Understanding and Maximizing Surety Credit and Bonding Capacity

Presented By:

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Marcum LLP
James W. Miller is an integral member of the Firm’s National Construction Industry group and is located in the New Haven office. He has more than twelve years experience compiling, reviewing and analyzing financial statements for construction contractors and other allied companies. James has also been involved in high profile and sensitive engagements regarding fraud and litigation support and due diligence projects for business acquisitions.

A sought-after speaker on construction accounting and auditing matters, James has conducted internal training seminars and has presented on issues and updates regarding the construction industry and construction engagements.

Mr. Miller’s specialties include troubleshooting problem job performance for construction projects and recommending practices to enhance profitability. He has considerable experience with construction claims matters and has provided litigation support services in this area. Additionally, Mr. Miller has an in-depth knowledge of systems analysis and with the tailoring of accounting software to meet clients’ needs.
Jeffrey P. Deldin, Jr. is a vice president at Bruen Deldin DiDio Associates, Inc. Based in Brewster, New York, Jeff works with clients in the New England and Mid-Atlantic territory. He began his career at BDDA in 1998 as a bond manager/vice president and became a CL manager in 2005. Jeff works on client bonding and insurance needs with a focus on the construction industry. He has experience with all lines of construction, including: general contractors, heavy & highway, subcontractors, specialty trades and environmental risks.

Jeff received his BS in Business Finance from the University of Connecticut. He sits on various agency council boards with BDDA key insurance carriers. He is involved with local, regional and national construction trade organizations as well as insurance and bond associations. In addition, BDDA has been a member of The Associated Builders & Contractors –CT Chapter since 1998 and Jeff and his staff has been active on several ABC-CT committees. Jeff has also served a member of the ABC-CT Board of Directors for 12 years.

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Course Objectives

This program is designed to help you learn about:

- Overview of Construction Industry
- Construction and Surety Outlook
- Understanding Surety Credit
- Key Financial Ratios
- Maximizing Surety Credit and Bonding Capacity
Overview of the Construction Industry
The Construction Industry

- Second Highest Failure Rate
  - (right after restaurants)

- High Risk Industry
  - (Higher risk should equal higher rewards)

- It’s all in the estimate.
Ten Most Common Causes of Construction Contractor Failures

1. **Growing too fast.**
   - A contractor that grows too fast may not have the internal infrastructure and resources to handle the work.

2. **Obtaining work in a new geographic region.**
   - Construction laws, building codes, business environment are all different.

3. **Dramatic increase in a single job size.**
   - Bigger job = Bigger headache
Ten Most Common Causes of Construction Contractor Failures

4. Obtaining new types of work
   • Contractors need to stay with what they know

5. Poor internal controls
   • Issues with document management, segregation of duties, define duties and responsibilities

6. Inadequate capitalization
   • Working capital is the lifeline of a construction contractor

7. Poor estimating and job costing
   • A contractor needs to know how much it will cost to finish
Ten Most Common Causes of Construction Contractor Failures

8. Poor accounting system
   • Contractors need financials and information to measure performance

9. Poor cash flow
   • Cash is *KING!!*

10. Buying dumb stuff
    • Fast cars
    • Restaurants
    • Ranches
    • A palace for an office
Construction and Surety Outlook
Construction Outlook

- 2007-2009 was the worst recession in 70 years (National Bureau of Economic Research)
  - Public budget constraints
  - Project delays
  - Completion of fewer projects
  - Decreased margins/inconsistent profit margins
  - Balance sheets stressed
  - Increased leverage
  - Decreased WC/NW
  - Tougher contract terms and conditions pushed down from owners
  - Increased labor compliance & regulatory requirements
Construction Outlook (continued)

- Construction spending up 39% since 2010 (US Census)
- Construction market is stable and improving
- Construction unemployment improvement
  - 20.6% in 2010
  - 6.4% in 2014
- Increased competition still has put downward pressure on margins and job profits
Surety Outlook Industry

- Modest top line growth
- Low loss ratios and increased construction activity increasing profitability
  
