A little more than seven years ago, an investment banker, a surety underwriter, and a commercial banker engaged in a spirited debate about the cooperation (or lack thereof) between bankers and sureties.¹ The dialogue illustrated the differences in each party’s worldview about providing credit to the construction sector.

Scott, Rick, and Dave recently connected at an industry event and decided to see if the seven years has lessened or widened the differences between bankers and sureties. Led by Scott, their discussion on underwriting approaches, credit ratings, intercreditor agreements, and public-private partnerships (P3s) follows:

Scott: Let’s start by checking to see if there is still any unfinished business from seven years ago. Rick, is there anything that bankers do that really pushes your buttons? Dave, how about those sureties?

Rick: There are certainly some areas where we could work together better. Take contractor ownership transition for example; the options available to many contractors are few and shrinking. This could lead to situations where company owners take steps before or in concert with ownership transition that reduce their companies’ creditworthiness and ability to get surety bonding. This is a negative outcome for everyone involved.

Dave: Given the tough construction market over the past five years, I have developed a better appreciation for the surety industry’s focus on a strong balance sheet and equity. Those contractors that have come through this tough period best have tended to have strong balance sheets. However, to respond to Rick’s comments, most ownership transition involves some additional leverage and taking some equity off the table. Any innovative solution between the bankers...
and sureties needs to address this issue. I feel that there remains a tendency for the sureties to be resistant to any plan that involves debt recapitalization.

Rick: Recapitalizing is okay, as long as it is done with enough permanent capital. A surety’s primary concern is with the contractor’s ability to perform the work and pay all the bills. This involves a lot of qualitative issues, which surety underwriters spend a lot of time assessing, but financial analysis also matters. Here, it’s the contractor’s balance sheet that takes center stage.

Because construction is risky and bad things sometimes happen to good companies, a contractor’s balance sheet is the cushion that allows it to grind through adversity, finish work, pay bills, and keep the contractor intact and the surety out of the soup. Therefore, surety underwriters focus on the size and quality of the balance sheet. They look for liquidity (mostly in the form of cash and fast-turning receivables), solid equity, and little debt or other forms of outside financing.

And, let’s not forget the all-important work-in-progress (WIP) schedules that accompany the financial statements. WIP schedules track job performance, of course, but also allow for verification of large balance sheet items such as billings in excess of costs, as well as the accuracy of any year’s earnings and cash flows.

Scott: This sounds a lot like what was said seven years ago. Have the last seven years brought anything new to underwriting in the surety industry?

Rick: The last seven years have brought an even greater focus on sound credit principles as well as solid underwriting and pricing decisions. These provide a surety company with the financial strength to continue to support its customers in the future.

Scott: Okay, time to stop picking on the surety (for the moment). Dave, what changes have you seen in the banking industry’s underwriting approach for the construction sector?

Dave: I am troubled by the banking industry’s increased reliance on internal and external credit ratings. Let’s call this the unintended consequences of regulation. After the 2008 financial industry meltdown, the public looked to industry regulators for answers as to why they had done such a poor job of regulating. So, the regulatory bodies began to demand that the banks create a consistent and quantitative set of metrics for evaluating credit risk. We all know the problems that came from over-reliance on external third-party ratings (e.g., Moody’s, Standard & Poor’s, Fitch Ratings).

From an internal credit rating standpoint, the push for standardization has resulted in a “one size fits all” approach to credit ratings in which a GC tends to be rated on much of the same criteria as a trade contractor, as well as the same criteria as a grocery store, an automotive manufacturer, or a service company. There is an obvious problem with this approach: The financial statements and business model of a GC are very different from a trade contractor or engineering firm and worlds apart from a retailer, manufacturer, or service company.

Scott: Rick, have you seen instances where the banking industry’s increased focus on credit rating models has caused problems for your clients?

Rick: At some level, yes. However, we are always better off, as are contractors, when they work with a banker who understands credit and who specializes in construction. These types of bankers are more likely to provide the right solutions and useful feedback, support the contractor when they actually need bank credit, and work with sureties as cooperative co-creditors.

Scott: This seems like a good time to bring up intercreditor agreements. Under what situations would you want to see an intercreditor agreement between a bank and surety?

Rick: Intercreditor agreements are generally negotiated during good times in an effort to set forth the bank and surety’s positions relative to each other as creditors of the contractor if and when tough times hit. In a situation where we are required to complete a bonded job, it is essential for us to have access to the job’s receivables, equipment, drawings, and other assets needed to honor our bond obligations and complete the work.

Dave: Rick, I understand your position. If the bond requires that the surety step into the contractor’s shoes to complete the job, then the surety should be entitled to the same rights as the contractor had under the contract, including collecting the receivables, using the equipment, etc. However, keep in mind that the bank has most likely provided a line of credit and other financing that have supported the working capital and equipment for all jobs (bonded and unbonded). Commercial banks are usually not too thrilled about turning over all rights on bonded work, which we have financed, over to the surety.
Rick: If we seem to squabble with bankers over intercreditor agreements, it’s because bankers usually take very narrow risk for pretty small limits, while sureties generally take very broad risk spread out across a contractor’s backlog and for very large limits.

