Surety Outlook 2017: Staying the Course

By James P. Schabarum II, CPCU, AFSB, Cavignac & Associates
Jase Hamilton, CPCU, AFSB, Cavignac & Associates

The U.S. surety industry will continue to realize growth in overall premiums, and likely experience a modest increase in loss activity in 2017.

With clear skies overhead, most contractors today are enjoying healthy backlogs and a return of acceptable profit margins -- the “telltale” sign of a true economic recovery.

However, there are clouds on the horizon that inevitably will be upon us all. While times are good but not great, today and in the near future, prudent contractors are studying the elements, properly manning and provisioning, and regularly charting their destinations to be disciplined and stay on course.

Elements

Both the U.S. economy and Surety Industry remain resilient and strong headed into 2017. However, there are dynamic factors in both that will affect the future and should be considered in evaluating and making business decisions.

Economy - Although slower than most may like, the U.S. economy continues to experience one of the lengthiest recoveries in its history (seven years). Current low inventories will be a key factor in fueling future growth.

Based on the Architecture Billings Index (ABI), which serves as a leading indicator for nonresidential construction activity, demand at A&E firms reached its highest level in over two years during the first half of 2016. Although there has been a slight slowdown recently in regions (see “Demand for Design Services”), the current ABI still shows growth in Architecture Firm Billings Continues in June

Demand for Design Services

REGIONAL
Business Conditions Soft in the Midwest, Improving in Other Parts of the Country

Graphs represent data from June 2015 – June 2016 across the four regions. 50 represents the diffusion center. A score of 50 equals no change from the previous month. Above 50 shows increase; Below 50 shows decrease. 3-month moving average.
continued positive growth in most states, including local demand in major metropolitan cities.

The American Institute of Architects’ (AIA) Consensus Forecast for 2016 and 2017 also predicts an overall slowing of growth in construction spending during the year ahead (see “Construction Forecast” table). Despite growth in the U.S. economic, employment, and consumer spending rates, various factors might slow the pace of the future economic expansion.

Although the Feds have adopted an interest rate strategy of “lower for longer,” and there has been a further emergence of global central banks, new domestic banking regulations have lenders tightening up on lending practices. Additionally, more strategic approaches to construction investments are being taken until the results of the 2016 election are known. Geopolitical and terrorism risks will also persist.

In the meantime, materials prices will continue to drop as the economy slows for overseas material manufacturers. Wages will continue to drive construction costs, with a shortage of trained workers. As there will be an easing of construction spending in the future, once again competition and margins will be tested for local contractors. Although an overall slower economic expansion is imminent, a slowdown does not translate to negative results. It simply reflects a stabilization of the market and a decreased rate of growth.

Surety Industry - The surety industry has charted a similar course as our economy, growing steadily as...
AIA Consensus Forecast was computed as an average of forecasts provided by panelists that submit forecasts for each of the included building categories.

In fact, the top 10 surety companies control 63.7% of the overall surety market (see “Surety Industry Results 2015”). Despite the current top-heavy profile of the market, the U.S. Surety Industry remains very competitive. There are now clear signs of softening underwriting terms and conditions for sureties that are committed to acquiring market share and retaining good, solid contractors.

Recent years have also shown a continued acquisition/consolidation trend, with the acquisition of Chubb & Son Inc. Group by ACE LTD Group and HCC Surety Group by Tokio Fire & Marine. More concerning is the recent trend of many “non-contract” surety companies entering the contract underwriting arena.

