

Surety 1.0

Bonding Basics for Contractors



Contractors Today



Key Results

- 10,000 Contractor Insureds
- \$300+ Million Inforce Premium
- Single biggest market for Federated

Contractors Today



Key Results

- Significant growth market
- Market leader in coverage, risk management, claims.
- Weak in surety services

Granite Re Acquisition



January, 2017

- Acquisition allows us to deliver on our promises to clients and association partners.
- Better positions Federated to partner with associations for your members surety and bonding needs.

Surety Basics



- Different than insurance.
- Contractor must qualify for surety bonds:
 1. Character
 2. Capacity
 3. Credit
- Serve as a financial guarantee that certain tasks will be fulfilled, work be performed or honesty of a party.

Surety Basics



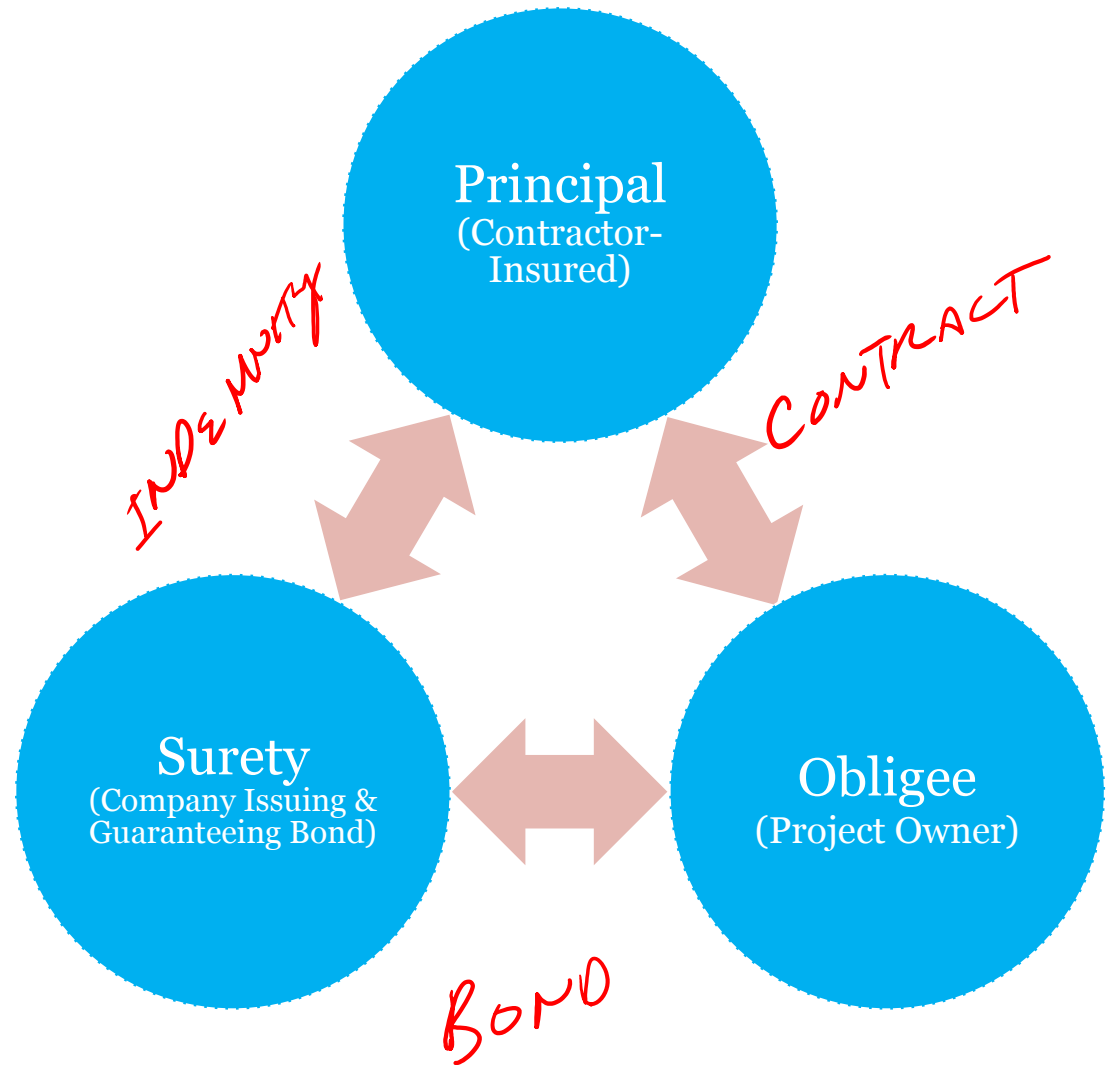
- Through ***indemnity agreements and subrogation rights***, surety has the right to recover all losses.
- 99.9 % of all performance bonds require indemnity agreements.

Different than Insurance

Principal – Contractor (insured) performing the services; the one required to furnish the bond.

Obligee – Party requesting a bond; oftentimes a project owner or general contractor; the one requiring the bond.

Surety – The party that sells, issues and guarantees the bond. Typically, insurance and surety companies.



