Red Flags & Warning Signs of Contractor Failure

The Roman playwright Terence observed 2,000 years ago that nothing is said that has not been said before. His statement is certainly true of red flags and warning signs of contractor failure. This article, from the surety industry's point of view, offers a timely review.

BY DEV STRISCHEK AND MARLA MCINTYRE

IT'S THAT TIME in the credit cycle to take a little extra time in reviewing contractor performance. According to BizMiner, an industry research firm, between 2004 and 2006, the number of contractors dropped almost 24%, from 850,029 in 2004 to only 649,602 in 2006.These numbers include building (non-single-family), heavy/highway, industrial buildings/warehouses, hotel/motel and multifamily home construction, and specialty trade contractors operating. Further, the dropout rate edged up slightly past 24% in 2007 alone. The dropout rate is mainly spurred by failure.

The good news is that the contractor failure rate has improved along with the economy. According to Rick Kinnaird, chair of the board, Surety & Fidelity Association of America (SFAA) and senior executive at Surety, Westfield Group, Westfield Center, Ohio, "Contractors continue to become better business people. They are more educated in the entire process, are using technology and business systems, and have become better managers of their businesses and their money. We are at the point where the economy will be the big driver relative to contractor failures. If construction work is severely cut back, margins will grow thin as competition heats up for fewer jobs. Marginal or financially leveraged contractors will run into problems and possibly fail."

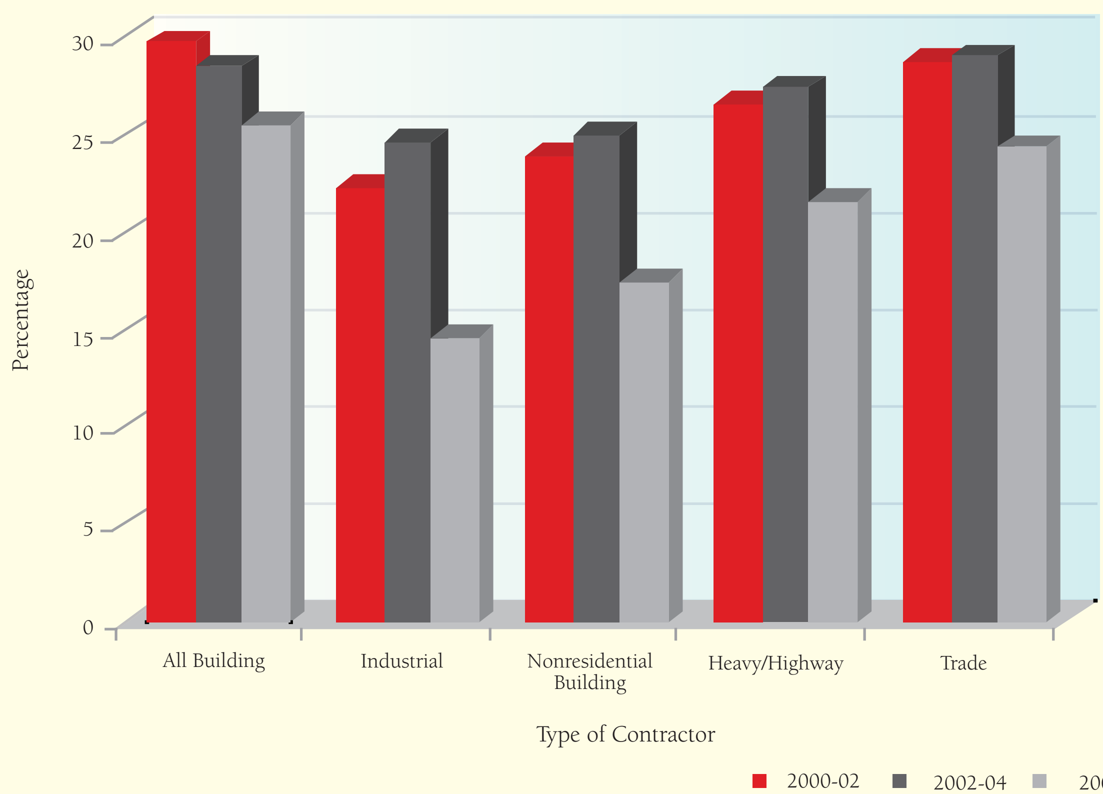
Every year, thousands of contractors, whether in business for two years or 20, face bankruptcy and business failure. These firms leave behind unfinished private and public construction projects—and still worse, billions of dollars in losses to project owners and taxpayers.