This new “arms race” for premiums has exposed many of these new players that have brought with them very loose interpretation of underwriting standards that they have been accustomed to in facilitating commercial (non-contract) bonds. Naturally, as demand increases to meet the current supply and these new companies increase their market shares,

<table>
<thead>
<tr>
<th>Construction Forecast</th>
<th>2016</th>
<th>2017</th>
<th>Forecast % Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonresidential Total</td>
<td>8.3</td>
<td>6.7</td>
<td></td>
</tr>
<tr>
<td>Commercial Total</td>
<td>9.9</td>
<td>7.5</td>
<td></td>
</tr>
<tr>
<td>Office</td>
<td>12.8</td>
<td>8.8</td>
<td></td>
</tr>
<tr>
<td>Retail &amp; Other Commercial</td>
<td>7.5</td>
<td>5.6</td>
<td></td>
</tr>
<tr>
<td>Hotel</td>
<td>14.8</td>
<td>7.8</td>
<td></td>
</tr>
<tr>
<td>Industrial Total</td>
<td>5.4</td>
<td>4.7</td>
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</tr>
<tr>
<td>Institutional Total</td>
<td>6.7</td>
<td>6.7</td>
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<tr>
<td>Health</td>
<td>6.6</td>
<td>6.9</td>
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<tr>
<td>Education</td>
<td>6.5</td>
<td>6.6</td>
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<tr>
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<td>2.6</td>
<td>4.0</td>
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<tr>
<td>Public Safety</td>
<td>1.8</td>
<td>4.2</td>
<td></td>
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<tr>
<td>Amusement &amp; Recreation</td>
<td>11.2</td>
<td>7.7</td>
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</table>

With market capacity growing, a surprising number of new players entering the industry, and more competing products (i.e. Subcontractor Default Insurance, Letters of Credit, etc.), the supply for surety bonds continue to outgrow the demand. Although we have seen an increase in the number of carriers, the lion’s share of premiums remains with the top five largest surety companies: Travelers, Liberty Mutual, Zurich, CNA and Chubb (recently acquired by ACE LTD Group). These top carriers write 50.3% of all premiums.

we move through the current cycle. The 2015 results showed the most profitable year in the history of the industry. The estimated total industry direct-written premium for the calendar year of 2015 was $5.62 billion, with an 18.3% loss ratio (the U.S. Surety Industry breakeven loss ratio is generally 34%). This record breaking pace continued through 2Q 2016, with more than an estimated $2.98 billion in total direct premium written and an 18.4% loss ratio -- slightly higher compared to 2Q 2015.
we can expect to see a continued increase in loss frequency in 2017 and 2018, and potential market adjustment as some of these firms are forced to leave the market.

A new development in the market has been the expansion of the number of insurers and dramatic increase in losses in Subcontract Default Insurance (SDI). As a competing product to surety bonds, SDI continues to take surety premiums away from the contract surety market. Now with significant apparent losses in the SDI market, SDI placements are being re-underwritten on a much more conservative basis, with many of the providers tightening the terms and conditions. SDI will still take its share of premiums from the surety industry, but for how long remains unknown.

The future of the surety market will remain bright if public spending continues to increase based on the new administration funneling funds into infrastructure, specifically in the transportation, education and military sectors. The concern that remains is whether these public funds will be enough to finance the increase in demand for infrastructure projects. Many believe public funding will not be adequate and the United States will begin to see an increase in public-private partnerships (P3s). P3s are an alternate procurement method where project financing is obtained through both public funds (tax payers) and private investors (often from foreign entities).

P3s began to pick up traction in the last two decades on larger capital improvement projects and have been proven to be a successful method for infrastructure financing in Europe and Canada. With the mounting federal, state and certain local budget deficits, the United States is poised to see an acceleration of P3s as an alternate procurement method. As P3s become more prevalent in the U.S. construction market, disputes over P3 contract terms and bonding requirements will emerge as a key industry issue in the upcoming years. Contractors competing in the P3 market will need new skill sets, supporting financial partners and stronger balance sheets.

### Manning and Provisioning

Being successful in reaching a desired location requires having the best people, backlog of work and supplies on board.

#### Exceptional Crews

“A skilled worker, regardless of the job description, remains a treasure.” Due to the slower growth nature of the current business cycle, the continuing pressure of the skilled worker shortage will remain a huge challenge. With a substantial percentage of the
workforce leaving the construction industry during the last recession, many post-recession businesses are struggling to find skilled workers. In addition, the construction industry has continued to lose the battle for a younger generation of skilled workers to more technology-based career opportunities. Coupled with the need for businesses to replace retiring baby boomers, the construction industry faces an uphill battle to repopulate its workforce.

