

EXECUTIVE INSIGHTS

SURETY INDUSTRY LEADERS OFFER VIEWS, EXPERTISE

COMPILED BY MARC RAMSEY

Terry Lukow
Executive Vice President
Travelers Bond, Construction Services

Today's economic climate is totally different from the very competitive, dog-eat-dog world a lot of construction organizations have seen before. Now more than ever, the industry is focused on managing both opportunities and growth. Contractors should ask themselves: Where can I capitalize in a given market considering my organization, my capabilities and my experience in a way that will allow me to gain the highest and best economic returns?



For an organization to be successful in today's marketplace, contractors should approach the construction industry with a strategic view rather than a transactional view. It's more than a strategic financial structure; it's a view composed of a business plan structure, risk appetite and relationships. Contractors must manage for the long term, not the short term, because long-term management will keep them in business while short-term management will only increase their risks.

A surety company looks for more than just a contractor's financial structure. It asks, "What is the strategic business plan?" and "How will contractors manage this economic boom in the marketplace?"

Doug Hinkle
Chief Underwriting Officer
CNA Surety

The construction industry represents great opportunity and risk, and it's important



to have open communication and a strong relationship with your surety. The surety's contribution to a contractor's growth plan is through the surety capacity that it provides, both on a single job basis and through an aggregate work program. Three key characteristics of a bondable contractor include good cash flow, reasonable funded debt load and a track record of performance.

The primary reasons for contractor default change little over time. Defaults often involve—independently or in combination—excessive growth, expansion into unfamiliar territory or expansion into areas of work without the necessary expertise.

A contractor should ask questions that confirm whether the surety understands and supports the business plan. A contractor should confirm the producer has the necessary surety expertise to bring value to the relationship and contribute to the success of a contractor operation.

William Cheatham
President
Zurich North
America Surety

Zurich develops a total profile on every customer/account—organizational structure, financial history, business philosophy, management experience, etc. We balance the pros against the cons. Then we credit rate the contractor from our own proprietary credit scoring model and decide whether the contractor qualifies for surety credit, and at what limits (i.e., job size and program).



We constantly try to strengthen our underwriting to enhance our customer selection process, and the most recent change is the credit-scoring model that helps identify financial characteristics. If you deal in surety bonding, you can expect credit-scoring models to be adapted in

some form, and these models will become an accepted practice.

My advice to emerging contractors is to learn from a position of strength. Find partners that will be mentors. Look for historical success and find a way to grab on. Ask yourself: What are my personal goals? What type of training will I require? What kind of personal commitment am I willing to make?

Timothy Mikolajewski
Senior Vice President
Safeco Surety



With due diligence, a surety underwriter can determine the true strengths and weaknesses of a contractor. The result is knowing the appropriate types and sizes

of projects a contractor can complete successfully. With updated and current information from contractors, surety underwriters can respond to the contractors' positive financial trends and be in the best position to maximize surety support.

We work with our clients to prevent a default by identifying the problem early. All parties can review the options and come up with a unified plan to prevent a default. Often, contractors wait too long to let their surety know a problem exists, resulting in few viable solutions. Drivers for contractor failure include working out of one's normal territory, relying on claims or underbillings to come through and having substantial debt or a substantial overhead burden.

Terrance Cavanaugh
Chief Operating Officer
Chubb Surety

Strong construction operations will be provided the necessary surety support to match their operational capacity, financial strength and business plan. Companies that have managed their business and balance sheet will have no difficulty securing the necessary surety bonding.



A critical issue is whether an individual construction company is ready to take on this current boom. The construc-

tion industry faces shortages in both the supervisory and labor pools. The shortage of available human resources will impact the abilities of a contractor to execute in a growing market.

On the other hand, contractors with strong human resources and a well-disciplined strategy will have an opportunity to take advantage of a tight market and generate better gross margins.

Adhere to a focused business plan, surround yourself with professional advisers and partners, engage a strong surety producer and consistently communicate the opportunities and challenges of your business to your surety.

Dennis Perler
President
Liberty Mutual Surety

Many contractor failures occur during rapid economic expansion. They are either undercapitalized, don't have the working capital or don't have the personnel in place. However, several contractors appear to have ample profit margins in their work.



One or two years of profitability, however, does not define a strong business,

and the credit business demands that sureties generate a string of consistent earnings. That's what attracts capacity and capital to the business.

The challenge for the surety business is to not become complacent and overly pleased with results. The surety industry needs to have a long-term view of profitability and growing earnings, not just the top line. We've gone through periods of reckless underwriting, but I'm hopeful that we've all learned lessons from the earlier part of this decade.

Mary Jeanne Anderson
Vice President, Surety
Arch Insurance Group

The biggest challenge is the high level of inflation of construction material and labor costs. This situation, combined with owners' tendencies to bundle smaller contracts into one large contract, creates a significant increase in job and overall program size without the benefit of a commensurate increase in the contractors' balance sheets.