Types of Contractor Bonds



- License and Permit Bonds
- Bid Bonds
- Performance Bonds
- Payments Bonds
- Maintenance Bonds

License and Permit Bonds



What are they? Why needed?

- Guarantees contractor will adhere to industry laws and regulations
- Protects consumers
- Required by jurisdictional bodies
- Typically written for a specific time period

Bid Bonds



- When a job is put up for ‘bid’, the contractor must supply a ***Bid Bond*** with their submission.
- The sole purpose of the bid bond is to guarantee that the contractor enter into the contract if they are awarded the job.
- Failure to do so would result in a penal amount, which typically is 5% or 10% of the bid amount.

Bid Bonds



- Bid Bonds are written for a **Specific** job.
- The surety does not need to know the specific bid to issue a bid bond.
- These bonds protect the project owner from unqualified contractors, and increase the likelihood that the project will remain on schedule.

Performance Bonds



- Once a job has been awarded, the contractor is required to submit a ***Performance Bond for that specific project.***
- As surety, we are guaranteeing that the contractor will ‘perform’ the job as per his bid and the contract specifics.

Performance Bonds



- Failure to do so means the surety is required to step in and complete the job per the bid and contract specifics. As surety, we bear the financial responsibility.
- Other parts of a performance bond, would typically include a ***Payment Bond and a Maintenance Bond.***

Dictionary of Construction Terminology



- Contractor – A gambler who never gets to shuffle, cut or deal
- Bid Opening – A poker game in which the losing hand wins
- Bid – A wild guess carried out to two decimal places
- Low Bidder – A contractor who is wondering what he left out
- Engineer's Estimate – The cost of construction in heaven

History of Suretyship



- Personal Suretyship among private individuals is an age old practice dating back to Hammurabi the ancient King of Babylon around 1792-1750 BC
- As the American economy became more industrialized, the amounts of money sureties had to guarantee became too large for personal sureties

A Surety Prequalifies A Contractor



- Determines a contractor's ability to meet current and future obligations.
- **Character**
 - What is the 'story' of the business and the owner(s)
 - Reputation
- **Capacity**
 - Experience matching requirements of the job
 - Equipment to perform the work

A Surety Prequalifies A Contractor



- **Capital**
 - Financial strength
 - History of promptly paying subcontractors & suppliers
 - Good standing with bank and established line of credit

Bonds Protect the Obligee – Not the Principal



Public Works

- Ensures that work will be completed to specifications for the agreed upon price
- Allows recourse for unpaid subcontractors and suppliers since they cannot file liens on public property

Bonds Protect the Obligee – Not the Principal



Private Projects

- Ensures that work will be completed to specifications for the agreed upon price
- Transfers the risk of unpaid subcontractors and suppliers from the owner to the contractor and the surety

Bonds Required on Public Works



Federal

- Heard Act (1894) & Miller Act (1935)
 - Require performance & payment bonds for public work contracts over \$150,000.

State

- “Little Miller Acts” (vary by state)
 - Require performance and payment bonds on state & local public works projects.

Insurance vs Surety



- Insured Purchases insurance for his/her protection
 - Insured may qualify by simply paying a higher rate
 - Insurance Company rates based upon actuarially determined statistics
 - Insurance company expects a certain amount of losses which drives a predetermined profit
- Principal purchases a bond for the Obligee's protection
 - Principal must qualify (financially) A higher rate will not protect the Surety from a loss
 - Surety uses rates that are unchanged since 1986. Rates charged are a fee for providing the service
 - Surety expects a no loss business

Reasons Contractors Fail



- Project Size Increase
- Geographic Unfamiliarity
- New Types or Sectors of Construction
- Key Personnel Replacement
- Managerial Immaturity
- Communications Problems with Owners, Subcontractors, and employees



Reasons Contractors Fail



- No Comprehensive Business Plan
- Poor Project Management/Execution in the field
- Poor Estimating and Job Cost Reporting
- Bank Pulls Support
- Accounting & Financial Management Problems
- No estate or continuation plan



TOOL
of the **WEEK**
UNDER CONSTRUCTION UNDER CONSTRUCTION UNDER CONSTRUCTION

Contractor Warning Signs



- Ineffective financial management system
- Bank lines of credit constantly borrowed to their limits
- Poor estimating and/or job cost reporting
- Poor project management
- No comprehensive business plan
- Communications problems
 - ✦ Owner
 - ✦ Subcontractors
 - ✦ Employees
- Poor Credit Score
- Poor Liquidity
- Poor Profitability



Characteristics of a Stable Contractor



- Formal and on-the-job training for all levels of employees
- Logical incentive based compensation plan
- Succession planning
- Visionary, inspirational leadership

Characteristics of a Stable Contractor



- Solid management of cash flow and overhead
- Management of debt and retainage
- Continuity plan
- Reasonable growth without overextending

Characteristics of a Stable Contractor

- Superior estimating skills and systems to manage costs
- Well defined market niche and 12-36 month growth plan
- Productive field managers trained to improve processes



Characteristics of a Stable Contractor



- Litigation avoidance
- Disaster preparedness
- Good Credit Scores
- Good Liquidity
- Good Profitability