Causes of Contractor Failure

The surety industry sees four major causes of contractor failure:

- Financial.
- Management.
- Overexpansion.
- Other/uncontrollable.

Failure Rates, 2000-06



Source: BizMiner

Failure rates are based on the number of firms in business at the start of the time series that were still in business at the end of the two-year period.

Financial Causes. Grant Thornton LLP's recent report, "2007 Surety Credit Survey for Construction Contractors: The Bond Producer's Perspective," cited slow collections (45%), low profit margins (44%), and insufficient capital/excessive debt (44%) as three major contributors to financial difficulties among contractors. Misuse of bank lines of credit and poor estimating and bid spread management round out the five top reasons for financial failure.

1. Slow Collections

Slow pay, or no pay, is an indicator of problems to come—either the contractor has become less selective in terms of who he works for, or the contractor was too quick to undertake the next job without weighing the risks.

2. Low Profit Margins

Too often, contractors take on cheaply priced work. Low profit margins are frequently a precursor to contractor failure. Sometimes the best jobs are the ones the contractor didn't take. Sureties frequently warn contractors against taking certain jobs—or they will deny bonding.

A surety looks at a contractor's operating profitability and completed contract profitability. Construction accountants typically use what is called percentage-of-completion (POC) accounting. Although POC is the preferred accounting method under generally accepted accounting principles, POC's matching of revenues and expenses also permits the contractor to recognize profit on uncompleted projects. A surety analyst takes a long view of the contractor's profitability by looking at the contractor's completed contract profitability over a four- or five-year period, subtracting the company's overhead during that same period and evaluating the results as more indicative of the company's profitability. The surety also views earnings retention as indicative of the contractor's willingness to increase his capital base.

3. Insufficient Capital and Excessive Debt

Insufficient capital means a reduced safety net. It is inevitable in the construction business that unanticipated problems will arise, whether natural disasters or unnatural disasters. Weather and geological events are facts of life, along with economic forces that may cause materials and labor shortages, rising prices, interruptions in supply and distribution channels, etc. Perhaps even more eventful are internal financial management mistakes. Signs that a contractor has an ineffective financial management system include:

- Tight cash flow or an inability to forecast cash flow.
- Receivables are turning over too slowly.
- Bills are past due.
- Vendors are demanding cash on delivery for supplies and materials.

4. Bank Lines of Credit

A red flag for the surety company is when a contractor overuses the bank line by failing to clean it up at the end of the year or overusing it over the course of the year. Excessive line usage or failure to clean up the line periodically are signs of a possible low-cash position or negative cash flow. "If we see contractors too consistently into their bank lines, they need capital, not credit," notes Gary Dunbar, president, Bond Division, Great American Insurance Company, Cincinnati, Ohio. "We understand when heavy-equipment operators max out their credit in the spring while they are doing all of their maintenance work and haven't been able to collect progress billings, but if a contractor is maxing out his or her bank line at an unusual period of time, that is a red flag for us."

5. Estimating and Bid Spread

"We see this typically through profit fade or other profitability volatility," Dunbar says. "If a contractor is beating his or her estimate on one job by 50%, but losing money on three other jobs, then I am not confident that the contractor did a good job in the bidding room, even though, on balance, the numbers worked out. That indicates to me that it is more random than good estimating. Good estimating depends on a good cost accounting system." Large bid spreads present another warning sign. "That is an indication of a desperate contractor when you see large bid spreads," Dunbar adds. "It signals that the contractor feels as if he has to get the next job." Some indicators of poor estimating and job cost reporting include:

- Revenue and profit margins decreasing over time.
- Continued operating losses.
- Loss or reduction of bonding capacity.
- Continuously bidding jobs too low.

