

Surety Challenges Ahead

BY BRIAN LAWSON



The surety industry has seen few changes to its products in the last 30 years. Other than the fear of the effect of sub-contractor default insurance, we still are primarily issuing bid bonds and consents at the tendering stage and 50 per cent performance and 50 per cent labour and material bonds at the award stage.

The changes we are faced with in current times are coming from the client end of the relationship. We are now seeing clients seeking bond participation in P3 project delivery models, and we are seeing more bonds in joint venture (JV) arrangements due to the growing dollar size of the major projects in B.C. On the ownership side in the contracting industry, we are faced with aging contractor owners who are looking to retire by either selling to employees or selling to larger contractor/ competitors. All of the aforementioned issues have an effect on surety underwriting and the surety industry.

In order to understand these effects, let's deal with them on an individual basis.

Bonding in P3s

Previously in P3 projects, bonds have not been considered a viable contract security option. This was primarily due to the fact that the financing bodies had mostly come out of Europe where bonds are not used and banking instruments (letters of credit) are the only allowable form of security. Recently the industry has been able to persuade the lenders that bonds are a viable option and the insurance and reinsurance companies that back the bonds have more than adequate strength to withstand a default.

Joint Ventures

As the project values continue to increase in complexity and value, we are seeing contractors look to JV's as a solution to participate in these larger jobs. The advantages to joint ventures are that it allows contractors to spread their risk on such large projects. It also allows less financially strong contractors to participate in an area that would otherwise be unattainable. Depending on the structure of the joint venture a surety should be able to look at the combined strength of the partners and may allow the stronger partner to carry the weaker one. This is due to the fact that the indemnitors (partners) will have a joint and several indemnity obligation to the surety company. Therefore, if one of the contractors were to collapse the other one would be forced to carry the load thus reducing the potential for the bond to be called.

Employee Buyouts

As mentioned we are now seeing the baby boomer effect enter its way into the construction industry. The latest construction boom is now over and some of the more senior contractors are deciding it is time to allow their children or employees an opportunity to run the show. The problem is that when these individuals take over they have fairly high expectation for bond support. They are used to a bond level that relied upon the strength of the balance sheet and its surplus of working capital and equity.

These critical components are usually depleted upon the departure of the previous owner. The new owners are not only faced with funding the purchase of the business but also funding the working

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requirements of the business itself. This double whammy has created a gap between what they can bid versus what they have been used to bidding.

It is recommended that prior to selling or purchasing, the owners (old and new) discuss a strategy with their surety broker that will work best for continuing the operation on a status quo basis. This discussion may also uncover the shortfalls of their plans and how their balance sheet will be impacted. In most situations we have seen the previous owners want their businesses to succeed and will assist in a smooth transition.

Corporate Buyouts

As in the previous discussion we are seeing more companies being bought out, not only by their employees, but also by their larger competitors. This strategy is usually successful as it allows continuity of the business and the employees are allowed some certainty for their future. One of the downfalls we have witnessed is that these purchases are sometimes purchased with debt serviced by the cash flow of the purchased entity. This is a fine business strategy but not necessarily a great surety strategy.

The added debt to the balance sheet is usually a huge detraction from the much needed working capital component. The purchase may create a large goodwill component which has limited value to most surety underwriters. The debt to worth computation becomes excessive and most of the leverage that the companies once had with their sureties is now eroded. Keeping the debt off of the balance sheet is a key strategy to consider.

Once again, sitting down with your surety broker prior to making these changes is critical in allowing for a more smooth transition. **CB**

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