HOW BOND-WORTHY ARE YOU?

Sureties Look at Variety of Criteria Before Bonding Contractors

Whether your company wants to pursue private or public projects, obtaining surety bonding can be a huge asset, if not a requirement. So how does a contractor go about obtaining a bond?

Sureties consider a number of fundamental factors. One is the contractor's reputation—its relationships with subcontractors, suppliers, lenders and owners. The strength of the contractor's financial statement is another. Is the contractor profitable? Debt, equity, capital, revenue, overhead and indemnity (both personal and corporate) may all be taken into consideration. Does the contractor have an accountant who specializes in construction? Does it have a history of successful projects and a schedule of ongoing and future work? Does the contractor have a comprehensive business plan, forecast or strategy for short- and long-term business? Does it have access to the necessary equipment to do the job? Does it have a risk management plan, and are plans in place in the event of the death or loss of key personnel?

Answering these questions may take time and effort, but they are a vital part of the process of developing key relationships with a surety underwriter and surety bond producer.

Doug Hinkle, chief underwriting officer for CNA Surety Corp., says, "Because surety is a credit business, there will always be a heavy leaning toward the financial resources of a contractor when considering the extension of surety credit. Character and contractor performance—the ability to consistently make money—shape the degree of financial resources required."

Edward Heine, president of the National Association of Surety Bond Producers and executive vice president of Payne Financial Group, adds that a strong, timely and accurate financial statement prepared by a CPA who is familiar with construction accounting says more about a contractor than only its financial strength. "When prepared properly, the statement automatically sends a signal to the underwriter that the surety applicant has developed professional tools to manage his business," he says.

Heine also lists a good credit score, profitability and work-in-process as important. "A surety underwriter assesses trends. How a company has performed over a period of time is a very important indicator," he says. "Underwriters look for consistent operating profitability creating working capital and equity that supports a company's business plan. Work-in-process statements that illustrate good project management through an accurate job-costing system is a focus."

Once the capital structure has been qualified, Heine adds, the business plan of the company is assessed. Personnel and their experience, internal controls, project administration, risk management, references and continuity plans should be explained. Key advisors that specialize in the construction industry, such as bond and insurance agents, CPAs, attorneys and bankers, can provide valuable services to the contractor. "Negotiating a surety program can be a very positive process if the application to the surety company is made by an agent that specializes in the surety product."

Once a contractor has obtained surety bonding, it can begin to improve its bonding capacity. The best way to maximize bond capacity, according to Michael Greer, vice president of surety at Penn National Insurance Co., is by working with an agent who knows the surety business well. Also, the contractor needs to take the lead in forming a relationship with the underwriter.

"Ask what kind of information the company wants or requires, and don't make the surety company wait until five months after your fiscal year-end to provide this," Greer advises. "The couple of dollars you might save with your CPA by avoiding the rush season might cost you multiples of that for your bond capacity."

Greer suggests contractors should worry more about building the net worth of the company, rather than trying to avoid paying taxes. "Many well-intentioned CPAs have hurt a contractor's bond capacity by telling the contractor to do all of these tax strategies that save the contractor money, but hurt their financial condition. Sometimes it comes down to: Do you want bond capacity or do you want to not pay taxes."

Greer recommends having a business plan and reviewing it with the underwriter. "And then stick to it," he says. "Credibility is the biggest factor in bond capacity. Besides losing money, the worst

Opening Markets to Emerging Contractors

By Samuel A. Carradine

In today's surety market, a strong financial statement, an unblemished history and a detailed business plan are vital elements for a contractor's surety capacity. While surety capacity is available for qualified, experienced and well-capitalized contractors, new and emerging contractors may lack the experience and resources necessary to qualify immediately for bonding.

Relationships with a surety underwriter and surety bond producer can provide invaluable resources as the contractor manages the company's growth and development that can help build bonding capacity.

"For most contractors, sufficient bonding capacity is probably the single most important tool to increase revenue because all public work requires bonds and a substantial portion of private work requires bonds," Henry Nozko, Jr., president of ACSTAR Insurance, says.

