What is Your Surety Thinking Now?

PARKER | SMITH | FEEK

May 2009

By Scott Fisher, Principal

To say we live in uncertain and volatile economic times is an understatement. We are likely in one of the biggest, deepest recessions we will see in our lifetime. Unemployment is high and rising. Prestigious and respected financial institutions have failed, and the Federal government has passed a stimulus bill of epic proportions to ensure our economy does not fall into financial chaos.

So now is a good time to ask: What is your surety thinking?

The short answer: likely the very same things you are thinking about. I polled the surety community recently to take their temperature and try to get a sense of how surety underwriters are looking at things. What is their attitude? What kinds of things are they keying on, and what are they most concerned about?

Their responses form a timely message for anyone who needs bonding in order to fulfill their business mission.

Business Plan

First off, is the need for a robust business plan that is underpinned by reasonable, credible assumptions. Sureties are looking for contractors who are facing these uncertain times by establishing certain goals and sticking to certain values. A business plan shows thoughtfulness and preparation. Sureties are much more comfortable with a proactive client than a reactive one.

The big issues to address are revenue, overhead and bottom-line profitability.

Where will you get your revenue? Will you get it from normal sources? Or will you have to branch out into a different line of work, in a different geography, or for a different owner (public vs. private)? Any change here will be a red flag for the surety and they will be intently interested in understanding your strategy.

The discussion of overhead goes to the idea that you are preparing your organization for difficult times. Are you making the tough decisions regarding personnel and other sensitive cost areas? Many are assuming that revenue will lag, so what are you doing to make sure the company stays profitable? Something has got to give.

A business plan that is well conceived and communicated does one more very important thing – it brings your surety closer to you so that you can avoid the one thing that will stress any surety relationship: surprises. Communicate early and often with your surety. When you have an issue or challenge, tell them. The surest way to limit or terminate your bond credit is to be full of surprises.

Balance Sheet

The commonly accepted three C's of surety underwriting are Capital, Capacity and Character. All are important, but the C for Capital is getting special scrutiny these days.

Cash: You can never have too much – but if you do, be mindful of where it is and spread it around so that not more than $250m is with any one bank, if it is in an interest-bearing account. Sureties are actively advising this.

Receivables: Expect to be grilled on stale, over 90 day receivables. There is a lot of pain out there and the probability of uncollectible debt naturally rises in today's environment. Sureties will be skeptical. Aging of A/R is becoming a part of regularly required information demanded by the sureties.

Underbillings: Yes, they are a current asset, but not your surety's favorite kind. Large and or persistent underbillings will be intensely scrutinized. Remember, a surety often sees underbillings as an unrecognized claim.

Equipment: Sureties will be watching capital expenditures like a hawk. Is now a good time to unload some equipment? Maybe; maybe not. Most important is how you manage this resource relative to your backlog. Adding debt in this environment should be done very deliberately.

Short term debt: Any contractor that relies heavily on the bank for short term financing (so-called working capital financing) must be very careful. Sureties will be less tolerant of this. If you use your line because of high receivables (=low collection) or underbillings, then your surety will view you as undercapitalized and bond credit will be restricted or in serious cases cut off.

Long term debt: Sureties are looking to see that companies can comfortably service long term debt. If you cannot, then you will need to get more revenue, get better margin work, cut overhead or sell the asset. Tough medicine, no matter how you look at it.

Income Statement

Revenue: What kind of revenue levels can you reasonably expect to achieve? This should be a basic part of your business plan. Make sure forecasts are reasonable. Unreasonable projections undermine a surety's confidence.

If revenue is lower, explain how you will adjust to make it work. If you expect revenue to be the same or higher, be prepared to explain why.

Margins: Due to diminishing opportunities there is increasing competition, which naturally puts pressure on margins. Sureties expect to see lower margins. Be prepared to explain how you will be able to support your business potentially in a lower margin environment.

Overhead: Sureties are closely monitoring contractors cost structure and will have more confidence in the contractor who is addressing the lower revenue/lower margin environment by proactively addressing overhead. Again, this should be a prominent feature of your business plan. Sureties expect to see cuts. If they believe a client is reacting too slowly or inappropriately in this environment, bond credit could be impacted.

Banking Relationship

Having a solid banking relationship is of paramount importance today. As we all know, credit is relatively tough to come by. A surety will look at your Bank Line of Credit as working capital insurance. If your line is too small or you are using it too much, this will make the surety nervous and negatively impact your bond credit.

The bank is an extender of credit just as the surety is. If the surety can look across the table and see a fellow credit-extender offering a contractor strong support, this will naturally give them greater confidence. The reverse is also true.

Private Work

Opportunities in the private sector are down, but they still exist. Due primarily to the credit crunch, sureties are much stricter and more aggressive in demanding a higher assurance that the financing for the contract is in place. In the past verbal confirmations may have sufficed. Expect now to dig deeper and have to provide documentation. Take this opportunity to use the surety as the bad guy and seek greater assurance for your own peace of mind.

Subcontractors

One of the areas of greatest concern for the sureties is subcontractors. Both directly as clients, and also for the potential exposure they pose to general builder clients.

Typically, subcontractors are farther from the money, more reliant on bank financing and are smaller organizations with less financial cushion. With the increasing financial pressure, there is the expectation in the surety community that there could be large surety losses related to subs.

Subs seeking bond credit should expect increased scrutiny. The bar overall is being raised on getting a bond.

And this, when general builders are being asked to bond more of their subs. This is an obvious point of tension and promises to become an even bigger issue.

Indemnity

Indemnity concessions still exist, but expect sureties to deal harder on making those concessions.

If you have limited personal indemnity, expect this to be reviewed on large jobs or large programs. A greater emphasis will be put on the personal financial statements of contractors.

Dealing with your surety

Sureties in the best of times experience a lag in information flow. They often feel they are the last to know. Anything you can do to enhance communication and timely inform the surety will give them less reason and opportunity to imagine the worst. Without a regular flow of information, unfortunately, they will think the worst. Now is not the time to leave your surety in the dark.

Keep in mind that for large or challenging bid requests, the surety should be given more time to process the information. The surest way to get a bad outcome, especially in this environment, is to drop a rush bid request on a surety. Submit the request 10 days or more before the bid for best results.

Final Comments

No one knows how long this recession will last. No one knows when the credit markets will stabilize. No one knows when the housing market will recover. No one really knows when that stimulus money will take effect, and what that effect will be. No one really knows anything.

The sureties don't know either.

The surest way to maximize your bond credit is to stay even closer to your professional advisors, including your bond agent and surety, and work the problem together.

For more information please contact Scott Fisher, Stuart O'Farrell, Ben Wolfe, Kara Harmala or Carl Newman in our Surety Department. Ph. 425.709.3600