<table>
<thead>
<tr>
<th>Loss Ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
</tr>
<tr>
<td>13.2%</td>
</tr>
<tr>
<td>2011</td>
</tr>
<tr>
<td>13.5%</td>
</tr>
<tr>
<td>2012</td>
</tr>
<tr>
<td>21.6%</td>
</tr>
<tr>
<td>2013</td>
</tr>
<tr>
<td>16.3%</td>
</tr>
<tr>
<td>2014</td>
</tr>
<tr>
<td>15.4%</td>
</tr>
</tbody>
</table>

- Strong reinsurance allowing sureties to extend more credit
- Top 10 sureties control 63% of total market ($5.5 billion in premiums in 2014)
- P3 (Public-Private Partnerships) getting stronger
Understanding Surety Credit
What is a Surety Bond

- **A surety bond is a guarantee of the contractor’s performance**

- **Reasons why owner requires a bond**
  - Ensures owner will receive finished product at negotiated price according to project plans, specs and contract requirements.
  - Ensures the owner all the project subcontractors, suppliers, and vendors are paid for services and materials provided on the project (Liens free).
  - The bond acts as a “Pre-qualification” of the contractor’s ability to the owner. Surety’s due diligence to determine the competency of the contractor.

- **A Surety Bonding Company is an “UNSECURED CREDITOR”**
  - The extension of surety credit is riskier than a traditional extensions of credit (Bank)
Surety Relationship (2 Party Agreement but a 3 Party Relationship)

- Surety
  - Reimburses surety for payment to owner
  - Pays owner for damages

- Contractor
  - Fails to perform

- Owner
Surety Bond Process

Surety Agent/Provider

- Organization information
- References
- Review of current work program
- Past jobs
- Current backlog
- Corporate financial statements and credit
- Personal financial statements and credit
- Banking relationship
- Internal control review

Underwriting

- Review of current/historical work-in-process schedules
- Detail review of scope of project compared to historical jobs
- Confirmation of banking relationships
- CPA prepared financials for 3 years
- Cash flow projections of project

Prequalification

- Organizational chart
- Resumes
- Business plan
- Work-in-process schedules
- Continuity or completion plan
- Letters of recommendation
- Financial statements
- Current line of credit agreement/statement
What a Surety / Underwriter Looks For

- **“Three Cs”**
  - Character of Contractor
  - Capacity with regard to skills, experience, knowledge, and equipment
  - Capital (Working Capital) to finance the project and ability to absorb a reasonable loss on one or more projects
  - Additional 2 Cs: Continuity & Contracts

- **Management Capabilities**
  - Information quality and reliability
  - Office, Estimating, Project, Field

- **Financial Condition and Performance**

- **Projected Bond Needs**

- **Indemnity Structure**

- **Credit History / Predictive Modeling**
# Types of Surety Bonds

<table>
<thead>
<tr>
<th>Bond Type</th>
<th>Description</th>
<th>The Surety’s Responsibility</th>
</tr>
</thead>
</table>
| **Bid Bond**     | • States that the surety believes the contractor has the ability and resources to complete the project at the bid price.  
                    • Assures that contractor will file its performance and payment bonds if awarded the contract. | • If contractor is awarded the contract but refuses to sign it, surety must pay owner difference between the winning bid and the next lowest bid. |
| **Performance Bond** | • Guarantees that contractor will complete project as specified by the contract. | • If contractor deviates from contract terms, surety must reimburse owner for any losses. |
| **Payment Bond**  | • Guarantees payment to subcontractors and suppliers.  
                    • Assures owner that project will be free of liens from unpaid subcontractors or suppliers. | • If contractor fails to pay subcontractors of suppliers, surety is required to pay. |
| **Maintenance Bond** | • Guarantees against any faulty workmanship or materials.  
                    • Usually good for one year after construction is complete. | • In the event of faulty workmanship or materials, surety must reimburse owner for any losses. |
| **Completion Bond** | • High risk performance bond put in place to guarantee a specific performance obligation for a owner.  
                    • Guarantees that the contractor will perform and pay for all contracted work. | • If contractor fails to perform, surety must find another contractor to finish the work. Possible long term obligation |
Surety Adjustments To Financial Statements & Why

