

Cavignac & Associates

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Surety Bonding No Longer a “Sure Thing” for Contractors

The local building industry, say experts, have been facing new challenges in 2002. A growing number of construction firms have found it increasingly difficult to obtain surety credit.

In fact, American International Group (AIG), the world's largest surety company, announced that it would no longer support construction firms with net worths under \$50 million. An estimated 500 construction firms worldwide already have been dropped by AIG.

“The reverberations of this surety fallout are being felt here in San Diego,” says Yehudi Gaffen, principal of local construction management firm Gafcon. In recent months, Gafcon has experienced a dramatic increase in its surety claims support work. The firm is even opening a new surety support division to provide assistance to bonding companies whose projects are in trouble.

What's Going On?

According to Gaffen, surety bonds have become more difficult to obtain due to the tightening of the insurance markets, struggling economy, 9/11 terrorist tragedy, increased litigation surrounding construction projects, predicted slow down in construction activity, and the failure of energy-trading giant Enron (which had a significant amount of bonded obligations with many surety companies that now have to cure defaults).

To make matters worse, the Surety Association of America (SAA) recently released a report indicating that the surety industry incurred record underwriting losses of \$1.5 billion in 2000. This is an increase of more than 100 percent from 1999. While loss results for 2001 are not yet finalized, all indications are that surety losses will be worse for this past year.

“The drive for premium growth in recent years resulted in a lack of focus on fundamental underwriting practices, leading to inappropriate levels of bond credit being offered,” says Gaffen. *“The strong construction economy of the late 1990s, combined with over-abundant surety capacity, allowed contractors to become over-extended.”*

“This year could be disastrous, as industry experts have predicted an increase in contractor failures,” says Ted Bumgardner, principal of Gafcon. *“More bonding companies will be required to step in to complete projects and pay off subcontractors who inevitably will file claims and liens on bonded projects.”*

Why is Bonding Important?

Surety bonding is a valuable credit source – one that is vital to most contractors' existence.

“It's important to know whether or not a contractor is bondable and to what extent,” says Bumgardner. *“Gafcon gets involved in checking contractors' bonding abilities based on capacity and bonding company rating. Owners, especially public owners, require a 100 percent payment and performance bond to ensure that the contractor will complete his contract and pay all his subcontractors.”*

According to Jim Schabarum, president of the Surety Association of San Diego, as well as principal and director of the Surety Bond Department at Cavnignac & Associates, surety bonding offers a number of benefits to various parties to a construction project.

“Bonds guarantee – to lenders, owners, general contractors and lower tier subcontractors, suppliers, laborers, and the public at large – that a bonded construction project will be built and delivered,” says Schabarum. “Bonds offer revenue opportunities to qualified contractors who can provide bonds for construction projects. Also, bonded contractors receive financial analyses and consultative services from the surety – an outside ‘credit partner’ – that help improve the contractor’s business operations.”

The bonding success of local construction firm Keeton Construction is a testament to these benefits. The 30-employee company has secured a higher bonding capacity than most general contractors of its size in San Diego and Riverside Counties.

“We’ve been able to earn the credibility we have by never having a claim against our surety and always having a positive cash flow from our very first job,” says President Bruce Keeton. “From a surety company’s perspective, we are low risk, profitable, and a highly liquid company – with the cash power of a large company. We’ve also secured high-level bank lines of credit as a backup to our cash reserves.”

Improving Bonding Capacity

According to Schabarum, before extending surety credit to contractors, surety companies consider many variables. In today’s tightening surety credit environment, contractors need to focus on hot key areas to improve their bonding capacity:

- 1. Know your surety underwriter** – If a contractor has an existing relationship with a surety, don’t lose it, *enhance* it. Accomplish this by face-to-face meetings on a regular basis.
- 2. Evaluate your surety broker’s abilities and capacity** – A professional surety bond broker represents and advocates the contractor’s interests, and should know the contractor’s business inside and out. A broker should provide ongoing, proactive advice on how to improve the contractor’s credit profile. Brokers with backgrounds as surety underwriters who are also involved in construction trade organizations and surety industry associations most often have the contacts and clout to obtain more surety credit and better terms for their clients.
- 3. Improve financial strength and presentation** – Sureties focus more than ever on contractors’ liquidity, which is comprised of a substantial cash reserve position and low interest-bearing debt.

In addition, sureties expect contractors to discontinue financial activities unrelated to the contractor’s core business, retain earnings and minimize the use of tax planning strategies. Contractors should upgrade the level and frequency of their financial presentations so that the surety can rely on more current information, which will enable the underwriter to extend better surety bond credit terms.

- 4. Increase bank operating line of credit** – A larger bank line of credit not only demonstrates a contractor’s credit-worthiness to a surety company, it also provides better cash flow capacity and loss paying power if a contractor needs it.

Forming a Bonding Relationship

Schabarum stresses that contractors need to build a strong relationship with an outside, trusted advisory team of construction-oriented professionals. The team should include the surety bond broker, surety company, a construction-oriented CPA, banker and attorney.

“Surety is based on relationships,” says Schabarum. “However, surety underwriting requirements will continue to become more demanding in 2002. Contractors that need surety bonds but don’t know how to qualify for them will have problems. Contractors with a trusted advisory team will be more successful in obtaining surety bond credit programs that they’ll need in the future. Surety bonds will continue to be available to well-run construction firms that have knowledgeable advisory teams.” ❀