Usually a combination of factors contribute to contractor default—tough project owners, adverse contract and bond terms and undertaking work beyond the contractor's experience and resources.

All contractors should investigate the claims handling philosophy of their bonding company and meet their claims professionals prior to the development of any claims.

Stephen Cory
President, National Association of
Surety Bond Producers
President, Cory, Tucker, & Larowe Inc.

As contractors gear up to handle the massive rebuilding in the Gulf Coast region, they need a plan for when the work slows down in three to five years. Contractors have an opportunity to make above-



average profits, and it would be a wise move to fix any current balance sheet issues that might affect surety capacity. Contractors should not over-

extend themselves based strictly on the availability of work. They should continue to measure capabilities against opportunities while remaining cautious and preparing for the next downturn.

Your surety agent and company should be part of your strategic team. Being part of the planning process will give them insight into your game plan and provide you with objective feedback. They should bring value to the process in terms of industry and market overview, as well as experience and service.

James Lee
President & CEO
Old Republic Surety Company

Sureties consider a number of criteria when determining a contractor's bondability, including character—how the contractor has reacted to adversity; continuity—whether the contractor is backed by proper legal documents and life insurance; and references—having outstanding operations and being well-regarded by customers, peers, creditors, owners, architects and engineers.



Sureties also look at a contractor's business plan, key employees, job radius from home, bidding history, relationship with suppliers and price commitment ability, bonding subcontractors, on-time completion and penalties involved, ability to provide uncompleted/completed work-in-progress schedules on a timely basis, tracking profit and loss of projects, labor contract expirations, contract forms preferred and utilized, hazardous waste portions of the job, equipment sufficiency and proper insurance.

A contractor also should have clean credit reports and sufficient credit with suppliers. The contractor should take advantage of supplier discounts when offered, have a banking relationship and backup banking relationship and have a capital spending program. A contractor also needs capital, net quick assets, net worth and profitability.

Henry Nozko Jr.
President
ACSTAR Insurance Co.

In terms of underwriting, ACSTAR may distinguish between classifications of work when providing surety bonds. For example, we view marine contractors, underground piping and structural steel contractors as a higher risk than acoustical ceiling, finishing carpentry and plumbing contractors. We also assess high risk and low risk in terms of geography. A contractor in Bangor, Maine, has a lower risk profile than a contractor in one of the Boroughs in New York City, which probably is the most difficult geographic landscape in the country. Los Angeles, Chicago and New Orleans are difficult, but don't come close in comparison to New York City.



Michael Greer
Vice President, Surety
Pennsylvania National Mutual
Casualty Insurance Co.

Well-managed contractors take advantage of opportunities, but they also need to know when enough is enough. A contractor with a "relationship-based surety" should be confident the surety will be available to provide additional capacity when necessary. However, a contractor should

not roll out of bed one day and decide the company should be three or four times bigger in the coming year. Growth needs to be planned, and above all it needs to be controlled.

There always will be good contractors and good surety companies. The key to both is consistency. Just like a surety looks for a contractor with consistent earnings, a contractor should look for a surety with consistency in its approach to providing surety bonding.

William Marino
Chairman & CEO
Allied North America

Contractors looking to capitalize on the current construction climate need to show their surety they have adequate human resources and financial capacity to pursue these opportunities. Credibility is crucial.



The surety underwriting process constantly compares estimates to actual performance. Contractors always should present information to their surety partner that is both tested and conservative. Failure to consistently perform as projected will have a negative impact on any surety relationship.

Contractors must clearly understand the factors that contribute to the expansion of their work programs. There is a direct correlation between balance sheet growth, successful completion of bonded projects, a clearly defined business plan and the expansion of a surety work program. The role of the surety broker is to work with the contractor on understanding the surety's expectations and regularly communicating with the carrier to assure the information used to arrive at decisions is accurate and complete.

Karen Barbour
President
The Barbour Group

The surety industry is well positioned to handle the construction explosion with more than 100 sureties looking to grow their market shares. To maintain overall profitability, sureties will be conservative in their underwriting with many choosing not to take risks on small or startup companies. But, some sureties geared toward

small business accounts are expanding their offices and hiring staff to absorb the surety void for small businesses.

Contractors must know the strengths and weaknesses of their key employees,



learn their market and their strengths in it and, above all, have the utmost confidence in their abilities before applying for their first bond.

The top three characteristics we look for in a bondable contractor are a positive attitude, trade experience and willingness to listen and heed advice. The top three items on a financial statement include timely receivables, reasonable over/under billings and low debt to overall net worth. A bonding agent needs to be a strategic advocate to put in place benchmarks and steps so the contractor has a clearly defined path to follow.

Michael Murphy
Executive Vice President
Bush, Cotton & Scott, A Hub
International Company

Environmental contractors continue to have very limited market choice and capacity due to exposure to potential long-term liability and lack of reinsurance. Aside from environmental construction, the Pacific Northwest shows few restrictions in terms of market competition or capacity.

