SURETY 101: BONDING AND INSURANCE FOR NEW AND EMERGING CONTRACTORS

2012 Webinar Series

Bonding and Insurance For New and Emerging Contractors

Associated Builders and Contractors, Inc.

Presented By:

Construction Bonds, Inc. a Division of Murray Securus

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Who is Construction Bonds (CBI)?

- Founded in 2003 by John Hughes, CBI was created to focus on helping small and emerging contractors gain access to surety credit
- CBI has experienced rapid growth (300% in five years)
- 2011 SBA Surety Bond Producer of the Year
- In 2010, merged with Murray Securus to help our emerged contractors obtain additional bond capacity

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Current Construction and Construction-Related Services Industry

- Approximately $1.1 trillion industry
- 8% of U.S. economy (GDP)
- 2nd largest economic sector in terms of revenue and employment
- Demographic shift in construction company ownership towards traditionally disadvantaged firms

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Barriers to Emerging Contractors Entry and Growth

- Contracting Opportunities
- Information and Management Expertise
- Trained and Reliable Workforce
- Capability and Capacity
- Performance Issues and Dispute Resolution
- <u>Bonding and Financing</u>

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How Contractors Have Addressed Barriers to Bonding

- Only bidding work where bonding is not required
- Bidding under prime contractor's bond
- Advocating for bond waivers
- Advocating for alternative insurance/guarantee products
- Obtaining First Bond or Increasing Bonding Capacity

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Issues in Access to Bonding for Emerging Contractors

- **Changes in industry appetite for emerging contractors**
- **Lack of understanding of the bonding process**
- **Poor credit history**
- **Poor financial records and company management**
- **Difficulty in identifying appropriate bonding support**
- **Breakdown in communications with bond producer/surety company**
- **Late entry in the bonding arena**

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Why Minority and Women Contractors are an Emerging Market for Surety Bonding

- Demographic imperative
- Customer requirements
- Increasingly cost-effective
- Excellent pool of quality minority and women contractors
- Historically under-serviced by surety and financial industries

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Surety Industry Strategies for Increasing Access to Bonding

- **Increasing Awareness and Understanding of Role and Importance of Bonding**
- **Developing Relationships between Bond Producers/Underwriters and Small/Emerging Contractors**
- **Encouraging More Bond Producers and Surety Companies to Outreach and Service Small/Emerging Contractors**
- **Advocating for Governmental Programs of Greater Support for Small and Emerging Contractors**
- **Using Underwriting Requirements as a Tool for Expanding Contractor Capability and Capacity through Educational Workshops and Bond Readiness Activities**

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Current Contractor Development and Bonding Support Programs

- SBA Bond Guarantee Program
- USDOT/OSDBU Bonding Education Program (BEP) – Country-wide
- State Bond Guarantee Programs
- New York State Surety Bond Assistance Program
- Other Federal, State and Local Capital Access Programs
- SFAA Model Contract or Development Program (MCDP)
  - Prince George's County, MD Economic Development Corporation, Small Business Initiative
  - Baltimore LOCAL Contractor Development Program (SBRC Baltimore)
  - University of Texas/Historically Underutilized Businesses (HUB) Office
  - Mississippi Development Authority, Minority & Small Business Development
  - Greater Cleveland Partnership/Committee on Inclusion
  - Cincinnati Minority Contractors Business Assistance Program
  - Washington, DC Department of Small & Local Business Development
  - Rhode Island SBA District Office/SBDC/SCORE/CWE
  - Essex County , NJ Office of Small Business Development and Affirmative Action
  - Indiana LSA/IBCC Model Contractor Development Program

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MYTHS AND REALITIES OF BONDING

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MYTHS AND REALITIES OF BONDING

MYTH - *The bonding industry has a capacity crunch.*

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MYTHS AND REALITIES OF BONDING

REALITY –

- The capacity of the bonding industry has never been higher.
- However, the appetite for risk varies from company to company and for very large projects, it may be difficult to obtain a bond from a single source.
- More likely is a co-surety relationship in which two or more bonding companies share in the risk

