

EXECUTIVE INSIGHTS

Overview of Industry Developments

BY MARC RAMSEY

Terrence Cavanaugh Chief Operating Officer Chubb Surety



Surety providers have a better awareness of their financial metrics and the expected return they need to provide to their parent organization. In addition to proper pricing, there will be more focus on efficiency and expense management, recognizing that there needs to be adequate revenue per customer to handle the credit analysis, servicing of accounts and risk assumed by the surety company. The construction industry will need to address these issues in their own operations to assure they make prudent decisions on risk versus reward on a per-project basis. How will they manage material escalation and availability, subcontractor performance, owner and financing pre-qualification in such a way as to build a consistent operational and financial track record? The focus, discipline and sound execution by both contractors and sureties will drive consistent performance, profitability and support for both industries.

William Cheatham President Zurich North America Surety

Zurich Surety is committed to expansion, and that requires growing the staff and skill levels. Technology drives efficiencies

within Zurich Surety allowing management of expenses and differentiates Zurich Surety over the next five years. Properly utilized credit scoring can enhance the construction industry by identifying risk characteristics at a peer level review more quickly. At the same time, a surety with this capability can use the objective underwriting process through credit scoring to balance the subjective surety/contractor business relationship. What should evolve is a value-added service that strengthens all parties, maximizing capacity for the contractor. Ultimately, the success with a growing customer makes the surety more profitable. So to speak, it is the life cycle.

Doug Hinkle Chief Underwriting Officer CNA Surety

The most common method of strengthening a contractor's balance sheet is through the retention of profits. The composition of the assets and the degree of leverage in the capital structure play a key role in determining balance sheet strength. Using your business as a personal bank or converting business resources into non-business related investments generally undermines the trading value of the firm's financial strength. I have noticed an increase in the number of CPA-prepared financial



statements that do not include completed job schedules, a reconciliation of earnings from completed work and current work in progress. This is important information to sureties and banks. The CPA financial statement should be viewed by the contractor as an opportunity to explain in detail how the business is operating. The more clear the explanation, the more comfortable the contractor's lending partners will be.

Terry F. Lukow Executive Vice President St. Paul Travelers

Contractors and brokers should focus more on a strategic business plan, rather than obtaining individual bonds or transactions. That is a focus the industry is missing in today's environment. This kind of approach to capacity leads to better business relationships—a strategic partnership, where the surety company is really in place to support a business plan and is looking at a construction firm from a holistic view. A strategic business plan is an assessment of the contractor's internal and external capabilities and a view of its marketplace in the near-term and long-term. It encompasses the risk appetite of the contractor and includes, as part of the strategic financial plan, how the contractor is going to manage their business.



Timothy Mikolajewski
Vice President, Contract Surety
Safeco Surety



I'm optimistic about the surety industry over the next two to three years. Solid underwriting fundamentals have been in place now for the last three years. While pricing still has a ways to go to get where it should be, there has been an upward trend over the last three years. This, combined with the fact that the large losses in the industry have stabilized, is indicative of an upward trend in surety companies' operating results. In addition, all signs are pointing to a rather robust construction economy over the next two to three years, which should give contractors plenty of job opportunities. This good construction economy, combined with the results of sound underwriting discipline and surety bond price increases, should give the surety industry reason for optimism.

Michael J. Mitchell, CPA, CPCU
Vice President, Surety
The Graham Company



A strong balance sheet and consistent profitability are the most important criteria for qualifying for surety bonding. Contractors that recruit and retain good people and make money and retain it in the business are more bond-worthy. Contractors should find a professional broker who can provide good, sound business advice and who takes a personal interest in their clients.

Dennis J. Perler
President
Liberty Mutual Surety



In both the construction and surety industries, the quality of execution separates the stronger companies from the weaker companies in a changing economic environment. With the surety industry experiencing significant consolidation and lost capacity over the past five years, contractors should recognize that many insurance companies remain committed to surety. The best sureties will invest in the people, technology, claims-handling capabilities and capital necessary to provide responsive and

professional surety service. In today's environment, contractors should examine the financial strength, character and capacity of their surety partners just as their sureties underwrite them. By aligning with a responsible underwriting surety, a contractor is better positioned to have stable and consistent surety capacity critical to long-term success.

Edward J. Heine
President
National Association of Surety Bond Producers

Executive Vice President
Payne Financial Group

A contractor's relationship with a professional surety agent/broker and surety underwriter can generate tremendous value. The surety professional has the benefit of working with a broad range of clients in the construction industry, and that knowledge creates perspective and resources that can assist their customers with their business plans. The surety industry loss ratios are improving and the capital base supporting the industry is generating improving rates of return that are necessary to ensure long-term stability. Several factors contributed to the loss activity, including poor accounting/cost controls, onerous contractual and bond language, too-rapid growth and a lack of management continuity. The application of such lessons learned in the management of a surety relationship can be beneficial. Construction firms that work with their surety professionals to assess such areas on a regular basis and measure their results should be positioned for success over the long term.



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

There appears to be more-than-adequate industry capacity and market choice to handle the needs of most small to middle-market sized contractors with work programs up to the \$150-million range. While the industry as a whole continues to put heavy emphasis on the retention of profits within the operating entity, more than an adequate number of markets are aggressively pursuing this class of busi-

ness, providing these contractors with stable and competitive underwriting, indemnity and pricing terms and conditions. However, in the case of subcontractors, the choice of market options remains much more limited. The industry will continue to scrutinize subcontractors' balance sheet components, particularly underbillings and reliance on revolving bank line borrowings, as well as overall leverage and geographic spread.

