MSP PL -09/2011 "Surety Outlook 2012: Where's the Beef?" September 2011

Construction Industry Update Newsletter

Surety Outlook 2012: Where's the Beef?

By James P. Schabarum II, CPCU, AFSB

Boom to bust went technology, real estate, and now the construction market. Hunting down and executing profitable work in the next few years will be critical to the survival of most contractors.

Surety losses are expected to increase in 2012 and 2013: since a downturn in construction activity means more bidders fighting for fewer jobs yielding lower profit margins. Primary factors affecting the overall state of the surety industry will be:

- Access to Capital
- Economic / Political Climate
- Sureties' Performance
- Finding "The Beef"

Capital

The recent reassuring words from Federal Chairman Ben Bernanke indicated the long-term strengths and growth fundamentals of the U.S. economy "do not appear to have been permanently altered by the shocks of the past four years." Many analysts agree that Bernanke's speech helped lift investor confidence.

While acknowledging the challenges we are facing, the overall tone of Bernanke's recent speech was optimistic. After reminding his audience that "the financial crisis that gripped global markets in 2008 and 2009 was more severe than any since the Great Depression," he stated that "restorative forces are at work today, and they will continue to promote recovery over time."

The Federal Chairman concluded his comments on a positive note by reiterating that even though policymakers have a tough job in supporting economic recovery while also tackling long-term debt, "those

challenges can be met and the fundamental strengths of our economy will ultimately reassert themselves." He also went on to pledge that the Fed will keep short-term interest rates low, and will do "all it can" to help the recovery.

Although interest rates may remain extremely low through 2012, access to capital remains tight. Without freed-up financing, a slower "recovery over time" should be anticipated.

Economy / Politics

In the first four months of 2011, construction spending was 8.4% lower than during the same period of 2010. Non-residential spending was approximately 39% below its peak, reached in January 2008, with $400 billion in spending. Federal construction spending topped out at $30 billion in 2010.

Employment figures, consumer confidence, the real estate market, and private investment have been struggling for the last few years. The economy is stalled, with a staggering 18.8% construction unemployment,

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slow job growth, and continuing residential mortgage problems. Private investments are few and far between because of difficult access and compliance to capital requirements. The government stimulus spending on supposed "shovel ready" projects is often strung out by the lack of financing. Public spending may see a boost in 2012 going in to an election year. However, public fiscal restraints will continue to be locked by the overwhelming political need for a balanced budget.

Sureties

The U.S. surety market is primarily concentrated on 25 top writers (see Exhibit A). The top 10 surety companies write 65% of the industry premiums. More so, the top 5 sureties -- Travelers, Liberty, Zurich, CNA and Chubb -- write 54% of all the surety industry's premiums. The continuing industry consolidation should be a concern for underwriting flexibility and conflicts in claims handling.

Still, the surety industry remains healthy, with a profitable industry loss ratio of 16.7% on approximately $5 billion in premiums in 2010. Reinsurance results for the surety industry have also been good, and contractors will find plenty of supporting capacity. As most sureties have evolved to excess-of-loss reinsurance with large deductibles, underwriting shifts will be driven by the direct market results more than reinsurance restrictions.

Capacity is increasing for single bonds and maximum lines. Surety rates continue to follow an inverted pricing curve, where the largest capacity users pay higher rates than the middle market — because many surety companies are willing to write the middle market, but only about six sureties will write the jumbo contractors ($500 million-plus work programs).

Loss frequency will be up for 2011 and is expected to continue to increase in 2012 and 2013. With more losses from smaller specialty trade contractors, sureties will likely see more severe losses from larger general building and engineering contractors. Two years of obtaining low-margin work with tough contract terms will begin to affect many contractors in 2012. Having significant interest-bearing debt and failing to cut overhead early and quickly could be the death of some contractors.