How can you prepare for the future? Get the best people onboard -- great people accomplish great things together. Businesses that want to not only grow, but also flourish, must continually recruit and develop the talents of their current and future teams. Ultimately, this responsibility falls on HR departments, with a revamping of hiring practices to attract and cultivate talent and ensure the company’s vision and business goals are met.

For many businesses, there has been a complete shift in culture, with policies changing from the ground up. For others that already have policies in place, the increasing demand for skilled workers requires an improved method of finding the best candidate for the job. Therefore, hiring practices must remain a constant focus and integral part of any company, along with coaching and consulting from HR professionals.

Right Mix of Backlog
Over the last few years, contractors have been running off undesirable thin margin work and reloading their backlogs with profitable projects. Having a laser focus on procuring the “right mix” of projects in a contractor’s backlog will have the most significant impact on future success. A formalized “Project Hazard Analysis” process should be performed on every potential job during project selection. A disciplined approach is necessary to evaluating the right project target size, scope, type (i.e. design-bid-build, design-build, best-value, P3, etc.), geographic location and risk exposures. At bid time, these factors should mirror an acceptable profit margin.

Maximizing Technology
The construction industry is exploding with new cutting-edge realms of technology. Recently there has been dynamic changes in using CAD, Virtual and Augmented Reality for design, digital blueprint applications, aerial drones for mapping and surveying, smartphones and BIM for project management, field 3D imaging, automated vehicles, machine guidance systems and robotics for production. Contractors that have the foresight and financial means to embraces and integrate the latest advanced automated equipment, methods and systems into the management and execution of their work will realize tremendous improvements in productivity, schedule performance and bottom-line results.

Cash Reserves
Maintaining adequate cash levels will be an increasing core value of successful contractors in the coming years. As many contractors are experiencing expanding backlogs, cash reserves become an even more critical component of supporting a successful operation. The amount of defaulted contractors triples during times of expansion. Often, many contractors do not have the cash flow or loss-paying power to keep up with their expanding backlogs.

“Best-in-class” cash flow management is made up of two key measures: “Cash flow” from operations and “bank lines” of credit. Managing cash flow from operations begins with establishing cash acceleration controls such as proactively negotiating preferred contract terms; preserving aggressive billing/collection procedures, including early negotiation of REAs and change orders; and setting beneficial payment and retainage schedules. Implementing these types of internal procedures that integrate project managers, controllers/accountants and management will ensure projects remain in the black and cash flow themselves through successful completion.

Even with implementing “best-in-class” controls, many contractors may not have the cash reserves to take advantage of project opportunities or withstand a large claim or loss. This underscores the importance of continuously increasing and maintaining an adequate...
operating bank line of credit. While some contractors wrongfully believe bank lines of credit will solve cash flows issues, bank lines should only be used as a secondary cash resource during trying times to resolve immediate issues (i.e. costs incurred by project delays or disputes) and to temporarily meet unforeseen expenses (i.e. equipment breakdowns). When establishing an operating bank line, a good rule to follow is to obtain a line of credit equal to 10% of the largest single-size job that will be undertaken (i.e. a $1 million bank line of credit will support a $10 million project).

Cash flow management is an ongoing process and should be proactively managed on a continuous basis. For contractors to pro-actively anticipate cash flow needs and successfully navigate through a potential catastrophic loss, it is recommended that cash flow projections be performed prior to undertaking a large project or backlog, then maintained throughout the year. These projections not only increase efficiency and bottom-line profits, but also become a very useful tool when negotiating preferred credit terms with a bank and surety.

**Charting Your Destination**

“If you don’t know where you’re going, then any road will take you there”. A critical factor to achieve success for any contractor is to have a viable business planning process that includes the input from trusted advisors.