As has historically been the case, underwriting standards are much stricter for most subcontracting trades. Contractors need to carefully balance the opportunities created by a strong construction economy with controlled and well-managed growth and geographic spread. It is critical to maintain a lean but flexible organization—both cost-wise and in terms of expertise—which can react quickly to economic downturns or significant and sudden changes in market conditions.



Three of the most important financial characteristics sureties look for in a contractor are adequate liquidity, lack of bank dependence and leverage, and a reasonable level of flexible overhead.

Peter Hammett
Vice President
Parker Smith & Feek, An Assurex
Global Partner

The construction boom has hit the Pacific Northwest. Building is at an all-time high, and the surety industry seems to be keeping up very well. The question is whether the construction industry can keep up with adequate manpower. The surety industry looks objectively at financial strength and experience when determining levels of surety credit availability for every contractor.

Contractors should select a surety underwriting company based on the underwriting company's experience in their type of



business. Each surety company has particular areas in which they are comfortable and succeed. Surety bond producers can help contractors grow by providing advice

on issues such as perpetuation and market focus, and selecting other advisers such as CPAs, attorneys and bankers. Underwriters also listen carefully to contractors' plans and use their experience in seeing where others have stumbled or excelled to help contractors set a clear goal.

John Stanchina
Senior Vice President and Division
Manager
Rutherford Companies, An Assurex
Global Partner

This is a great time for the construction and surety industries. For anyone who is adequately capitalized and has a solid business strategy, excellent controls in place and proven management, capacity will not be an issue. This will be the case whether you are in the small, middle-market or jumbo segments.

Align yourself early with a group of professionals who understand and specialize in construction, including a professional surety



and insurance agent/broker, CPA, banker and attorney. Find a surety with an underwriting philosophy that matches your business plan. Make sure you have open

and honest dialogue with your agent and report problems immediately. Surety professionals have tremendous resources that

can assist a contractor in a tough situation.

Be realistic, and don't be penny wise and pound foolish. Long-term strategies prevail over short-term gains.

The key items on a balance sheet are cash, equity in relationship to debt and the amount of underbillings as a percentage of working capital and equity. Sureties want to ensure underbillings and receivables turn into cash. Some sureties tend to consider an underbilling either as unrecognized profit fade or unapproved change orders, and will quickly discount underbillings in their credit modeling.

Michael Cusack
Senior Vice President—Managing
Director, Surety, and Operations Board
Member

Aon Construction Services Group

What has developed in the bonding market over the past four to five years in terms of underwriting discipline will continue for the foreseeable future. With exception to certain regions—most notably the New England states—the majority of the U.S. construction industry is enjoying one of its strongest economic periods ever.

The convergence of new project opportunities, a static supply of competent trade labor and restricted surety credit has forced contractors to be more selective in the pursuit and acquisition of new work. In responding to market conditions, contractors have been more thoughtful in the deployment of their bonding capacity and, as a result, have been more disciplined in setting margins on new projects.

The trend toward shorter bid lists and higher margins will continue as the surety industry is expected to adhere to sound underwriting fundamentals in the near-term, with underwriters continuing to be selective in the acquisition/development of new contractor relationships.

Robert Meade
Senior Vice President
American Arbitration Association

The strong economic climate for construction services reinforces the need for construction executives to consider contract terms that enhance performance and reduce risks of project delays. When consulting with owners

and contractors, sureties should discuss plans for managing disputes throughout the life of



the construction project. Conflict avoidance processes help construction partners resolve disputes before they escalate and delay construction. Partnering is a

commitment by all stakeholders to achieve goals and objectives—including processes to control and address obstacles and disputes.

Dispute management options include a dispute resolution board—typically a panel of three neutrals appointed by the parties that become part of the project team, attend periodic meetings, review essential project documents and assist in the identification and resolution of issues and potential problems.

However, even with strong conflict avoidance procedures in place, sureties should encourage contractors to include in their contracts clear, well-devised dispute resolution clauses that incorporate procedures, such as mediation, to resolve disputes as early and efficiently as possible.

Steven Raffuel
Surety Practice Leader
Commerce Banc Insurance Services

The surety market continues to be firm for all contractors. Bond capacity is available for well-managed companies in all geographic regions. Steady as she goes is the mantra of the industry right now, meaning that the glass is full. I don't expect any significant changes in the marketplace over the next few years, unless some considerable new capacity becomes available. As for the differing market segments, \$10 million to \$100 million contractors will do just fine because they are manageable exposures that generate good premium activity for their surety. Perhaps the single most valuable asset a professional surety agent or underwriter brings is their history of looking at the experiences of hundreds of contractors over time. We've seen the successes and failures, and can provide insight to contractors to help them get past operational hurdles, or avoid the many trap doors along the path to growth.

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