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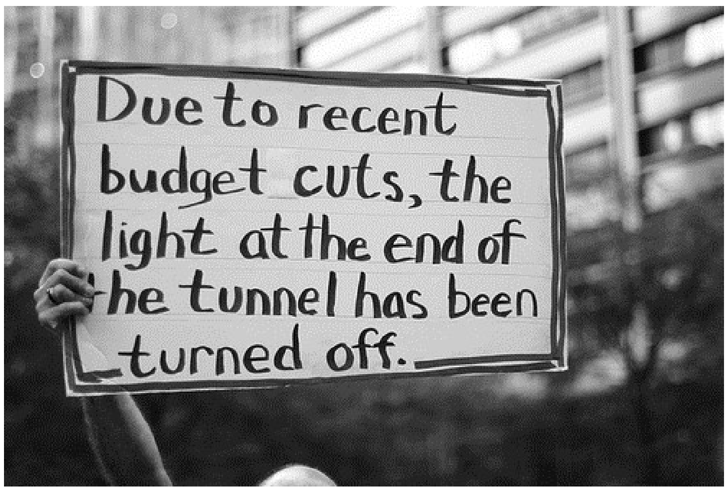
MYTHS AND REALITIES OF BONDING

MYTH - *Given the current economic crisis, there is likely to be a reduced demand for bonds.*



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MYTHS AND REALITIES OF BONDING

REALITY –

- Where there has certainly been a slowdown in construction, this is most critically felt in residential construction where traditionally bonding has not been required.
- With the economic stimulus activity, the market for public sector construction, in which bonding is almost always required, actually increased between 2007 and 2010, despite the economic downturn in other sectors of construction.

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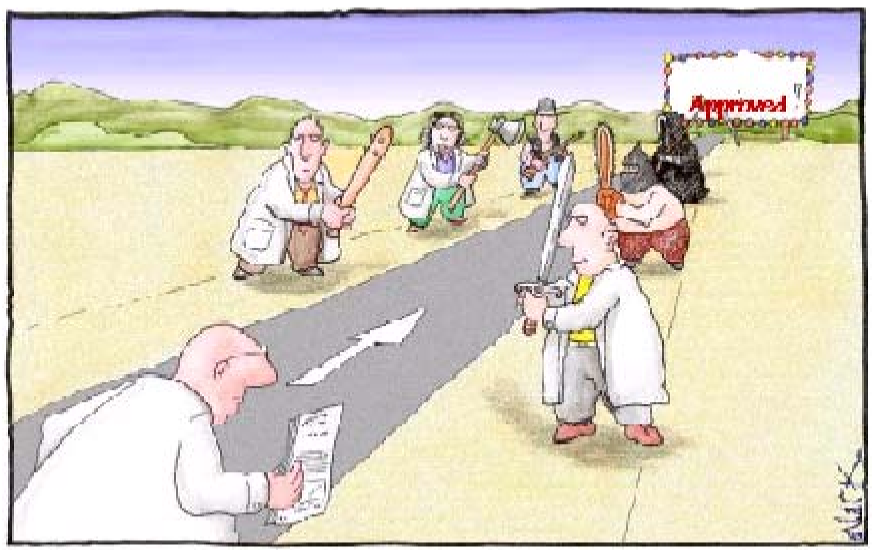
MYTHS AND REALITIES OF BONDING

MYTH – *All bonding companies are the same.*



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MYTHS AND REALITIES OF BONDING

REALITY –

- Different bonding companies have different appetites for risk and underwrite in different ways. For example, some companies require collateral, others do not.
- Some companies focus solely on smaller contractors (usually under $20 million) while other companies go after the big guys.
- There are companies who are comfortable working with bond guarantee programs such as SBA while others are not.
- There is a surety company out there whose market is likely to fit the needs of any size contractor.