Scott: I think that this is one of those areas over which sureties and bankers will continue to agree to disagree. So, let’s change gears and talk P3s. P3s are kind of like Dippin’ Dots, which has been marketed as the “Ice Cream of the Future” for about 25 years. Like the ubiquity of Dippin’ Dots at amusement parks, it feels like P3s have finally arrived. Our clients, contractors, and design firms alike are thrilled about the new sources of funding. However, P3s bring with them some levels of uncertainty for both sureties and lenders. How do each of you feel about P3s for your business and the construction industry?

Rick: Given the high demand for assets like roads, hospitals, and court houses (to name a few), combined with limited public resources to pay for them, we think that P3s will continue to generate momentum over the coming years. Larger and well-financed companies will be rightly interested in pursuing this work as design-build contractors. As a surety, we would want to be sure that the risks borne by the developer to finance, operate, and maintain the asset are not passed on to the design-build contractor through the contract or otherwise.

Then, there is the more complex matter of a contractor wanting to provide financing or take an ownership or other long-term interest in the operations of the asset. In our view, very few North American contractors have balance sheets that are able to take on this sort of long-term and illiquid asset and the risks associated with managing it.

Dave: I agree with Rick on this. There is a huge need, particularly in upgrading our infrastructure, but given the budgetary constraints faced by most government agencies, much of the needed work will not get done without P3s.

I have two major concerns for my contractor clients. Rick alluded to my first and most important concern – I have seen many P3 proposals where the real driving force is not the financing, but rather the risk allocation. Far too often, I see development or ownership risks being pushed down to the contractor. Unfortunately, most of these risks (e.g., throughput levels or technology required by the sponsor/owner) may be outside of the contractor’s control.

My second major concern occurs when the contractor gets the “opportunity” to make an equity investment in the development in order to get the construction contract. If it is a de minimis investment, fine, but it often is considerably more. Again, most North American contractors are neither capitalized to finance such projects, nor structured to manage the developer/owner risks.

Scott: Some of our contractor colleagues and clients have asked us to review their situation and assess whether we can help them monetize their equity investment in these P3s without jeopardizing any ongoing maintenance or operations work. There are a number of potential investors who are very interested in making these kinds of investments.

Dave: That is great in that it may address the contractor’s need for cash not to be tied up in an illiquid asset, but it doesn’t address the fundamental difference between building a project and managing that project’s operations or maintenance for up to 20 years. They are two different businesses and require two different business models. Those contractors that can modify their processes and culture to efficiently manage P3s will be more successful than those that try to superimpose the new requirements over their existing business model.

Rick: I’d like to address the “portfolio” element of the P3 risk. We know that some P3s may move forward without the payment and performance protection offered by a surety bond. Whether we provide a bond or not, if our customer takes that risk into its portfolio of projects, then it is a risk that we have to consider in underwriting the entire account. Participating in a P3 without a surety bond doesn’t mean the risk to our customer is of no consequence to the surety.

Scott: Dave, we have seen a number of projects – P3 and otherwise – that require a bank letter of credit rather than the traditional surety bond. To what extent is the banking industry ready to step in and fill the void?

Dave: I guess that I have to ask why the project would require a letter of credit? Often, a letter of credit is in the mix because a surety bond is not obtainable. The sureties have a hard enough time managing their surety risk and for the most part are probably a lot better at it than commercial bankers. Why should I think that I could do a better job at their business than them? That’s sort of like a road builder suddenly deciding to build skyscrapers.
**Scott:** Rick, earlier you mentioned the need for better cooperation and creativity between banks and sureties in ownership transition situations. Construction companies typically sell, whether through management buyout, ESOP, or sale to a third party, at multiples of EBIT or EBITDA. How do you reconcile the surety industry’s focus on the balance sheet with a business that is driven by cash flow?

**Rick:** I don’t want to be misunderstood on the importance of positive cash flow. Income statements and cash flow speak to the contractor’s ability to make a profit and turn it into cash. However, the balance sheet is the real test of the company’s ability to do these things over time. The balance sheet represents the accumulation of operating results and the quality of management decisions made over time. And, it’s the balance sheet – not future cash flows – that a contractor can use to solve problems fast.

**Scott:** I am confused about that as I’m not sure how a balance sheet – which carries liquid assets like cash and A/R, but is also filled out with illiquid assets like unbilled A/R, inventory, and equipment – can help “solve problems fast.” I feel that if future cash flow resulting from a strong backlog (as discussed earlier) is actually realized (albeit a big “if”), then it would offer much more flexibility to all stakeholders – especially owners/investors.

**Rick:** Many contractors’ balance sheets are a lot more liquid than you might think. It’s this existing liquidity, already earned and on the balance sheet, plus future liquidity that is earned from the backlog, that can help a contractor solve problems. Of the two, existing liquidity is the surer source of funds.

**Dave:** I think what we have here is a fundamental difference in the risk/return trade-offs between a senior creditor or surety and an owner or investor. Banks and sureties are structured to take relatively low risk in exchange for relatively low returns. The upside for banks is getting the loan repaid; for sureties, it’s having the job completed without any issues. Neither organization is structured to take equity type risks. This is why we both pay attention to the balance sheet in addition to the projected cash flows – it represents our cushion against a company falling short of realizing those projected results.

