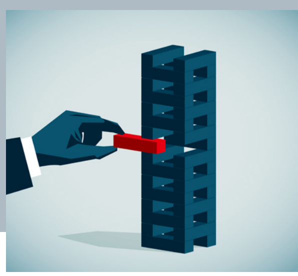
Managing and Mitigating Subcontractor Default Risks



By Mike Bond; Head of Surety: Zurich North America

Surety bonding can serve as an effective tool to help protect general contractors from the challenges associated with subcontractor default.

I have some good news and some bad news. The good news is that construction spending is slowly rebounding to its pre-2008 levels. The bad news is that many contractors and subcontractors, weakened by the tough market conditions over the past six years, are struggling to cope with the challenges of an increased backlog. According to the Surety and Fidelity Association of America, in 2014 (the last year we have complete data) contract surety claims increased significantly from the prior year.

Some segments, mostly related to subcontractor performance, which showed strong loss activity included:

Segment	Loss Ratio *
Federal: Drywall and Glazing	740%
Federal: Siding and Glazing	1027%
State / Municipal: Painting and Sandblasting	109%
Private: Carpentry	89%

* Surety and Fidelity Association of America, President's Presentation, 2015 (www.surety.org/page/AnnualMeeting2015)

While 2015 showed some increased growth in the construction market, smaller contractors and subcontractors continue to face extremely challenging conditions.

Consider this: The third-largest U.S. homebuilder saw its net income drop by 30% in the third quarter of 2015 (compared to the same period in 2014), indicating a scarcity of tradespeople as the reason for a slowdown in its home completions.[1] Also, a leading Midwest curtain wall subcontractor went bankrupt in 2012 due to an inability to manage cash flow.[2] This left many general contractors scrambling to find a replacement provider and missing project deadlines.

These are just two examples among hundreds of general contractors and subcontractors that are having difficulty weathering one of the biggest challenges in construction today: successfully managing higher backlogs with fewer people to do the work.

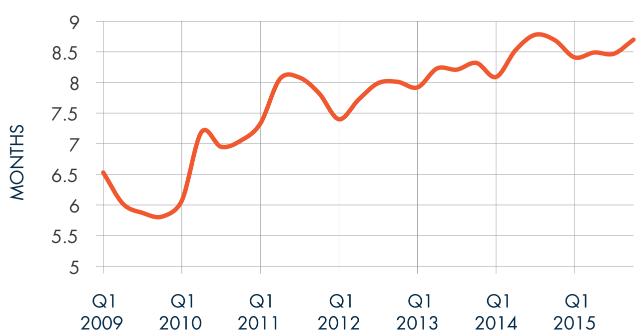
Stress of More Construction, Less Labor

In the wake of the 2008 financial crisis, many tradespeople left construction for a different industry, decided to retire or even returned to their homelands (if they were immigrants). The industry began to recover in 2012, reaching double-digit growth in spending, with the U.S. posting a 13.7% year-over-year gain in August 2015.[3] This increase in construction spending has resulted in a severe worker shortage, with 86% of contractors reportedly having trouble filling craft positions.[4]

With quality workers harder to find, contractors are paying more to attract craftspeople to their projects. A 2015 wage and benefits survey reports a significant 6.4% jump in average base wage in the U.S. since midyear 2014 compared to an annual increase of 3.9% in 2014.[5] This is the biggest increase seen since 1986 and is putting additional strain on the cash flow of subcontractors.

EXHIBIT 1

CONTRACTOR BACKLOG INCREASES BETWEEN 2009 AND 2015 (in months)



Source: Associated Builders and Contractors, Construction Backlog Indicator, Q4 2015.

The scarcity of skilled labor poses a triple threat for contractors and subcontractors. It leads to increased costs for the subcontractor, increased risk of not finding enough

[1] Gopal, P. "PulteGroup Slides After Builder's Earnings Miss Estimate," Bloomberg, October 22, 2015, http://www.bloomberg.com/news/articles/2015-10-22/pultegroup-slides-after-homebuilder-misses-earnings-estimates

[2] Korman, R. "Trainor Glass Default Raises Questions About Sub Vulnerability," Engineering News-Record, March 14, 2012, http://www.enr.com/articles/12658-trainor-glass-default-raises-questions-about-sub-vulnerability.

[3] "Craft Pay Ramps Up As Worker Gaps Grow," Engineering News Record, October 7, 2015, http://enr.construction.com/business_management/workforce/2015/1007-pay-ramps-up-as-worker-gaps-grow.asp#.Vi4EBcgoZjo.mailto

[4] ibid

[5] ibid

skilled workers to even finish a contract, and the increased risk that the quality of the work executed suffers. While some of these risks fall squarely on the subcontractor's shoulders, the general contractor (and even the owner) will ultimately have to deal with delays or the cost of rework arising from these risks.

