "Many small and emerging contractors are owned by individuals who satisfy participation goals established by the government on many public projects. By helping small and emerging contractors, the surety industry is also helping many large, established contractors meet their participation goals."

MIDDLE-MARKET CONTRACTORS

The middle market—around $100 million—may be the most competitive. "Capacity is readily available for qualified contractors, as there are many sureties in this arena," says Terrance Cavanaugh, chief operating officer, Chubb Surety. "[If] surety companies maintain their underwriting discipline, which has restored profits, competition should remain strong."

Middle-market contractors, ACSTAR's Nozko suggests, are large enough to have sophisticated operations and don't have the high-risk profile associated with small or specialized contractors. As these firms grow, they must transition and develop their accounting, cost controls, field management and business planning to meet their increasing financial targets.

Barbour adds, "The surety industry may require some contractors to guarantee a certain gross profit percentage on jobs in excess of $50 million to provide a stronger comfort level when seeking support from reinsurers. It is becoming apparent that these contractors will need to at least guarantee a 4 percent gross profit margin for such projects to be bonded."

And, according to William Marino, chairman and CEO, Allied North America, "Quality professional support from construction industry-focused accountants, attorneys and surety brokers is expected, and a strong risk-management protocol, joint venture partners and historic project performance are necessities."

JUMBO-MARKET CONTRACTORS

While the jumbo marketplace historically referred to projects exceeding $250 million, in a relatively short time it increased to highs of $500 million and $750 million. "For the right contractors, the numbers seem to be pushing $1 billion," says Old Republic's Lee.

While this market has fewer players, surety executives insist adequate capacity exists. These contractors have to be more strategically focused to create the kind of surety capacity they need.

"Although there seems to be an increase in markets that will support this level of project and program," explains Chubb's Cavanaugh, "aggregate capacity is still selective on deciding which contractors qualify for surety capacity."

John Stanchina, senior vice president and division manager, Rutherfoord Companies, an Assurex Global Partner, says, "Joint ventures and co-surety arrangements used in the 1970s are again being utilized on larger projects and programs."

Michael Murphy, executive vice president, Bush, Cotton & Scott, A Hub International Company, agrees. "Recent industry results and expanding reinsurance capacity are sufficient to meet the surety needs of a very strong construction economy, with large work programs in excess of $500 million and very large single projects continuing to require co-surety arrangements in many cases," he says.

Even with strong joint ventures, sureties may struggle to assemble the capacity necessary to provide 100 percent performance and 100 percent payment bonds. "On projects with contract values greater than $750 million, owners have to evaluate the possibility of accepting reduced penalty bonds," says Allied's Marino. "This presents a significant challenge on public projects where an act of legislature is generally required to proceed."

Murphy adds, "The large contractor market continues to be the most restrictive in terms of flexible underwriting criteria and available reinsurance capacity."

Larger, well-capitalized contractors with operational discipline are generating tremendous margins in this market. Surety executives attribute improved profitability to shorter bid lists, more discipline in the deployment of surety capacity and higher margin expectations. In fact, surety executives say larger construction franchises have embraced this surety capacity environment, and most firms view the detailed underwriting analysis, close surety scrutiny and disciplined extension of capacity as a healthy process.

SURETY OUTLOOK

The outlook for the surety industry over the next 12 to 24 months will hinge on a number of factors, including the economy, disciplined underwriting and available surety capacity in the market.

"We have seen significant inflation in construction over the past three years," says Rutherfoord's Stanchina. "Continued material and labor inflation may become an issue as the cost of construction has the potential to outgrow the equity and liquidity that contractors retain through traditional operating earnings. This has the potential to put pressure on the surety program leverage and force contractors to look for additional capital from shareholders or other outside sources to support surety capital requirements."

Doug Hinkle, chief underwriting officer, CNA Surety, is optimistic about the next few years for the surety industry. "Primarily through consolidation, the top 10 sureties now write more than 60 percent of all the surety business. Second, most sureties seem to have a greater focus on their capital allocation and the need for adequate return on that capital. Finally, there has been a movement toward greater underwriting sophistication," Hinkle says. "Traditional economics suggest that fewer players in the market, greater focus on return on capital and greater underwriting control would lead to longer-term market stability."

Timothy Mikolajewski, senior vice president, Safeco Surety, adds, "Absolutely, 2005 was a good year for the surety industry, and 2006 looks to be an excellent year. With continued sound underwriting discipline and pricing, the outlook for the surety industry over the next several years in the small, middle and jumbo markets looks good."

Top 10 Writers of Surety Bonds

2005 (Preliminary)

	Direct Premium Written (millions $)
1. Travelers Bond	$885
2. CNA Insurance Group	$382
3. Zurich Insurance Group	$368
4. Safeco Insurance Group	$309.5
5. Chubb & Son Inc.	$234
6. Liberty Mutual Insurance Group	$210
7. Hartford Fire & Casualty Group	$181
8. Arch Capital Group	$109
9. HCC Surety Group	$103
10. International Fidelity Insurance Co.	$86.6
Total All Surety (Top 10)	$2,870
Total All Surety	$4,528

Source: The Surety & Fidelity Association of America (SFAA), "Top 100 Writers of Surety Bonds—United States," 2005 (preliminary, including contract and commercial surety). Detailed statistical reports are available for purchase at www.surety.org. SFAA now offers a subscriber service to non-members that includes a newsletter; statistical reports; *Binder of SFAA Standard Fidelity Forms*; *SFAA Manual of Rules, Procedures and Classifications for Fidelity, Forgery and Surety Bonds*; a web listing; and reduced rates on other publications and special data requests. For more information, contact Barbara Finnegan Reiff at breiff@surety.org.

Ramsey is communications manager of the Surety Information Office, Washington, D.C. For more information, call (202) 686-7463 or email sio@sio.org.