- Accounts receivable over 90 days (except retainage)
- Accounts and notes receivable from officers, employees, owners, 3rd Parties
- Inventory
- Prepaid expenses
- Cash value of life insurance
- Current liabilities
- “The Tax Plug”
Exhibit: Determining Working Capital for Surety Credit

<table>
<thead>
<tr>
<th>Current Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets – GAAP Basis</td>
<td>$ x,xxx</td>
</tr>
<tr>
<td>Subtract:</td>
<td></td>
</tr>
<tr>
<td>Receivables from officers, employees, owners</td>
<td>(xxx)</td>
</tr>
<tr>
<td>50% of inventory not at job site</td>
<td>(xxx)</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>(xx)</td>
</tr>
<tr>
<td>Add:</td>
<td></td>
</tr>
<tr>
<td>Cash surrender value of life insurance</td>
<td>____ xx</td>
</tr>
<tr>
<td>Current Assets – Surety Credit Purposes</td>
<td>x,xxx</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Current Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities – GAAP Basis</td>
<td>(x,xxx)</td>
</tr>
</tbody>
</table>

| Adjusted Working Capital for Surety Credit | $  xxx   |
Key Financial Ratios
Financial Info

- Latest CPA financial statements with work-in-process schedules (2-3 years)
- Accounts receivable aging
- Marketable securities (available-for-sale)
- Overbillings and job borrow
- Property and equipment
- Debt
- Underbillings
- Profitability on a job-by-job basis looking for “profit fade”
- Statement of cash flows
Financial Ratios

- Profitability
- Liquidity and cash management
- Fixed assets
- Debt
- Equity
- General and administrative expenses
- Officers’ salaries
### Example Ratios Used by Sureties

<table>
<thead>
<tr>
<th>To Measure</th>
<th>Use Ratio</th>
<th>And Look for</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profitability</td>
<td>Gross Profit Percentage as a % of Sales</td>
<td>• Trends</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Comparison to industry averages</td>
</tr>
<tr>
<td>Profitability</td>
<td>Net Income as a % of Revenue</td>
<td>• Trends</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Comparison to industry averages</td>
</tr>
<tr>
<td>Profitability</td>
<td>Backlog Gross Profit to G&amp;A</td>
<td>• Should be greater than 50%</td>
</tr>
<tr>
<td>Profitability &amp; Liquidity</td>
<td>Underbillings to Equity</td>
<td>• Must be less than 20%</td>
</tr>
<tr>
<td>Liquidity &amp; Profitability</td>
<td>Underbillings to Working Capital</td>
<td>• Less than 25%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Be able to explain underbillings</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Net Quick</td>
<td>• Must be greater than 1:1</td>
</tr>
<tr>
<td></td>
<td>Current Assets – (Inv + Ppd) : Current Liab – Def Taxes</td>
<td>• Comparison to industry averages</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Retention of profits in Company</td>
</tr>
</tbody>
</table>
## Example Ratios Used by Sureties (continued)

<table>
<thead>
<tr>
<th>To Measure</th>
<th>Use Ratio</th>
<th>And Look for</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity</td>
<td>Cash to Equity</td>
<td>• Should be greater than 20%</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Cash to Overbilling</td>
<td>• Must be greater than 1:1</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Working Capital to Overall Maximum Cost to Complete (Bond Program)</td>
<td>• 7.5 or greater</td>
</tr>
<tr>
<td>Liquidity &amp; Cash Management</td>
<td>Cash Balances and Sales</td>
<td>• 5% cash to sales</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Review trends of cash balances</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Average cash balance</td>
</tr>
<tr>
<td>Liquidity &amp; Cash Management</td>
<td>Accounts Receivable Turnover</td>
<td>• Less than 90 days</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Less retainage</td>
</tr>
<tr>
<td>Debt</td>
<td>Total Liab : Net Worth</td>
<td>• Less than 3:1 is considered good</td>
</tr>
</tbody>
</table>
## Example Ratios Used by Sureties (continued)