Management causes. The construction consulting firm FMI Corp., Raleigh, North Carolina, recently did an in-depth study of management causes of large-contractor bankruptcies. FMI grouped causes into strategic, organizational, and uncontrollable. FMI attributes most causes of contractor failure, whether financial or even events beyond a contractor's control, to management weaknesses—inadequate management, failure to manage risk, changes

Top Reasons for Contractors' Management Failure

in ownership or key personnel, poor project management, and lack of a business plan.

1. Inadequate Management
Incompetent or untrained personnel may fail to implement, manage, and monitor cost controls, so buying equipment or acquiring new businesses without clear justification and planning are red flags of possible cost-control inadequacies.

2. Failure to Manage or Consider Risks
There should be a subcontractor bonding policy in place. When a contractor assumes risk for subcontractors by not requiring performance bonds from the subs, it frequently cuts into the general contractor's own profits. Another red flag is a low-bid strategy dependent upon boosting the job profit margin through subsequent change orders or reliance on low subcontractor estimates without adequate risk protection.

3. Change in Owner or Key Personnel
Loss or serious illness of a loved one, disability, and death distract most people. These personal tragedies are likely to divert the time, energy, and effort of mid-sized or smaller construction companies' owners and negatively impact their operations. Divorce and failure have an especially high correlation because, typically, half of the assets go away—usually the liquid half. Contractors often underestimate the effect on their company when key personnel leave, whether to start their own company that will compete for the same market or because of disagreement with management. Family disputes within a company can have a serious impact. "Family disputes can be a death knell to construction companies if they are not resolved quickly," says Kinnaird.

4. Poor Project Management
How a contractor manages projects is a key success factor. Indicators of poor project management include:
- Inadequate project supervision.
- Inability to get reasonable prices on change orders or the inability to administer and collect on change orders. Procedures for handling change orders should be clearly defined in the contract.
- Missed completion deadlines or behind-schedule work. If the project is not completed on time, there is likely to be a penalty for missing the completion date. If the project is behind schedule, the contractor should be able to identify the reasons and initiate the appropriate actions to get back on schedule.
- High incidence of claims. One or more projects has a claim. If a contractor is constantly involved in litigation, poor project management is typically an issue. When the surety claims department starts getting notified of disputes with subcontractors, material men, or obligees, the fault likely lies with the contractor and not with the disputing parties.
- Safety violations on a job site. A safe site is a well-managed site. If a job superintendent is enforcing the safety rules, the quality of the work is also likely to be good. Violations suggest the opposite—unsafe conditions and defective work.

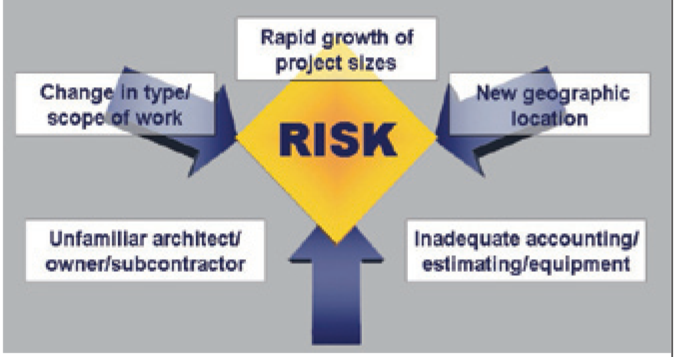
5. No Business Plan
With no contingency plans, no "road map," no goals, or no objectives, the contractor may not be prepared for changes. "Good agents ask their clients or prospects what their business plans are, as opposed to establishing a line of surety capacity and specifying the single-sized job the contractor can bid on and the aggregate program that can be executed," explains Ed Heine, executive vice president, Payne Financial Group, Missoula, Montana. "We ask about their capabilities to make sure we have a surety program that is supportive of their business plan."