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MYTHS AND REALITIES OF BONDING

MYTH – *Bonds are too costly.*

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MYTHS AND REALITIES OF BONDING

REALITY –

- In actuality, there is very little cost to the contractor for a bond because the cost is picked up by the owner as a line item expense to the project.
- A bonded contractor is at no competitive disadvantage because of the bond because all bidders on that project will be required to provide bonding and the cost variance for the bond from contractor to contractor is usually minimal.
- There are usually no cash flow implications for the bond because the bond premium comes out of the first draw and most sureties will wait until that draw to be paid.

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MYTHS AND REALITIES OF BONDING

MYTH – *Bonding is the same as insurance.*

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MYTHS AND REALITIES OF BONDING

REALITY -

- Although issued and underwritten by bonding companies that are usually part of larger insurance operations, the bond itself is more like a credit product.
- Underwriting is not based on actuarial tables but is transaction-based and specific to the project in hand.
- The bonding company underwrites with the full expectation that the contractor will complete the project on time, under budget and pay all suppliers and subcontractors, just as a banker fully expects that a lender will pay back a given loan.

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MYTHS AND REALITIES OF BONDING

MYTH - *Bonding companies are imposing more stringent underwriting standards for contactors to qualify for bonds.*

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MYTHS AND REALITIES OF BONDING

REALITY –

- While it is true that some bonding companies are tightening their underwriting requirements, what is happening more often than not is that the contractors are having more difficulty meeting the already existing underwriting standards, in large part because of the credit crisis.
- Contractors are having a more difficult time finding and maintaining appropriate lines of credit and bonding companies are even having to take the unusual step of underwriting the financial institutions that are providing the credit to the contractor, just in case these institutions may have some difficulties of their own in honoring line of credit agreements.

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MYTHS AND REALITIES OF BONDING

MYTH – *There are special requirements a contractor has to meet in order to get a bond.*

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MYTHS AND REALITIES OF BONDING

REALITY –

- There is nothing special about the requirements that the bonding company imposes on the contractor other than to run a sound business.
- If you look at the list of requirements for submission of a bond application package, each of the items asked for is something that a prudent contractor would want to have in place to run their business.
- No special efforts need to be undertaken for a bond that would not need to be undertaken for the survival and growth of the company, even if they were not seeking bonding.

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<u>MYTHS AND REALITIES OF BONDING</u>

MYTH – *You have to have a certain credit score to qualify for a bond.*

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MYTHS AND REALITIES OF BONDING

REALITY –

- Personal credit scores are one of many things that a bonding company will look at in underwriting a contractor.
- To be sure, good credit is always helpful, but a good track record is also important.
- And most importantly is the financial condition of the company and in this instance, cash is king.

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MYTHS AND REALITIES OF BONDING

MYTH – *Bonding is a roadblock that keeps contractors from growing.*

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MYTHS AND REALITIES OF BONDING

REALITY –

- On the contrary, not having bonding is probably the biggest roadblock to a company's growth in the construction industry.
- Bonding is a door opener in that it lets owners and larger prime contractors know that you are a quality contractor with the capability and capacity to undertake the job in question.

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MYTHS AND REALITIES OF BONDING

MYTH – *The bonding industry just doesn't want to bond small and minority contractors.*

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MYTHS AND REALITIES OF BONDING

REALITY –

- One only needs to look at the business census data for the construction industry to see that this industry is increasingly becoming an industry of smaller, women and minority contractors.
- Historically, the way in which the bonding industry has grown is that bonding companies take on a company when it is small and work with that company as it grows.
- If the bonding industry is to continue to prosper by writing bonds and growing with the contractors, it must write bonds to those small contractors that are out there, including women and minorities.