<table>
<thead>
<tr>
<th>To Measure</th>
<th>Use Ratio</th>
<th>And Look for</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>Interest-Bearing Debt : Net Worth</td>
<td>• 0.8 to 1.0</td>
</tr>
<tr>
<td>Debt</td>
<td>Debt Coverage</td>
<td>• Over 1.25</td>
</tr>
<tr>
<td>Debt</td>
<td>Bankline : Bonding Program</td>
<td>• 10% of max bonding program</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Trend of using of line</td>
</tr>
<tr>
<td>General and Administrative Expense</td>
<td>G&amp;A : Revenue</td>
<td>• Comparison to industry averages</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Whether ratio stays relatively constant in slow times</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Should be less than 5% (excluding other discretionary expenses)</td>
</tr>
<tr>
<td>Officers’ Salaries</td>
<td>Officers’ Salaries : Revenue</td>
<td>• Comparison to industry averages</td>
</tr>
</tbody>
</table>
Maximizing Surety Credit and Bonding Capacity
Maximizing Surety Credit

- Ten times adjusted working capital for surety credit for an individual project
  - Composition of Working Capital is Important

- Ten times net worth for a maximum credit for a work program
  - Composition of Net Worth is Important
  - Off Balance Sheet Equity (Depreciated Equipment)
# Maximizing Surety Credit – Financial

## “Positive” Impact

- Stability of sales/manageable growth
- Gross profit/operating margins stability & growth over time
- Retain profits in Company
- Decrease interest-bearing debt
- Maintain line of credit
- Continue to improve composition of working capital (cash, quick turning accounts receivable)
- Timeliness of financial reporting

## “Negative” Impact

- Significant fluctuations of sales, gross profits & operating margins
- Significant distributions to stockholders/members
- Continuing to increase financing agreements
- No line of credit in place
- Working capital comprises of significant underbillings
- Financial statements submitted past 6-month period/year-end
- Poor cash flows
Maximizing Surety Credit – Work-in-Process Schedules (“WIP”)

- **Maintain Adequate Cost Accounting System**
  - Ability to produce timely & accurate WIP schedules for surety
  - Ability to produce supporting documents for all items on WIP schedule
  - Extensive use of manual processes (use of spreadsheets)

- **Management’s Review and Analysis of WIP Schedule**
  - Ability to track and explain contract gross profit margins
  - Ability to properly estimate jobs without historical “fades” – conservative estimation until projects are complete
  - Track and explain “underbillings” or contracts
  - Know burn/run-off rate
Maximizing Surety Credit – WIP Schedules (continued)

- **Contract Risks**
  - Ability to explain to the surety what the risk is on the contract
  - Ability to drill down on contract terms, conditions, language, warrant periods, LD’s, etc.
  - Experience with owner and owner’s personnel
  - Experience with type of project
  - Experience with subcontractors
Maximizing Surety Credit – Other

Other

• Keep surety informed of any changes in organization
  - Business plan
  - Key people
  - Subcontractors and suppliers
  - Labor pool

• Partner with construction experiences professionals
  - CPAs
  - Attorneys
  - Bankers
  - Insurance and bond agents
Warning Signs (other than financial)

1. Inadequate insurance coverage

2. Lack of business plan
   • Cash flow
   • Work flow
   • Organizational
   • Succession

3. Inadequate project management

4. Excessive employee turnover in key positions (including service providers)

5. Extraordinary litigious
Warning Signs (continued)

6. **Significant change in contracts**
   - Type of work (public vs private, scope, trade, etc)
   - Location
   - Size

7. **Inaccessibility of principal/management**
   - Poor communication with key business advisors (agents, CPAs, surety, banks, attorneys, etc)

8. **External factors**
   - Budget cuts
   - Increased number of bidders
   - Reduced profit margins
   - Increases in cost of funds
Other Recommendations

- Don’t Wait!!!

- Meet with CPA and Bonding Agent
  - Expectations to satisfy BOTH tax and bonding/banking requirements

- Get Advisors Involved **EARLY** in Process
  - Any claims/issues
  - Large projects/potential bids
  - Use advisors to help review contracts for any special provisions
THE END

QUESTIONS???