Edward Heine, president of the National Association of Surety Bond Producers and executive vice president of Payne Financial Group, says while emerging contractors may have experience in a particular field, many have never had experience with bonding, so developing the information that sureties require and designing a financial structure that meets surety requirements can be frustrating.

"Surety bonding is focused on pre-qualification and not everyone in the market can qualify for surety credit," he says. "If one does, the amount of public construction dollars supporting construction activity in a local market is significant and represents an abundance of opportunity."

"A company in a specialty trade that can demonstrate bonding capability may have a more positive profile for general contractors that are seeking higher-quality subcontractors," Heine adds. "In the private sector, it is common for private owners and their lenders to require surety bonding, particularly on larger projects."

Michael Greer, vice president of surety for Penn National Insurance Co., says smart, well-managed contractors use their ability to post a bond as a marketing tool to win jobs.

"The ability to post a surety bond from a credible surety company is a status symbol among contractors," he says. "A surety bond says that a company has undergone a thorough financial and managerial review and that an independent expert is willing to stand behind the company."

So how do new and emerging contractors achieve this status symbol? Many begin by taking advantage of programs that have been developed especially for them to help during this beginning stage.

The Model Contractor Development Program

The Surety Association of America (SAA) and its members are committed to ensuring that bonds are available and accessible to qualified contractors. SAA leads several efforts to increase bonding capacity for minority, women and other emerging contractors. SAA launched the Model Contractor Development Program (MCDP) in 2001 to assist emerging contractors. The program:

- educates small, minority and women contractors about surety bonds and assists them in becoming bondable;
- identifies resources available for obtaining a first bond such as the SBA Bond Guarantee Program and similar state and local programs;
- provides assistance and referrals for obtaining appropriate accounting, project management and financing expertise;
- assists with increasing bond capacity; and
- offers other components such as networking and outreach, and advocacy and policy development.

Technical Assistance to Federal, State and Local Jurisdictions

Many federal, state and local governments have developed or are developing bonding support programs for emerging contractors. SAA members, staff and local surety associations around the country provide technical assistance or guidance with several programs. For example:

- New Jersey Economic Development Authority's Request for Proposals (RFP) engages a bonding consultant to provide surety bonding and working capital loan assistance services for the statewide school construction program;
- The state of Ohio, Department of Development's Bond Guaranty Program for emerging contractors is slated for rollout later this year.
- The Tennessee Department of Transportation (TDOT) Bond Guarantee Program for Small and Disadvantaged Business Enterprises assists small businesses in obtaining bonds for subcontracts on TDOT construction projects.
- The SAA and the U.S. Department of Transportation (DOT) have a cooperative agreement to rebuild the DOT bond guarantee program in which SAA provides guidance on program operations (underwriting, resource requirements, claims handling and cost). The groups developed an e-commerce methodology for bond execution and processing and assist in providing interns from the SAA/INROADS Internship Program.
- A memorandum of understanding (MOU) between SAA and the Economic Development Corporation of Prince George's County, Md., expands the bonding assistance component of the county's Small Business Initiative (SBI). The SBI provides direct assistance, including bonding assistance, to small and minority-owned businesses with emphasis on the county's multi-billion dollar National Harbor Project.
- The Small Business Administration (SBA) Surety Bond Guarantee program guarantees bid, performance and payment bonds issued by surety companies to small and emerging contractors. This government backing allows sureties to write bonds for contractors that would not otherwise meet minimum underwriting standards.
- The Surety Association of South Texas developed a program for small and minority contractors.

The surety industry's proactive role in the development and implementation of these programs will continue to be an important contributor to their success.

Carradine is director of development and diversity, the Surety Association of America, Washington, D.C. For information on SBA programs, call (202) 205-6540 or visit www.sba.gov/osg/. For more information on bonding assistance for emerging contractors, call (202) 778-3638 or email scarradine@surety.org.

thing a contractor can do is say they are going in one direction and then ask for a bond on something outside of their plan."

As for financial strength, there are some things a contractor can do to improve a weak balance sheet. Henry Nozko, Jr., president of ACSTAR Insurance Company, advises, "Strengthening can usually occur by reducing revenue and overhead, as well as concentrating on collecting receivables and liquidating portions of equipment and inventory."