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Bonding vs. Insurance

- Surety Bonds are a non-traditional insurance product
- Surety bonds are similar to bank credit
- Surety provides assurance that contractor can complete project and pay bills
- Surety companies guarantee 100% of contract amount

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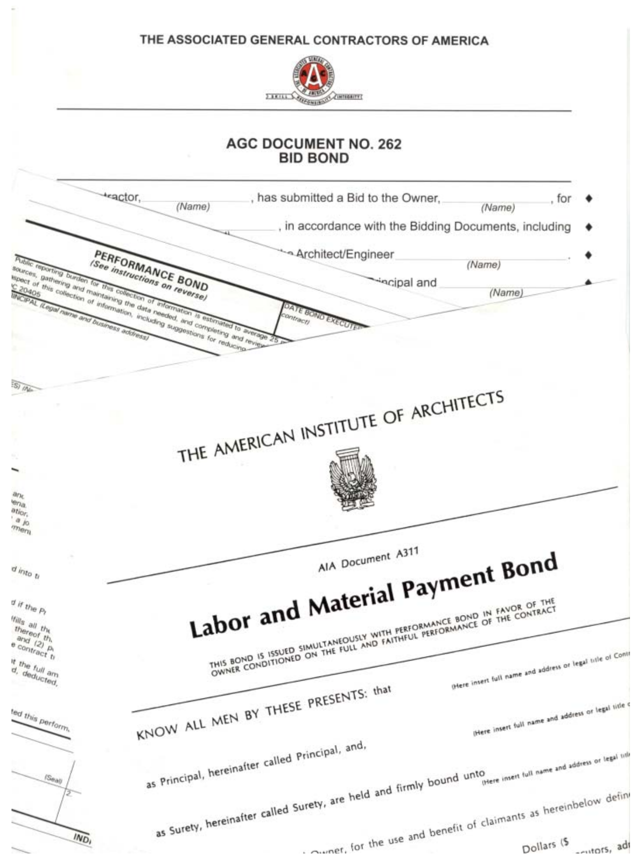
A Bond is a Three-Party Contract

- Contractor
- Surety
- Obligee



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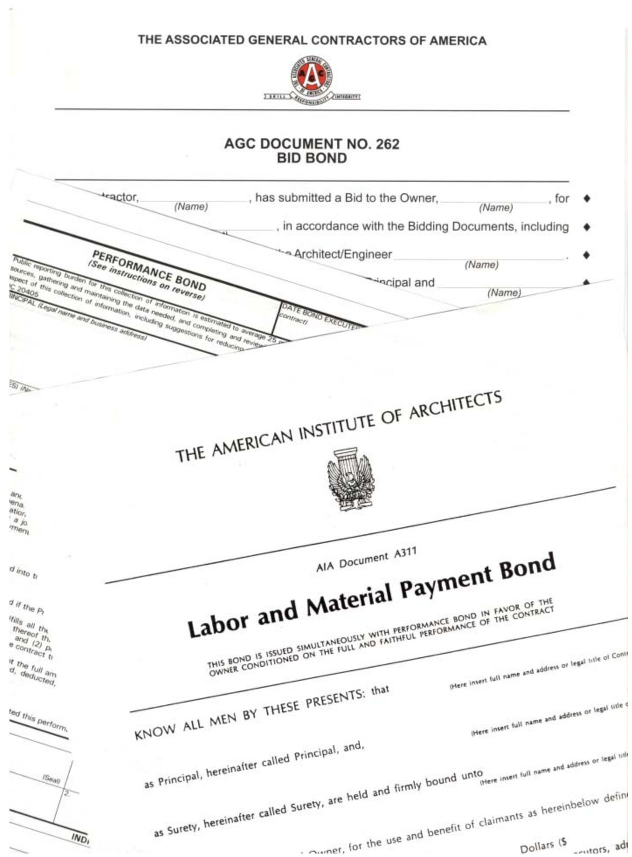
Types of Surety Bonds

- Bid
- Performance
- Payment



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The Bid Bond

The **bid bond** assures that the bid is submitted in good faith and that the contractor will enter into the contract at the price bid and provide the required performance and payment bonds.

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The Performance Bond

The **performance bond** protects the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions.