John Stanchina
Senior Vice President and Division
Manager
Rutherford Companies

There is so much work in the construction market that the number-one challenge for contractors over the next 24 months will be managing material, labor, shortages and inflation risks. And correspondingly, the number-one challenge for the surety industry will be to make sure that contractors have a handle on this risk and that the surety industry doesn't go back to the late '90s and overextend itself, heading us back into a losing cycle. We see that the surety market has improved significantly, and it appears 2005 will be an excellent year for the surety industry. There is real competition for middle market surety accounts, and this is beginning to put pressure on the underwriting discipline. Capacity issues remain for both jumbo contractors and mega projects. The only caveat is we can ill afford to have any significant surety markets pull out of the industry, similar to what happened earlier this year with several major markets.

Henry W. Nozko, Jr.
President
ACSTAR Insurance Company

It appears the construction industry will remain strong during the next year, particularly for road construction and for medical and educational facilities. Large projects in excess of \$250 million most likely will be bonded by co-surety arrangements, which will probably help stabilize conditions within the industry and result in a better market for principals and obligees. Demand



for bonds will continue to rise, particularly in the private sector. Significant losses in recent years were avoided by obligees and absorbed by sureties, which demonstrates the incredible value offered by bonds that continue to be offered at an inexplicable bargain cost.

William A. Marino
Chairman and CEO
Allied North America



Developing a comprehensive financial risk management plan is crucial to the maximization of available surety credit in the current surety marketplace. Owners continue to push additional responsibility and the corresponding financial exposures in the direction of the contractor, and we believe that this trend will only continue to evolve as traditional procurement practices become taxed by the limited available financial resources of both public and private owners. Even though a surety may not be willing to cover some of these exposures under a bonded construction contract, if they believe that these unbonded exposures are not appropriately mitigated, it will have a negative impact on a contractor's surety program. Contractors need to be aware of their limitations and partner with financially strong firms that are capable of providing the necessary expertise when project scope reaches outside of identified core competencies.

Phil Tobey
Vice President and Director of Surety
The Dale Group

Adequate bonding capacity is based on getting good advice from your agent and CPA and determining what to do with it. I often tell my clients, as well as prospects, I can make all the recommendations and suggestions in the world, but at the end of the day, it's your company. You make the final decision in terms of what to do with that advice. Establishing a reasonable program, acting on good advice, successfully completing jobs and maintaining profitability will eventually lead to additional bonding capacity and hopefully business growth. Being in a tight market where a lot of contractors cannot get bonded, establishing a



program, even a modest one, separates a contractor from the rest. It's something to advertise.

Karen Barbour
President
The Barbour Group



Obtaining bonding credit is no different than other investments that provide a return for your risk. A surety company is willing to give you one to 20 times the value of your net worth in order to produce the revenue you need to grow your company. New and emerging contractors should feel confident that for every dollar they retain in the firm, there is a promise of at least 10 more. But unlike other investments, as the owner of the company, you, the contractor, have control over your risk. It is truly up to you to perfect the return.

Casey Warnecke
Senior Vice President
Marsh Global Surety Practice

With the rapidity of change that the surety industry has experienced over the last four-plus years, it is more critical now than ever for a contractor to be working with a professional surety broker that brings value and can facilitate the establishment and maintenance of a strong relationship with a surety. Strategies for contractors' surety relationships today include communicating frequently with the surety in terms of financial and other information, knowing the branch and home office surety underwriters (visit the home office once a year), having a business plan and discussing it with the surety, underwriting the surety and having a backup surety in place.

Michael Cusack
Senior Vice President, Regional
Surety Director and Operations
Board Member
Aon Construction Services Group

Contractors should routinely review and modify the structure of their company's capitalization. Balance sheets are strengthened by increased retained earnings, but the introduction of other forms of equity and long-term restricted debt can assist firms in qualifying for increased bonding support. Con-



tractors should evaluate if their debt structure is in line with, and supporting, fixed assets. The composition of contractors' capital structure should be appropriate to meet liquidity needs, as well as facilitate growth and increase profitability.

Michael F. Greer
Vice President, Surety
Penn National Insurance Co.

We are very hopeful that the construction industry will remain in a mode of putting profit ahead of revenue. There are selected areas of the country where work is plentiful, but others where contractors are still struggling to find enough volume. Revenue for the sake of revenue leads to losses. More importantly, contractors should not take a blasé attitude about their surety. Long-term relationships do matter when times are tough. A relationship means knowing the people making the decisions and having a dialogue with them. If your surety doesn't want to visit with you every year, then you aren't important to them and you need to find a company that will value you enough to come visit you and ask questions.

Michael D. Williams
President
North American Construction
Services Inc.

Many pressures face a small contracting entity today, i.e. the ever-changing costs of materials, employees demanding more benefits (health care, salary) and human resource issues that were not present a decade ago. Couple the ever-growing personal life pressures with competition in the marketplace and no assurance as to where the economy is headed. Stress plays an important factor in the health and success of the organization. Contractors and their owners need to learn to budget their corporate expenses but also their personal expenses so as not to always be leaning on the company as a personal piggy bank. If they can learn to operate lean and live lean, the excess profits can be used to strengthen their position and provide for a rainy day.



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