Sureties are very hungry for the best contractors and will compete on capacity, indemnity and rates. However, sureties are very tight on struggling contractors in a tough construction market. When losses mount as expected, reactionary surety underwriters will become much more conservative. Surety underwriters are now more concerned about project financing, contract terms (including warranty and efficiency guarantees), collection of account receivables (and retainage), access and use of bank debt, and exposure to subcontractor default. As a result, sureties will now want to meet with contractors and evaluate financials more frequently, look harder at the details, and confirm acceptable contract, bond form, and financing terms. More often, sureties will require subcontractors to bond back to primes and generals. Overall sureties will be expecting a higher standard of conduct from contractors in the years to come.

"The Beef"

All contractors should accurately assess their own capabilities. It is important to look at operating profitability and maintain a history of completing contracts profitably. Complete, accurate, and timely job costing and financial reporting is mandatory in today's environment.

Contractors need to communicate good and bad news in real time to their surety business partners. The most important thing a contractor can do is keep the surety informed when problems arise. If approached in a proactive manner, most surety companies will work a problem through with the good contractor.

Construction is cyclical and contractors should prepare for the pent-up demand that will build during a recession. While contractors must retrench during lean times, they also need to protect their core resources and be ready to

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RISK MANAGEMENT SEMINAR SERIES

Employee Handbooks
Friday, October 14, 2011
Registration: 7:30 am
Program: 8:00 am - 10:00 am

Sexual Harassment Prevention Training
Friday, December 2, 2011
Registration: 7:30 am
Program: 8:00 am - 10:00 am

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* NOTE: **Due to the popularity of our seminars and limited space available, we regret we cannot provide refunds or credits with less than 72 hours advance notice of cancellation.**

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Top 25 Writers of Surety Bonds – 2010*		
	Companies	Direct Premium Written (Millions)
1.	Travelers Bond	867.8
2.	Liberty Mutual Insurance	751.2
3.	Zurich Insurance Group	512.3
4.	CNA Insurance Group	406.5
5.	Chubb & Son Inc. Group	256.9
6.	Hartford Fire & Casualty Group	177.2
7.	HCC Surety Group	176.1
8.	International Fidelity Insurance Co.	143.3
9.	ACE Ltd. Group	109.5
10.	NAS Surety Group	104.8
11.	Great American Insurance Companies	98.3
12.	The Hanover Insurance Group	92.9
13.	RLI Insurance Group	84.8
14.	Lexon/Bond Safeguard Insurance Co.	80.5
15.	Chartis Group	65.4
16.	WR Berkley Corp Group	63.9
17.	Arch Capital Group	63.3
18.	Merchants Bonding Co. Group	59.5
19.	Westfield Group	59.1
20.	Insco Dico Group	50.3
21.	Alleghany Group	49.0
22.	SureTec Insurance Co.	46.3
23.	Cincinnati Financial Group	45.5
24.	Old Republic Group	38.7
25.	Bankers Insurance Group	36.7
*Source – SFAA		

Surety Outlook *(continued from page 2)*

bid work when the economy rebounds. Contractors should be vigilant on:

- Conserving capital and staying liquid. "Cash is King!"
- Aggressively billing and collecting and minimizing underbillings and retentions.
- Procuring materials and locking in prices whenever possible.
- Having the right size bank line of credit available to support the company's business plan. Have a backup bank lined up in the event the primary bank reduces or does not renew the credit line, or becomes financially unstable.
- Not "buying" a job to keep employees busy; rather, adjusting overhead and maintaining profit margins. Bidding the job, not the competition.
- Bonding subcontractors. Requiring bonds on subs is an effective way for contractors to manage risk. Follow your subcontractor bonding policies, especially in today's economic climate. Subs should be bonded when they represent a key trade to the project, a significant portion of the work, they are the sole source for anything or when the contractor is unfamiliar with the subcontractor.
- Qualifying the sureties they receive subcontract bonds from.
- Doing what they do best. "Sticking to Your Knitting."
- Understanding their contract and requiring effective and equitable terms.
- Reading the bond forms and watching for onerous language.
- Protecting their top talent who will manage projects well no matter what the market conditions are will be essential when the economy recovers.
- If choosing to team up on a project, selecting and structuring their partnerships carefully. It's easy to get married and costly to get divorced!
- Working with a construction-oriented CPA, banker, and attorney.