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The Payment Bond

The **payment bond** assures that the contractor will pay specified subcontractors, laborers, and materials suppliers associated with the project.

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Cost of Bonds

Project Amount	Approx. Bond Premium
$1 Million	$7,700 – $13,500
$5 Million	$33,200 – $47,250
$10 Million	$56,950 – $81,000
$20 Million	$101,950 – $146,000
* Premiums may vary depending on size, type & contractors bonding capacity.	

*For a small and emerging contractor, premiums can start around 2.5-3%.

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Cost of Bonds (examples)

- Established Contractor
  - $500,000 Contract
  - Reviewed/Audited Financial Statements
  - Frequent Bond User
  - <1.0-1.5% Bond Rate (average – 1.35%)
    - <$5,000-7,500
  - Likely no other costs involved (collateral, escrow, SBA)

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Cost of Bonds (examples)

- Emerging Contractor
  - $500,000 Contract
  - Limited Financial Info. (Tax Returns/Quickbooks)
  - Limited Bonding History
  - 1.8-3.0% Flat Rate (average – 2.5%)
    - $9,000-12,500
  - May not include cost of getting bond (i.e., funds control, collateral, SBA fees)

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The Surety Bond Producer

- Performs initial prequalification of contractor
- Primary surety industry contact
- Communicates with underwriter & helps negotiate level of surety capacity
- Provides sound business advice

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The Surety Underwriter

- Primary goal is to prevent default
- Makes decisions on surety capacity
- Extends surety capacity to ensure success of contractor

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Prequalification Process

- Sound financial statements
- Committed & competent personnel
- Business plan
- Personal & corporate indemnification

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Prequalification Criteria – The 3 "C's"

- **Capacity** – Can the contractor perform the obligations of the contract?
- **Capital** – Does the contractor have the financial strength to fulfill the terms of the contract?
- **Character** – Historically, how has the contractor performed? What is the contractor's reputation?

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Capital: Financial Strength

- In-depth, detailed evaluation of contractor's financial strength:
  - Annual report
  - Interim statements
  - Investment strategies
  - Cost control
  - Continuity and succession planning

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Capacity: Ability to Perform

- Can contractor fulfill obligations?
- Analysis of past projects
- Current work load
- System check on work & cash flow

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Character: References and Reputation

- Of the construction firm
  - Business relations with
    - Primes, subcontractors and vendors
    - Previous owners
    - Banks
- Of the construction firm owner
  - Personal financial statement
  - Credit reports

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Other Prequalification Criteria

- Good references and reputation
- Ability to meet current and future obligations
- Experience that matches contract requirements
- Necessary equipment or the ability to obtain it
- Financial strength
- History of paying subcontractors and suppliers

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Information that the Surety Requires

- Organizational chart of company
- Resumes of key personnel
- Contractor’s business plan
- Financial Statements (last 3 to 5 years)
- Work in Progress
- Continuity and contingency plans
- Subcontractor and supplier references
- Bank line of credit (if any)
- Letters of recommendation

Quality of Financial Statements

- Audit
- Review
- Compilation

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Earning Trust: Maintaining the Surety Relationship

- Immediately notify surety of problems
- Provide balance sheet and profit & loss statements based on percentage of completion
- Communicate openly
- Provide accurate, detailed & consistent feedback

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Types of Insurance

- Liability Insurance
  - Business Auto Policy (BAP)
  - Commercial General Liability (CGL)
  - Workers’ Compensation
  - Umbrella Coverage
- Property and Casualty Insurance
  - Property Insurance
    - Building Insurance
    - Business Personal Property Insurance
  - Casualty Insurance
    - Key Employee
    - Business Continuation

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Value of a Good Insurance Agent

- Acts as a consultant in the selection process of other team members (e.g., banker, lawyer, accountant)
- Helps to establish a comprehensive insurance plan
- Helps the contractor with business planning, especially discussions on risk management
- Helps the contractor increase his or her insurance program

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For More Information

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