Contractors should measure their goals and objectives in a definitive way. One way is to look at the work-in-process statement to see whether estimated profits or estimated total costs are being revised as events occur or conditions arise. Problems can begin when the contractor fails to address them or forgets to manage the various aspects of the business plan that have been presented to the surety, the bank, or others.

"If contractors are not managing the costs on their jobs, if they're not watching the performance of their people, and if they're not regularly measuring the activities that are geared toward achieving their objectives, they'll find that business plans are not met," Heine explains.

A red flag also is raised when a contractor requests a level of surety credit that is not aligned with the objectives of his or her business plan. "For example, if a contractor is doing \$50 million a year and plans to grow 10% a year, we would expect the contractor to do \$55 million next year," Dunbar notes. "If the contractor asks for a work program to support \$100 million, there is a disconnect between whether the contractor truly needs that amount of surety credit and whether he or she truly intends to grow 10% per year."

Top Reasons for Overexpansion/Growth



Other Top Reasons for Contractor Failure

Changes in business strategies are another potential problem. Suppose a HVAC contractor that installs duct work decides to buy a tin shop, a manufacturing business. Now the HVAC's financial statements are going to be more complex as it shifts from essentially an installation service to include a manufacturing process with the concomitant capital-intensive balance sheet.

Overexpansion/Growth Causes. Whether due to significant increases in the size of individual projects, the type of work it is performing, or expanding into a new geographic area, overexpansion is a leading cause of contractor failure. Problems with accounting, management, personnel, and performance can all turn "good growth" into unrealistic growth. Typically, contractors can deal with one "new" at a time—location, key management personnel, job type, size, customer, architect, or key subcontractor. Before a contractor expands its scope of business operations, it needs to have in place a strong infrastructure of:

- Project management depth with experience and technical expertise. Rapid growth can result in outgrowing management talent, systems, or processes.
- Accounting systems.
- Equipment.
- Understanding of the new territory, the labor pool, subcontractors, the owner, and regulations.
- Estimating. An increase in the backlog of work or estimators facing a shorter lead time to prepare bids is a warning sign.
- Well-defined market niche and growth plan. Cultivate a corporate culture where everyone "sells" the company.

According to Kinnaird, "Sureties look for a connection to the new region. An in-depth knowledge of the construction environment can develop through partnering with local players, such as hiring key staff who are from the new area or who have experience with that market. Sureties will encourage contractors to ease into new markets, taking on smaller projects in order to understand the new territory."

Other/Uncontrollable Causes

Other major risk factors include unreasonable owners, onerous contract terms, inflation and high material costs or shortages, lack of skilled labor, and uncontrollable work environment-type issues—such as inclement weather and unidentified poor site conditions. Onerous contracts and unreasonable owners warrant some additional discussion.

1. Onerous Contract

Sometimes the contract works against the contractor. It can be in the indemnification wording, which may exceed any construction organization's capability to insure against the risks that it assumes, therefore loading those risks onto an inadequate balance sheet. It might be in the change condition clause, or dispute resolution clause, or any number of provisions in the contract that address warranties and completed-operations exposure that need to be taken into account.

There is no one approach that the surety industry can recommend to construction lenders that will allow construction clients to properly assess all those things. However, fundamental risk management is essential, no matter the size of a contractor. "All construction contracts should be read carefully and assessed according to risk standards that are acceptable to each client," Heine advises. "Developing your own construction contract that serves as a standard for your company is an excellent means of defining terms acceptable to you. Implementing policies that create consistency in this area is the hard part, but is an essential part of risk selection and contract administration."

Kinnaird adds, "Many things outside of the contractor's realm of control and responsibility are being incorporated into construction contracts."

2. Unreasonable Owners

Communication problems, such as disputes between the contractor and owner or poor communication from the field to management, also may lead to contractor failure. A good surety relationship is characterized by a constant flow of information, including quarterly financial reports. A contractor doesn't need to share all of the problems he might be having with an owner or a subcontractor, but a surety should be informed when there are large underbillings on jobs where there are disputes or there are accounts receivable for items that the contractor feels entitled to but the owner disagrees.