**Business Planning**

Preparation, implementation of strategies and measuring performance is critical to success. It doesn’t matter if you’re a multibillion dollar corporation or a start-up company just getting its feet off the ground. A current business plan serves as a roadmap not only internally, but for your outside partners. Without a proper business plan, you’re essentially departing for an unknown destination without directions. In time, you may in fact make it to the target destination, but more times than not, you will end up off target and lost, wasting precious time and resources.

For many companies, it is easier to ignore planning altogether. Often small businesses wrongly view the cost to develop a business plan as outweighing the immediate benefit. We constantly implore to all of our clients the value of putting together a comprehensive business plan. Like your business, your business plan should always be evolving and be updated at least annually to ensure you haven’t drifted off course. It should show who your firm is, where it’s been, and where it’s going. Once your business plan has been developed and adopted, it should be communicated throughout your organization and shared with your outside partners.

An important part of a business plan is that it provides a baseline for measuring your success. Meeting or exceeding the goals set forth in the business plan will demonstrate efficient operations to outside partners, including banks and sureties. A great business plan will greatly enhance qualifying for the maximum and best credit terms available.

**Trusted Advisors**

To be successful, businesses need to surround themselves with successful people. A circle of trusted advisors acts as a personal board of directors for you and your company. Trusted advisors will provide the knowledge and expertise necessary to navigate through the roughest of waters. Whether it’s your banker, accountant, lawyer, risk manager, insurance or surety broker, these professionals should be the first port of call when you are looking for a deeper understanding, a solution to a problem, or simply someone to bounce off of an idea, issue or opportunity.

**Staying the Course**

Innovation, discipline, and grit are key elements to success. The climate and conditions of today’s market remains relatively fair, but in order to avoid headwinds and stay the course, business owners must continue to be diligent. As the captain of your own ship, it is your responsibility to understand the elements of the current environment, properly man and provision for success, and set the destination for your company. Developing a plan to anticipate rough seas and arrant wind patterns is no easy task and success is never guaranteed. But it’s critical to surround yourself with an exceptional crew and team of trust advisors that you can rely on to ensure you reach your destination.
Cavignac & Associates is sponsoring the upcoming Challenged Athletes Foundation (CAF) Adaptive Youth Surf Clinic.

This is a great event where we partner with the CAF team and volunteers to teach 100+ kids how to surf. If you aren’t familiar with the Challenged Athletes Foundation, they are a local non-profit that provides opportunities and support to people with physical challenges so they can pursue active lifestyles through physical fitness.

You might be interested in volunteering with us at this event. As a volunteer, we get in the ocean with the kids and help push and catch them into waves. It is always a fun-filled and extremely rewarding day. All you would need to bring is a wetsuit and towel.

The event details are below. If you would like to join us please, let Kelly Potter from our office know (kpotter@cavignac.com), and register here as a volunteer: http://support.challengedathletes.org/site/Calendar?id=100984&view=Detail

Friday, October 21
Volunteer Check-in 8:15am – 1pm
(you can stay as long as you’d like)
La Jolla Shores – 8200 Camino Del Oro
La Jolla, 92037

Risk Management Seminar Series

Human Resources Legal Update
Friday, November 11, 2016
7:30am Registration
8:00am - 10:00am Program

Sexual Harassment Prevention Training
Friday, December 2, 2016
7:30am Registration
8:00am - 10:00am Program

Workplace Romance & Other Touchy Subjects
Friday, December 9, 2016
7:30am Registration
8:00am - 10:00am Program

Reserve Early, Seating is Limited!
To register, click on the ‘register now’ button in the announcement email, or contact Bethany Mongold at mongold@cavignac.com or call 619-744-0540.
Halloween Safety Tips

For some Americans, Halloween is one of the most anticipated holidays. Unfortunately, it can also be rather dangerous. Use the following suggestions to help keep your child safe this year.

Costume Safety Tips
- Choose fire-resistant costumes, wigs and accessories.
- Avoid potentially dangerous props, like hard swords.
- Opt for non-toxic face paint or makeup instead of masks.
- Decorate costumes and treat bags with reflective tape if your child will be out after dark.