We are also aware of the very uneven pace of recovery among the various market segments. Certain segments have held together better and show stronger signs of growth. Scott, what do you see as the hot markets in the M&A world?

**Scott:** Energy, energy, and energy – it is the area right now. Contrary to popular belief, M&A in the engineering and construction sector is not driven by a need to add people; instead, it is focused on bulking up services, geographies, and end-markets. We do expect that some of the softer markets right now – public works in particular – should pick up steam this year as priorities and budgets are reset and reestablished. There is a lot of optimism right now coming from the areas that have been downtrodden.

**Rick:** From a surety perspective, a hot market can lead to very high acquisition prices, which typically translate to lots of goodwill. Goodwill may hold its value in an up market, but tends to get written off very quickly if performances don’t match expectations.

Also, though there are many strong contractors that have managed their businesses well throughout the recession, there are also many others that have not. Making an acquisition today means buying backlog that was built during the recession, which may have real risks.

**Scott:** What do either of you see coming down the road in either the banking or surety industry that might impact the construction industry for better or worse?

**Dave:** In June 2012, the Federal Reserve Board officially came out in support of Basel III, the proposed reforms developed by the Basel Committee on Banking Supervision. It seems almost certain that most of the provisions will be adopted and likely phased in over time. Basel III has three proposed rules that may negatively impact the construction industry.

First, there would be an increased level of capital required to support lending. Banks can either raise new equity capital or downsize the loan portfolio to match the existing capital. Second, commercial and certain residential real estate lending would carry higher capital requirements, making it more expensive or difficult for owners and developers to obtain the financing for projects. Lastly, unused lines of credit would require higher levels of capital, making it very expensive to provide large backup lines to contractors looking to improve their prequalification or meet bonding requirements.

There is one more potential problem from Basel III. Since the primary bank lenders for P3 projects have been the large European banks, most analysts feel that the new capital requirements may be very difficult for many of these large European banks. Consequently, many may pull out of the
U.S. markets altogether as they consolidate down to match their already strained capital. However, if there is a void in this space and money to be made, then I have no doubt that new funding sources will step forward.

**Rick:** To address Dave’s last comment, it is rare for us to require a contractor to get a bank line of credit. Most of our customers already have them.

Now to address Scott’s question: The surety market moves in cycles. The market is currently pretty soft, meaning there’s lots of capacity at historically low prices. This comes from profitable industry results, a dampened construction market since 2008, and therefore less demand for surety capacity. But surety losses are beginning to mount, which tends to reduce surety capacity. If this happens, then surety capacity may become a constraint for contractors looking to expand as the economy improves.

**Scott:** Some of our clients would have described surety capacity as a “real constraint” years ago – I hope you aren’t saying that it’s going to get worse. Now, let’s wrap this up before it gets too depressing.

Over the past seven years, the construction industry and its broader marketplace have experienced a whole new level of volatility beyond what our banker or surety could have imagined. If heeded, the conservative approach advocated by our prior article may have helped some contractors withstand difficult times.

While we investment bankers differ from commercial bankers and surety underwriters (and you both from each other) on a number of areas close to our hearts, we (and our clients) see you both as partners and understand that transparency and consistent communication will help us all win.

**Endnote:**


SCOTT M. KOLBRENNER is Managing Director of Houlihan Lokey in Los Angeles, CA, where he heads the Engineering & Construction Practice. His recent transactions include financing, restructuring, strategic advisory engagements, fair market value, ESOP, and solvency opinions. Scott is a frequent speaker at industry events, including those hosted by CFMA, AICPA, ABC, AGC, Engineering News-Record, McGraw-Hill Construction, and many others. He was recently recognized by Investment Dealers’ Digest as a recipient of its “Forty Under Forty” award. Scott earned a BA in Psychology from the University of Colorado at Boulder and a JD from Harvard Law School.

| Phone: 310-712-6524 |
| E-Mail: skolbrenner@hl.com |
| Website: www.hl.com |

RICK CIULLO is Chief Operating Officer of Chubb Surety in Warren, NJ, where he oversees Chubb’s worldwide surety business.

Rick earned a BA in economics and history from Wesleyan University in Middletown, CT. He also continues education through Vistage, a worldwide organization dedicated to executive-level education and development.

| Phone: 908-903-5555 |
| E-Mail: rciullo@chubb.com |
| Website: www.chubb.com |

DAVID L. SAUERMAN is Managing Director for the Construction & Engineering Division of The PrivateBank in Chicago, IL. With 31 years in banking, Dave has worked exclusively in construction and engineering for 27 years.

A member of CFMA’s Chicago Chapter, Dave is a previous author for *CFMA Building Profits*, current Vice Chair of the Publications Committee, and a frequent presenter at CFMA events. He is also a member of ASA, The Illinois Road and Transportation Builders Association, and the Illinois CPA Society’s Construction Contracting Committee.

| Phone: 312-564-1237 |
| E-Mail: dsauerman@theprivatebank.com |
| Website: www.theprivatebank.com |