Construction Industry Update

MSP Construction Update 11/2004: "Surety Market — Outlook for 2005" November 2004

Surety Market – Outlook for 2005

By James P. Schabarum II, CPCU, AFSB, CWCA

Last month, our Commercial Insurance Update newsletter featured our annual commercial and workers compensation insurance outlook for 2005. The article, which can be found on our Web site at www.cavignac.com/pdfs/Cml1004.pdf, also focused on the insurance industry as it relates to contractors.

Surety Market Outlook

Shortly before this article was written, the surety market was showing signs of recovery similar to the entire insurance industry. However, in the last few weeks, the Surety Association of America reported preliminary results for the first six months of 2004. The direct loss ratio was a whopping 77.5%. Ouch!

With the surety industry's direct loss ratio breakeven point at plus or minus 34%, the surety industry appears to be trending toward increased losses, although this may be misleading. Looking back, surety company results peaked in 2001 with a direct loss ratio of 82.5%. In 2002, the direct loss ratio for the industry dropped to 69.9%, and in 2003 results continued to decline to 49.4%.

Now, in 2004, when the surety industry is showing a strong trend of recovery, the six-month results are up again. Don't be alarmed. The six month 77.5% loss results recognizes one large loss — Modern Continental — that has been looming for years. If this loss were removed from 2004, the surety industry results today would show a continuously improving direct loss ratio in the high 30% range for the first six months of the year.

Today's "hard" market is nothing new. In the 1980s, the surety industry also experienced tough times along with the rest of the economy. Business failure rates were at record levels, interest rates were in double digits, and the economy slowed. By the mid to late 1980s, however, surety losses peaked.

Throughout the 1990s the economy boomed, interest rates dropped, and surety results were profitable again. Surety bonding capacity was accessible, easy to obtain, inexpensive, and the most favorable terms were available. Many surety companies relaxed underwriting to compete for market share. Excess surety capacity built up in the market place, and anyone who could fog a mirror could get a bond.

After a dozen years of profitability, in 2000 the surety industry once again experienced record

Surety Market — 2005 *(Continued on page 2)*

In This Issue:

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Surety Market – 2005 *(Continued from page 1)*

losses. Besides increased contract failures of nearly $1.8 billion in combined claims in 2001 and 2002, major losses occurred in the commercial surety market with the demise of Enron, WorldCom, and others.

In reaction to severe losses, some surety companies went out of business or exited the market. Significant market consolidation has continued to occur, with some markets simply restricting capacity, increasing rates, and taking a more disciplined approach to underwriting.

Sureties have "returned to the basics" of underwriting, and have become far more cautious about bonding large programs, long-term and erroneous contracts. Underlying obligations in contracts are scrutinized on many levels, including the scope of work, bid spreads, bond forms, and financing. Often availability of surety credit or increase in premium rates and surcharges are associated with extended warranties, environmental and design exposures, and capacity requirements.

Today surety companies focus on evaluating the credibility of all information received by the underwriter. The conservative underwriting analysis of information has resulted in an increase in the level of frequency, quality, and amount of financial reporting required from those seeking bonds. Sureties also focus on profit-fade related to under- and over-billings as well as cash flow from use of bank lines of credit and debt service and a myriad of other key ratios.

Surety Outlook for 2005

With 2004's first six-month loss ratios showing a significant rise, it is certain that the surety industry as a whole will continue to tighten its underwriting requirements until it again returns to profitability. Unfortunately, this is likely to be several years in the future. Regardless, healthy contractors should continue to implement best practices and use the following strategies to obtain surety credit:

1. Build a positive, credible reputation and track record.
2. Nurture a successful, safe organizational culture.
3. Improve effective internal and external communication.
4. Develop surety relationships by Trusted Advisor meetings with your surety bond broker, surety and reinsurance representatives, CPA, banker, and attorney.
5. Employ strong financial and administrative personnel.
6. Develop and formalize Standard Operating Procedures (SOP) for all activities.
7. Know your surety company's "hot spots" – key financial ratios, adequate cash balances, bank line of credit usage tolerance, etc.
8. Improve the quality and timeliness of financial reporting and bond requirements.
9. Over-capitalize the balance sheet to the work program needs.
10. Conserve cash and minimize interest-bearing debt.
11. Aggressively drive a cash management plan – "Cash is King!"
12. Work off interest-bearing debt and increase the spread on bank lines of credit.
13. Expand and upgrade accounting presentation – job costing, labor milestones/ schedules, cash flow schedules, etc.
14. Scrutinize contract terms, bond forms, financing arrangements, warranties, and bid spreads.
15. Bond critical subcontractors.
16. Don't "buy" jobs!

With further consolidation in the marketplace, we can expect continued tight terms and conditions for surety credit in 2005. With the ten largest premium volume surety companies now controlling more than 65.5% of the market place, it is likely that premium rates will increase. Less negotiation will be available on terms such as bonding subcontractors, acceptable contract specifications, full indemnity and other underwriting requirements. There will also be a likely rise in the frequency of credit schemes using creative, unlicensed surety entities and alternative products to bonds.