This takes time, though, according to Heine. "There is no magic wand that allows a construction firm to develop a stronger financial condition overnight."

The retention of after-tax profits in the company is another fundamental requirement. "Generally speaking, surety companies prefer committed capital to support the business, as opposed to the use of debt (from a bank, third party or shareholders). Operating lines of credit that can support cash-flow requirements are important, but surety companies prefer that such debt be short-term in nature," he says.

"Long-term debt created by capital expenditures preserves working capital and is a very useful tool, but the company should not leverage itself to the extent that debt service would impede the company's ability to perform," Heine concludes.

According to Michael Cusack, senior vice president, regional surety director and operations board member at Aon Surety, "In order to develop confidence and trust in the surety producer/underwriter relationship, individuals need to transact a certain volume of business, work through disagreements—while remaining focused on preserving the relationship—and develop mutually agreed upon strategies to service accounts."

The most important characteristics that contractors must demonstrate to qualify for a bonding relationship are experience and profitability, Cusack says.

Nozko agrees experience is important, and asks, "Has the contractor performed similar projects in terms of size and scope of work?"

Ownership stake—in the case of non-public companies—also is important. "The current management needs to have a substantial ownership stake in the company, and the current owner/managers need to have been in place for at least 10 years," Nozko says. During a financial review, Aon concentrates on tangible equity, working capital, the ratio of tangible equity to revenue, the ratio of debt to equity and the ratio of receivables to revenue. For public companies, it considers all of these, plus the length of time the company has been an SEC reporting entity, for which it prefers to see a minimum of 10 years.

The bottom line is the surety company wants the contractor to succeed. The better the surety knows the contractor, the better it can support the contractor. There is not one piece of the puzzle that matters most in the surety relationship.

"Some surety companies just focus on the numbers," Greer says. "At Penn National, we look at the entire picture. We focus on what a company does well and try to strengthen what it doesn't do so well. The key areas are always going to be, does a company understand what kind of jobs it is good at? What are the risk factors in these types of jobs and how does it manage these risks? Can the company make money on its projects, can it manage its overhead and revenue levels and is it willing to leave profits in the business?"

The Surety Information Office, Washington, D.C. is the resource on contract surety bonds. For more information, call (202) 686-7463 or email sio@sio.org.

A Contractor's Scorecard—How Sureties Track Runs, Hits and Errors

By Mike Anderson

Contractors need stable, reliable surety relationships that support their firms' management, business plan and resulting opportunities presented by customers and market segments. If a construction executive can answer these questions affirmatively, he has positioned the firm to have an excellent working relationship with its surety.

- Am I completely familiar with my surety bond producer's surety submission and ongoing work for my company?
- How does the surety analyze my company?
- Have I reviewed my surety's financial analysis? (This is their scorecard for extending credit.)
- Have I communicated what I expect of my surety and do I clearly understand the surety's expectations of my company?
- What are my surety's underwriting results?
- What level of reinsurance support does my surety rely on to service its business?
- Have there been any changes to my surety's single project and aggregate program capacity?
- What are my surety's financial ratings?
- Have there been recent personnel changes within my surety at the local or home office level?
- What is the status of my stand-by surety?
- Do I understand stated vs. "adjusted" working capital/liquidity?
  - Hint: restricted cash, prepaid expenses, accounts receivable greater than 90 days, related party receivables/notes, disputed CEE>B's, inventories, tax refunds and unlisted investments are normally excluded, in whole or in part.
  - Cash value life insurance, retentions, marketable securities and certificates of deposit may be included.
- Do I understand stated vs. "adjusted" equity/net worth?
  - Hint: working capital items, goodwill/intangible assets and asset values above cost are normally excluded, in whole or in part.
  - Subordinated debt may be included.
- Do I know what sureties focus on?
  - original vs. current estimated margins on open jobs;
  - completed projects' margins;
  - underbilled projects;
  - overbillings vs. cash vs. pure job borrow;
  - unearned gross margin and cash flow remaining on open jobs; and
  - projected G&A expense coverage.

Anderson is executive vice president and managing director of surety for Willis, a global insurance broker. For more information, call (610) 254-5634 or email mike.anderson@willis.com.