Struggle to Manage Growing Backlogs

In spite of positive industry growth, many subcontractors can't manage the significant increase in backlog over the last six years. Since 2009, the average number of months of contractor backlogs (all types of contractors) has increased 33%—from 6.53 months in the first quarter of 2009 to 8.70 months in the fourth quarter of 2015 (Exhibit 1).[6]

The 2008 economic downturn stressed many subcontractors' balance sheets. In its aftermath, we saw a willingness to accept thinner margins when bidding, plus higher costs when executing the work. Combined, these factors have reduced subcontractors' working capital. The financial cushion they built up in the heady, pre-2008 market may have dried up by now. As backlogs increase, capital resources are strained and many subcontractors find it difficult to execute on their existing workloads.

What's striking about this trend is that many subcontractors have not adjusted their business models to the new margins and are carrying too much overhead to maintain their operations. Juggling tighter cash flows and labor pools in this "new normal" is pushing even large subcontractors out of business. This, in turn, creates heightened risk for general contractors and their clients.

It is counterintuitive, and somewhat ironic, that subcontractors who managed to survive when the market was at its absolute lowest are now failing, in the midst of the recovery. But those of us who have lived through a few different construction cycles know subcontractors should be watched more closely during upticks.

For subcontractors who may be dealing with cash flow issues, slow payments might further weaken their ability to fund a growing backlog. Because subcontractors are at "the end of the payment line," slow payment by the owner is compounded by slow payment by the general contractor. That means subcontractors have to wait months, if not years, for final closeout payments. This waiting game has led to a number of subcontractors calling their surety with the news they can't make payroll at the end of the week, in spite of a strong backlog.

Protection from Subcontractor Issues

Right now subcontractors are facing the burden of a substantial backlog for the first time—with those woes compounded by lower labor availability and rising cost pressures. Since subcontractors have been working on slim margins for the past four years, there is less room for error and mismanagement, as well as an elevated potential for default.

To manage these issues, general contractors must closely consider the risk profile of their subcontractors and give themselves a full degree of protection from performance or default issues. One of the more comprehensive protection tools for general contractors is a surety bond. Bonding a subcontractor has a proven record of success. While there are alternatives to surety bonds, many general contractors see the value of surety to manage subcontractor default risk.

A reputable surety company performs a full degree of due diligence on the subcontractor—from evaluating capabilities to work-in-progress schedules to balance sheets—be-

[6] Associated Builders and Contractors, Construction Backlog Indicator, Q4 2015

fore granting a bond. Through the process of obtaining a surety bond, the general contractor benefits from a prequalification of the subcontractor. The surety underwriting process helps ensure that a subcontractor has a certain level of strength and can execute the contract. The surety then stands behind that analysis by issuing the bond—guaranteeing that either the subcontractor will perform or the surety will step in to make sure the contract is completed.

The Power of the Surety Bond

Potentially devastating risk may arise as a subcontractor's backlog increases. If the general contractor wants to avoid any unforeseen curveballs along the way, there are many ways to identify those risks before they occur. Prequalification is one tool that all general contractors should use. Establishing and following a rigorous prequalification procedure is key—although following those prequalification procedures can be more difficult than some contractors imagine. There are many cases where a local project manager overrides the prequalification requirements with the rationale of "we know these guys," only to have that subcontractor go quickly into default.

Surety bonding is a method to help protect owners and general contractors in the event of subcontractor default in the following ways:

- **Prequalification assurance.** With a surety bond, the general contractor is assured that the subcontractor's capability to execute the contract has been analyzed by the surety. Surety underwriters are trained to evaluate subcontractors and determine the projects—from a size and complexity perspective—that the companies can undertake.
- **Performance guarantee.** Losses due to subcontractor failure can be covered with a surety bond. In addition, the general contractor knows that the surety company can step in to help, should a default occur.
- **Cost-effective protection.** The price of the surety bond is a small price to pay, given what is at stake should the subcontractor fail to perform. The third-party financial backing and risk transfer of a solid surety can make up for the expense of the bond. A reputable surety company will look favorably on a subcontractor bond.

It may take several more years for the average number of months of backlog in the field right now to decrease. Contractors should consider surety bonding as a tool to help protect themselves from potential financial losses or project delays caused by subcontractor default. The stakes are just too high.

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