Trick-or-treating Safety Tips
- Accompany children under 12 at all times.
- Insist that trick-or-treating only be done in familiar areas.
- Plan a route if older children are going alone.
- Designate a specific time for children to return home.
- Instruct children to never enter a stranger’s car or home.
- Remind children to always look both ways before crossing a street, to be aware of their surroundings and to use sidewalks whenever possible.
- Tell your children not to eat any treats until they return home.
- Discard treats that appear to be open or tampered with.

For more tips on how to celebrate Halloween safely, click here.
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Prevent Backpack-related Injuries

According to the U.S. Consumer Product Safety Commission, over 5,000 children under the age of 19 suffered backpack-related injuries last year. The vast majority of these injuries were caused by overloaded and incorrectly fitted backpacks.

While you may not have complete control over the weight of your child’s backpack, you can purchase a well-fitting, comfortable backpack. When shopping for a backpack, search for:

- The proper size (never wider or longer than your child’s torso, never hanging more than 4 inches below waist)
- Padded back and shoulder straps
- Multiple compartments and a waist or chest strap to help balance the weight
- Reflective, lightweight material

Purchasing a good backpack for your child is just the first step in preventing backpack-related injuries. Be sure to encourage them to always use both straps when carrying their backpacks and to only pack what is absolutely necessary to carry.

Breast Cancer Awareness Month

Breast cancer is the second most common type of cancer and the second leading cause of cancer deaths for women in the United States. Top risk factors include getting older, race and family history of breast cancer, which are things you cannot change.

Regardless of your personal risk factors, you can use these prevention strategies to reduce your risk of breast cancer:

- Maintain a healthy weight.
- Exercise regularly.
- Avoid exposure to carcinogens and radiation.
- Abstain from drinking alcohol or limit intake to one drink per day.

In general, living a healthy lifestyle can help lower your risk of developing cancer and increase your chances of surviving cancer. If you are concerned about your personal risk of developing breast cancer, call or visit your doctor.

For more information on risk factors, prevention tips and breast cancer screening, visit www.cdc.gov/cancer/breast/.

PERFECT PUMPKIN PANCAKES

2 cups flour
6 tsp. brown sugar
1 Tbsp. baking powder
1¼ tsp. pumpkin pie spice
1 tsp. salt
1 egg
½ cup canned pumpkin
1¼ cup low-fat milk
2 Tbsp. vegetable oil

PREPARATIONS

1. Combine the flour, brown sugar, baking powder, pumpkin pie spice and salt in a large bowl.
2. In a medium bowl, combine the egg, canned pumpkin, milk and vegetable oil. Mix well.
3. Add the wet ingredients to the flour mixture and stir just until moist. The batter may be lumpy.
4. Lightly coat a griddle or skillet with cooking spray and heat on medium.
5. Pour ⅛ cup of the batter onto hot griddle or skillet. Cook until bubbles begin to burst, then flip pancake and cook until golden brown. Repeat with remaining batter.

Makes: 12 pancakes, one pancake per serving

Nutritional Information (per serving)

| Component       | Value  
|-----------------|--------
| Total Calories  | 127    
| Total Fat       | 3 g    
| Protein         | 4 g    
| Carbohydrates   | 21 g   
| Dietary Fiber   | 1 g    
| Saturated Fat   | 2 g    
| Sodium          | 115 mg 

Source: USDA
Spotlight On Community

Cavignac & Associates is proud to support local and non-profit civic organizations, including Casa de Amparo.

MISSION:
To support those affected by and at risk of child abuse and neglect, through a range of programs and services that promote healing, growth, and healthy relationships.

VISION:
Casa de Amparo is recognized as a major force in the field of child abuse prevention. Partnering with the greater San Diego community, we ensure that children and their families receive unique and innovative services for healing, for stopping child mistreatment of any kind, and for ending generational cycles of abuse. The result is a community where child abuse and neglect are not tolerated, and where child abuse awareness and prevention are priorities.

For more information about Casa de Amparo, go to www.casadeamparo.org