In spite of everything, sureties want to see a contractor growing its balance sheet from profitable operations and retaining its earnings. Growth in net retained earnings is still "The Beef".

Conclusion

In times of economic uncertainty or difficulty, a well-developed surety relationship is essential. A professional surety bond producer and surety company underwriter are key players on a contractor's team. There are three basic stages to a solid long-term surety relationship:

- Meeting. At least once a year, contractors should meet with the surety underwriter and surety bond producer. The company's CPA, bankers, and attorney should attend.
- Maintaining the relationship through frequent open and honest communication. Routine job information is an essential component of this communication. Job site visits are valuable. Regular and accurate financial reporting is a must.
- Nurturing the relationship. This requires commitment, trust, communication, timely reporting, and teamwork.

Sureties want more than a contractor that can build a project. They want a sound business partner that is rational, committed, honest, and knows how to run a successful construction company. In other words, they want a company that will continue to grow and be profitable.

Articles courtesy of Cavignac & Associates Employee Benefits Department

LIVE WELL, WORK WELL

Are You Disaster Ready?

A disaster can strike at any time, whether an accidental house fire, a natural disaster or an infectious disease outbreak. Are you prepared to handle each of these situations?

The best thing you can do to prepare for any disaster, according to the American Public Health Association (APHA), is to have a stockpile stored in an easily accessible place, as a disaster may leave you without electricity, clean water, and other necessities for days or longer. The APHA recommends checking your stockpile twice each year when you reset your clocks for daylight savings. Stockpiles should include:

- Three-day supply of non-perishable food and water (one gallon per person per day).
- Emergency supplies such as flashlight, batteries, radio, matches, utility knife, cash, garbage bags, whistle, fire extinguisher, extra keys and IDs, local maps, etc.
- First aid kit with common over-the-counter remedies, supplies such as gauze and bandages, and necessary prescription drugs.
- Food, water and supplies for your pet, if necessary.
- Personal items, such as glasses or contact lens supplies, diapers and baby supplies, sleeping bag or blanket for each person, change of clothes for each person, jacket and cold weather items for each person if applicable, moist towelettes and other personal hygiene items.

Also, keep important documents, such as birth certificates, marriage certificates, insurance policies, passports, Social Security cards, banking information, prescription information, etc., together in a safe place for fast access.

Prostate Cancer: Early Detection Saves Lives

September is Prostate Cancer Awareness Month, and there's no better time to be aware of prostate cancer, the most commonly diagnosed cancer among men. One in six American men will be diagnosed with prostate cancer in their lifetime, according to the Prostate Cancer Foundation.

The PSA (Prostate Specific Antigen) blood test can help detect prostate cancer in its early stages. Though it does not show whether or not you have prostate cancer, it shows abnormalities that would prompt further testing, where cancer may be identified.

The survival rate when prostate cancer is detected early is nearly 100 percent, and the PSA test can help with early detection. The American Urological Association recommends that men receive a PSA test starting at 40.

Some men assume that only older men get prostate cancer, but this is false. It is extremely uncommon for men under 40 to get prostate cancer, but for ages 40-59, the risk jumps to 1 in 38 men.

Some also assume that no symptoms mean no cancer. However, prostate cancer is often symptom-free, which is why it is important to get tested.

Though all men have some risk of getting prostate cancer, the following things can increase your risk:

Age: Though men over 40 all have risk, the older you get, the greater your risk.

Race: African-Americans are the most likely to develop this cancer, while Asian men have the lowest risk.

Family History: If your father or brother has prostate cancer, you are twice as likely to develop it.

In addition to getting tested, research suggests that exercising, maintaining a healthy weight, and eating a low-fat diet rich in fruits and vegetables can lower your risk. Talk to your doctor today about getting tested for prostate cancer, and other ways you can take charge of your health.

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