"A surety bond producer's job is to make sure contractors understand that an open line of communication is the best way to manage their problems, particularly with their surety, because the surety industry has a phenomenal amount of resources at its disposal," Heine says. "When the surety is brought in early to assess a particular issue, their counsel can be invaluable, given their perspective and all that they know. They can serve as a contractor's business partner. They have a common interest in the contractor's success, and they will work with the contractor to provide guidance when needed."

The loss of loyal customers is another sign the contractor may be in trouble. It may be caused by a decreasing reputation for the company's ability to perform contracts on time and within budget.

Managing the Risk

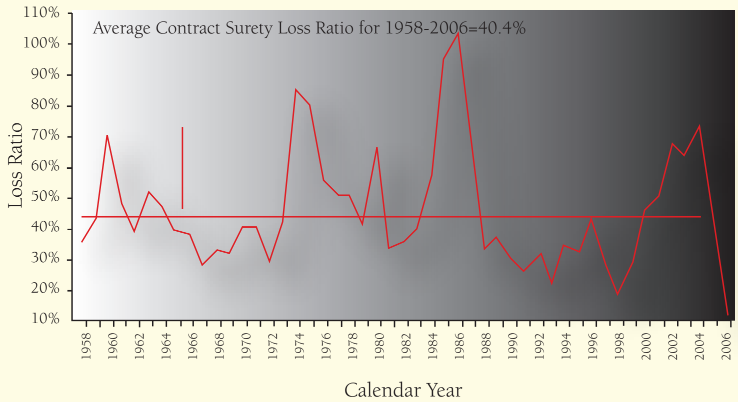
So who pays when a contractor fails? If the contractor is not bonded, the taxpayer, owner, or lender does. For bonded contractors, these failures translate into losses for the surety industry. SFAA reports that sureties have paid more than $10 billion on contract bond claims since 1992.

In 2005, the surety industry paid $114 million in losses on private construction. Especially heavy losses occurred in private construction of commercial buildings, education facilities, and industrial and office buildings. Losses have dropped dramatically in 2006, to $57 million for private contracts. From 1995-2006, the surety industry paid more than $1.4 billion.

Some Dos and Don'ts to Help Contractors Avoid Default

- Do fully and carefully comply with all the terms of the contract.
- Don't pay the contractor for work not performed.
- Do obtain lien waivers before approving pay applications, if they are required.
- Do timely default the contractor pursuant to the terms of the contract. (Don't assume that the surety will accept liquidated damages asserted by the owner if he or she allows a project to unnecessarily flounder, resulting in unnecessary liquidated damages. Two contractors cannot perform the same work at the same time. This is why most bond firms make formal termination of the contractor a condition precedent to the surety's performance obligations.)
- Do fully comply with the terms of the bonds.

Contract Surety Industry Loss Ratios
CY 1958-2006



Source: The Surety & Fidelity Association of America

Surety bonds provide protection by screening out unqualified contractors. However, as illustrated above, any number of events can cause a qualified, bonded contractor to fail. When a bonded contractor encounters difficulties, under the typical payment and performance bond, the surety may step in with technical expertise, financing, or other resources to keep the contractor on the job. If not, the surety completes the project.

"The surety really wants the contractor to succeed," says Kinnaird. "If default occurs, the contractor, producer, and underwriter have all failed. The surety's job is to prequalify the contractor for an owner and deliver a completed project as specified with the subcontractors and suppliers paid."

Dunbar says the surety industry is extremely cyclical, going through periods of making decent money and periods of severe losses. "One of the values of the surety product is that it smoothes out the results for our obligees to the extent the sureties pay for the volatility in the construction cycle. Surety has been close to a breakeven business for 48 years. It doesn't make our shareholders very happy, but it should indicate a good value for the dollar on the construction-related surety product."

Conclusion

Bankers and sureties share in the risks of underwriting and supporting the efforts of contractors. As Lily Tomlin once said, "We're all in this alone." Both banks and bonding companies extend their credit to contractors, and both creditors share a common underwriting philosophy in evaluating contractors. As the credit cycle turns, we are likely to be sharing more such insights into construction success and failure. ❖

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