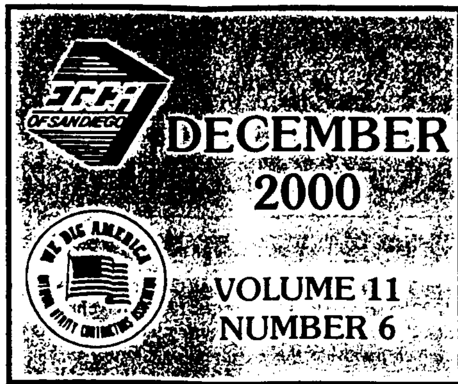

EGCA MAGAZINE

Changes in bonding industry mean less bonding capacity

By John Maloney
Maloney & Associates

Those of you who have been in business for several years have seen various types of "business cycles" that affect contractors. For example, the insurance industry is now in a "Hard Market" as is manifested by 25% average increases in current workers compensation prices.

Bonding companies do not have the luxury of price increases as their "insurance brethren" do; however, this does not mean that major changes are not in the wind. The "Hard Market" is just beginning in the bond business. No, the sky is not falling, but many contractors who are accustomed to certain levels of bond credit are about to experience a rude awakening. There will be less available "bonding" capacity for many contractors, and underwriting guidelines will become much tighter.

Why does this happen during such a strong construction economy? There are two simple reasons.

First, losses. Preliminary "guesstimates" are that the bonding industry will suffer losses this year from anywhere between $600,000,000-$900,000,000. That's a lot of coin, and yes, these numbers result directly from contractor failures throughout the country.

Let's be honest: over the past several years during the "Soft Market" things were too easy. Bonds were easy to obtain and too many people received levels of bond credit that they did not deserve. Bonding companies practiced what they call cash flow underwriting.

This means increasing their market share, writing more bonds, collecting more premiums and investing these premiums in Wall Street. This sounds like a good plan, but they simply do not operate with sufficient margins to pull this off over time. These losses have also penetrated to the "reinsurers" which is the money behind or safety net for the insurance industry. They will, in turn, dictate tougher underwriting practices to the various bonding companies

The second factor contributing to this hard market is the merger and acquisition mania. Out of the top 25 of the largest bonding companies from 10 years ago, only a handful remain intact. This results in less competition and less overall available capacity. The urge to merge and desire to acquire are not always the best thing for the consumer.

This hard market is very real and will affect many people. The following are some things a contractor can do to enhance their bond program and maintain their sanity during these times;

- I hate to overly simplify things but, stick with the basics that successfully built each of your businesses.
- Supply financial information and work in process reports on a timely basis.
- Know "where you are at" on all jobs and be prepared to explain any significant underbillings or profit fades.
- Keep a keen eye on debt levels in relation to overall equity of the business. Generally, a "debt to equity" ratio of 3:1 or greater raises some eyebrows.
- Balance sheet management...communicate your desired work levels and see what it takes in terms of working capital and corporate equity to get there. Also, communicate any tax planning maneuvers or major equipment purchases with your "bond person" in order to determine any potential adverse effects to your bond program.
- Manage your cash effectively. Utilize "sweep" type accounts and have retensions placed in escrow type accounts where your money continues to work for you.
- Maintain strong relationships with construction-oriented bankers and CPAs.
- Last, but certainly not least...select a bonding agent who understands the technical nature of the business, is committed to the construction/bond business and maintains relationships with various bonding companies.

Yes, there are major changes in the wind and unfortunately when business cycles change the pendulum usually swings too far to one side. The bond business still continues to be a relationship-driven business.

Our principal underwriting factor should be: Is the guy good for this job? Unfortunately, many will be and won't get the bond in this hard market. This is just another example of "economic Darwinism"...Survival of the Fittest!

Maloney & Associates, EGCA member, is an insurance agency that specializes in providing surety bonds to contractors throughout Southern California.