Contractors can expect sureties to look at their work programs more closely, which can lead to changes in the amount of capacity sureties are willing to offer. Although all surety companies have the capacity to support an increased work program, they may not have the same appetite for risk as they have had in the past. Nevertheless, a contractor with a solid reputation, balance sheet, profitable work program and experience should have no problem obtaining the surety bond credit it needs. Overall, the surety industry is healthy and will continue to respond to the challenges and opportunities in the construction industry.

Disclaimer: *This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.*

Year-End Planning vs. Year-End Reacting

By Michael R. Strahan, CCFP, Cavignac & Associates

A typical surety relationship is built around extending credit from year-end CPA prepared financial statements with little consideration given to other factors. Because these statements are so critical to obtaining the support you need to meet your business objectives, why do most contractors seem to operate in a vacuum when it comes to preparing them?

Generally, only after the CPA has completed the year-end statements are they shared with the surety agent/broker and representative from the surety company. The parties then arrange a meeting to discuss how the year-end turned out, and then credit parameters are set.

This seems like an easy way to damage a relationship, as expectations from the contractor after year-end planning may not meet the reality of what the surety industry will extend in terms of credit, and hard feelings can result.

Proactive Planning

This situation can be easily avoided with a little planning by the contractor and the agent/broker. Instead of taking a reactive role after the year is over, hold a proactive planning session one to three months before the year-end statement is finalized.

While this alone may not eliminate the potential for disagreement between the expectations of the contractor and what the surety is willing to extend, the parties will potentially find a middle ground that is acceptable to all involved, making the year-end statement less of an event.

At a minimum, the attendees in this meeting should include the contractor, the CPA and surety agent/broker. The agent/broker can convey to the contractor what the surety industry expectations are while also taking the contractor's information and expectations to share with the surety. While not ideal, this does allow the flow of information to be proactive.

The meeting will be more effective if the surety representative attends. Not only will it provide a relationship building opportunity, but the parties that have the most impact on the decision-making process will be face-to-face. The opportunity for miscommunication is reduced if all vital parties to the surety relationship are at the table.

Taking it one step further, you may also consider having your banker attend. Bank line of credit underwriting is not all that different from surety underwriting, and the CPA year-end financial statement carries a significant amount of weight with bankers as well. It may prove extremely beneficial to make sure they are in agreement with the year-end plan and again, it allows you the opportunity to build your relationship.

Expanding the meeting participants to include your insurance broker, insurance underwriter and attorney can extend the benefits of the meeting even further.

Meeting Preparation

In preparation for the meeting, you should have your most current month-end financial package, a pro forma balance sheet, and an income statement for the year-end. You should also have a written business plan for the coming year that discusses revenue, income expectations, job sizes, scopes of work, and the geographic spread of your business.

With this information in hand and all parties in attendance, the surety representative and contractor can discuss year-end strategies, and how their decisions will play into the surety company's ability to support the contractor's objectives in the coming year.

This approach will allow time for modifying strategies and objectives for the coming year. It will also either confirm that what you are doing is supportable by the surety company, or allow the surety company time to get comfortable with your strategy.

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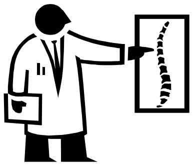

Risk Control Corner

By Stuart Nakutin, AIC, WCCA, WCCP, CDMC

At Cavignac & Associates, we work with our valued partner clients to reduce and manage their Total Cost of Risk (TCOR). One way this is done is by developing with our clients and their insurance companies better, formalized systems for human resources, safety programs and claims control.

We help our clients identify the factors and situations that drive their insurance-related costs, and implement a plan to manage those losses. Our ultimate goal is a safer workplace and lower insurance costs.

We know that fewer claims and lower loss ratios result in more competitive pricing for our clients. Every task performed by our risk management staff is directed at achieving that result.

Some of Cavignac & Associates' construction risk control surveys include**:**

- **Workers Compensation Claims Management –** Winning strategies for lowering your experience modification factor
- **Early Return To Work Program –** Evaluation, development and implementation
- Formal **Fleet Safety Program**
- **SB-198 Compliance** / Injury, Illness & Prevention Program implementation

We also provide our clients with:

- Formal claim and loss control recommendations
- Open claim reviews
- Experience modification projections

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Need Employee Retirement or Medical Benefit Plans?

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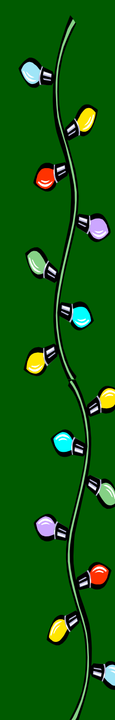
Associated General Contractors of America (AGC), *the nation's largest and oldest construction trade association*, offers competitive rates, freedom of plan choice, and the ability for you to pay no payroll taxes on your contributions.

Contact Patrick Casinelli in the Employee Benefits Department of Cavignac & Associates. He is an active member of AGC and can provide you with complete information and assistance in the AGC Pension, Medical and Benefits Plus plans.

Just in time for the HOLIDAYS!



As part of our commitment to the San Diego community, Cavignac & Associates supports many charitable organizations. However, during the Holiday season the outlook for the San Diegans some of these organizations serve is particularly bleak. We invite you to visit the Web sites of these organizations and join us in supporting them!

- **Monarch High School – www.monarchschools.org**
- **Polinsky Center – www.wic.org/orgs/polinsky.htm**
- **Senior Community Centers – www.servingseniors.org**