THE BIG PICTURE: SURETY IS MORE THAN A LINE OF CREDIT

BY MATTHEW ROSENBERG

Construction is an inherently risky business. Each year, thousands of contractors fail, leaving billions of dollars of uncompleted projects. Of those contractors that go out of business, statistics show that two-thirds have been in business for more than six years, while one-third have been in business for more than 10 years.

Serious problems arise when these construction projects are not protected by surety bonds. While most public projects are bonded, and taxpayers are protected by the security of a bonding company, only a smaller percentage of private projects are bonded, despite the tremendous benefits afforded by bonds.

The guarantee that the contractor will perform (performance bond) and pay its suppliers and subcontractors (labor and material payment bond) is the benefit provided to the owner (obligee). The obligee, which is the beneficiary of the bond, would prefer not to make a claim on the bond unless it's the last option. Rather, the obligee seeks assurance that the contractor will successfully complete the project and pay all of the suppliers and subcontractors. While the bond guarantee that the surety provides to the owner is of great importance, arguably the primary purpose of bonding is to prequalify contractors.

THE THREE Cs

Because surety underwriting is a continuum, no wonder many contractors develop close relationships with their agents and sureties. Bonding companies require timely financial information and frequent meetings. Contractors should work to foster a strong bond with a surety. The surety and the agent want clients to be successful–not only to prevent losses, but also to promote a healthy and profitable client.

For sureties, success relates to the Three Cs:

1. *Character:* The surety wants a sense that the company has the highest integrity and that the owner is honorable.
2. *Capacity:* Capacity is the expertise, manpower and experience to handle the project. Generally a surety will consider a project no larger than twice the size of the largest project completed by the contractor.
3. *Capital:* Capital is the financial strength to handle the total backlog of the company, whether the work is bonded or not.

MORE THAN JUST A GUARANTEE

Contractors can be only one bad subcontractor away from having an unprofitable job and three bad jobs away from going out of business. Along those lines, past due receivables devastate the cash flow and bond availability of construction companies.

Consequently, sureties continually underwrite their clients through detailed review of financial statements and job schedules. Financial statements must be reviewed or audited and received no less than annually, though often semi-annual review may be preferred. Accounts receivable are typically the largest asset on a contractor's balance sheet and are scrutinized closely. Annual meetings to discuss the year completed and the year ahead all play an important part of the underwriting process.

DEATH AND TAXES

Two certainties in life are death and taxes. Not many people like to talk about death or plan for it. But when it comes to business, estate planning is critical. The stock of many construction companies may be controlled by one or two owners. Sureties must understand how stock would be transferred and how estate taxes would be paid upon the death of a shareholder. Contractors should be just as concerned as their surety, if they want the company to remain in business after their demise. Estate planning is worth the effort in planning for the future benefits of loyal employees and family.

Estate planning should be a part of the overall business plan of any company. The best projects usually include detailed and accurate plans from the engineers and architects. Similarly, sureties view the superior contractors as those that have strategic business plans that chart the goals of the company into the future. This helps the surety understand the client's needs and desires and give advice about growing a bonding program.

Qualities of a Successful Contractor: A Surety Perspective

Contractors that obtain the most from their surety program possess many of the same traits:

1. They are highly disciplined and organized.
2. They stay within their niche and geographic territory.
3. They take calculated risks that involve great thought and debate within the organization and through advisors.
4. The best companies have a team of professionals that they rely on in decision-making:
   - accountant;
   - banker;
   - lawyer;
   - surety agent and company; and
   - insurance broker.
5. Highly successful construction companies set goals and plan for the future.
6. They develop solid internal controls such as hiring a qualified controller/CFO.
7. They know their cash flow and aged receivables (those over 90 days).
8. They keep track of the profitability on all substantial projects.
9. They can answer virtually every question a surety may ask or quickly find the answer.

JUST DON'T SAY NO

Everyone wants to hear the word "yes," but a surety sometimes says "no." Sureties may take issue with the job size, the type of work or the total workload (backlog) of the contractor client. Certainly, a discussion should occur prior to or immediately after a declination in case the underwriter does not have all the facts or does not understand all of the issues of the project. For example, the project could be more equipment-intensive, or the job could be exactly within the contractor's niche, but is simply larger than its typical project size.

On the other hand, the job may not be the best project for a contractor, and the surety sometimes proves to be the voice of reason. The surety should be viewed as a member on the board of directors. It provides a more impartial vantage point than the owners or executives of a construction company. The surety's unbiased and experienced viewpoint can prevent a problem before it is realized, or at least help a contractor get back on track.

Several years ago, a surety required one of its contractors in Sacramento, Calif., to obtain a bank line of credit despite the contractor's continuous objection. The surety's advice can literally save a client's business. Yet to this day, the contractor still complains at each underwriting meeting about the need for a bank line. What he fails to remember is that the bank line saved the company when it had some large past due receivables that almost devastated its wellbeing. Without the bank line, that contractor would surely be out of business today.

Occasionally, contractors are surprised to see competition that they do not hold in high regard on a bid list. Yet, some contractors are more financially secure than one might imagine. Some contractors may post collateral or use third-party funds administrators. Others may obtain backing from a company with more financial strength that cosigns on the indemnity agreement like a father cosigning his son's car loan.

These are not ideal methods of obtaining bonds. Sureties would rather see a company stand on its own merits through years of profitability, guided by a sound business plan.

Construction companies should remember three important points. First, remember that the surety provides business counseling as part of its service to clients. Second, the surety wants to work with companies that have a solid organization and a knowledgeable team of advisors. Finally and most importantly, the surety wants you to succeed as much as you do.

SURETIES VIEW THE SUPERIOR CONTRACTORS AS THOSE THAT HAVE STRATEGIC BUSINESS PLANS THAT CHART THE GOALS OF THE COMPANY INTO THE FUTURE.

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