Cost of Surety Bonds



- Fee for underwriting service
- Typically between .5% - 2.5% of total contract price
- Rates vary depending on Surety, Contractor, and size & type of contract
- Owner pays bond premium
 - Premium is built into the contractors bid

Choosing Professional Advisors



- Surety Specialist
- CPA
- Banker
- Lawyer
- Insurance Advisor

Surety Specialist



- Specializes in bonding
- Awareness of local, regional & national trends
- Knowledge of construction accounting & financing
- Respected in construction industry
- Knowledge of contract documents
- Experience in strategic planning & management practices
- Active in construction & surety industry associations

CPA



- Select a CPA who is knowledgeable in construction accounting
- Statements should recognize revenue using Percentage of Completion
- Statements should include:
 - ✦ Accountants Opinion page
 - ✦ Balance Sheet
 - ✦ Income Statement
 - ✦ Statement of Cash Flow
 - ✦ Work in progress schedule
 - ✦ Accountant's explanatory notes

THERE ARE 3
KINDS OF
ACCOUNTANTS
IN THE WORLD.

THOSE WHO CAN
COUNT & THOSE
WHO CAN'T.

Banker



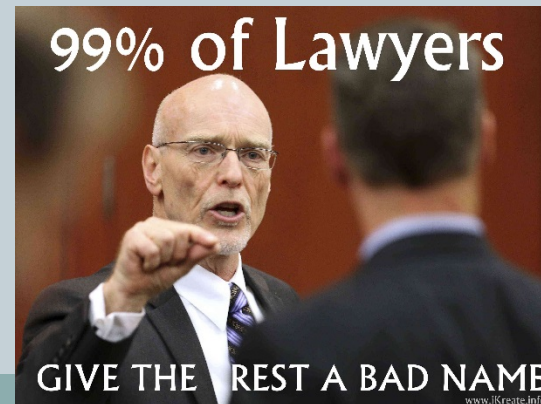
- Select a banker who can assist you in:
 - ✦ Financing equipment
 - ✦ Line of Credit
 - ✦ Depository accounts
- Understands contractors
- Develop a relationship
- Maintain good communication
- Choose a bank that fits the size of your company



Lawyer



- Get one before you need one
- Specializes in Contract Law
- Understands construction contractors and surety
- Spends appropriate time on your needs
- Good explanation of billings



Insurance Advisor



- Experienced in contractors risk
- Represents a company that specializes in contractors
- Provides risk management resources
- Reviews your unique exposures and offers solutions – 400+ endorsements.
- Explains coverages
- Annual review

Contract Bond Underwriting



A process that involves:

- Analysis, interpretation, and application of financial data
- Assessing the contractor's organization and management capabilities
- Assessing the risks associated with each project and backlog of projects undertaken by the contractor
- Consideration of non-financial information
- Rate the policy/bond



Information Surety Needs



- Financial statements for the last 3-5 years
- Current personal Financial Statements of owners
- Organizational chart of company
- Resumes of key personnel
- Contractor's business plan

Information Surety Needs

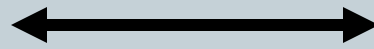


- Work in progress
- Continuity & contingency plans
- Subcontractor & supplier references
- Bank line of credit
- Letters of Recommendation

Three C's of Surety

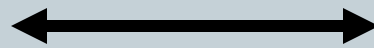


Capital



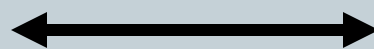
**Financial
Strength**

Capacity



**Ability to
Perform**

Character



Reputation



Working Capital



- Working capital measures how much in **liquid** assets a company has available.
- The number can be positive or negative, depending on how much debt the company is carrying

Current Assets – Current Liabilities = Working
Capital

$$\$75 \quad - \quad \$50 \quad = \quad \$25$$

Equity



- The ownership interest of shareholders in a corporation
- Net Worth
- $\text{Equity} = \text{Assets} - \text{Liabilities}$

Bond Man



Tax Man

Contractors Must Balance

- Keeping financial statements strong enough to have desired bonding capacity
- Deferring and minimizing tax payments

Contractor Qualifies for Surety Credit...

Now What?

General Rules of Thumb

- Single Job Size

- ✦ 10x Adjusted Working Capital
(Adjusted Current Assets – Current Liabilities)
- ✦ 5x Adjusted Equity (Total Adjusted Assets – Total Liabilities)

Contractor Qualifies for Surety Credit...

Now What?

General Rules of Thumb

- Aggregate Job Size
 - ✦ 15x Adjusted Working Capital
 - ✦ 10x Adjusted Equity

Contractor Qualifies for Surety Credit...

Now What?

General Rules of Thumb

○ Bonded vs. Unbonded

- ✦ Surety Companies use either bonded or total backlog for the aggregate job size
- ✦ Cost to complete on jobs, either bonded or total backlog, is used to determine work on hand

Underwriting Tools



- **Collateral**

- ✦ Liquid asset, pledged for the surety's protection

- **Escrow**

- ✦ Contract funds deposited with a third party to be delivered upon fulfillment of certain conditions, as established in a written agreement.

Surety Industry Premium

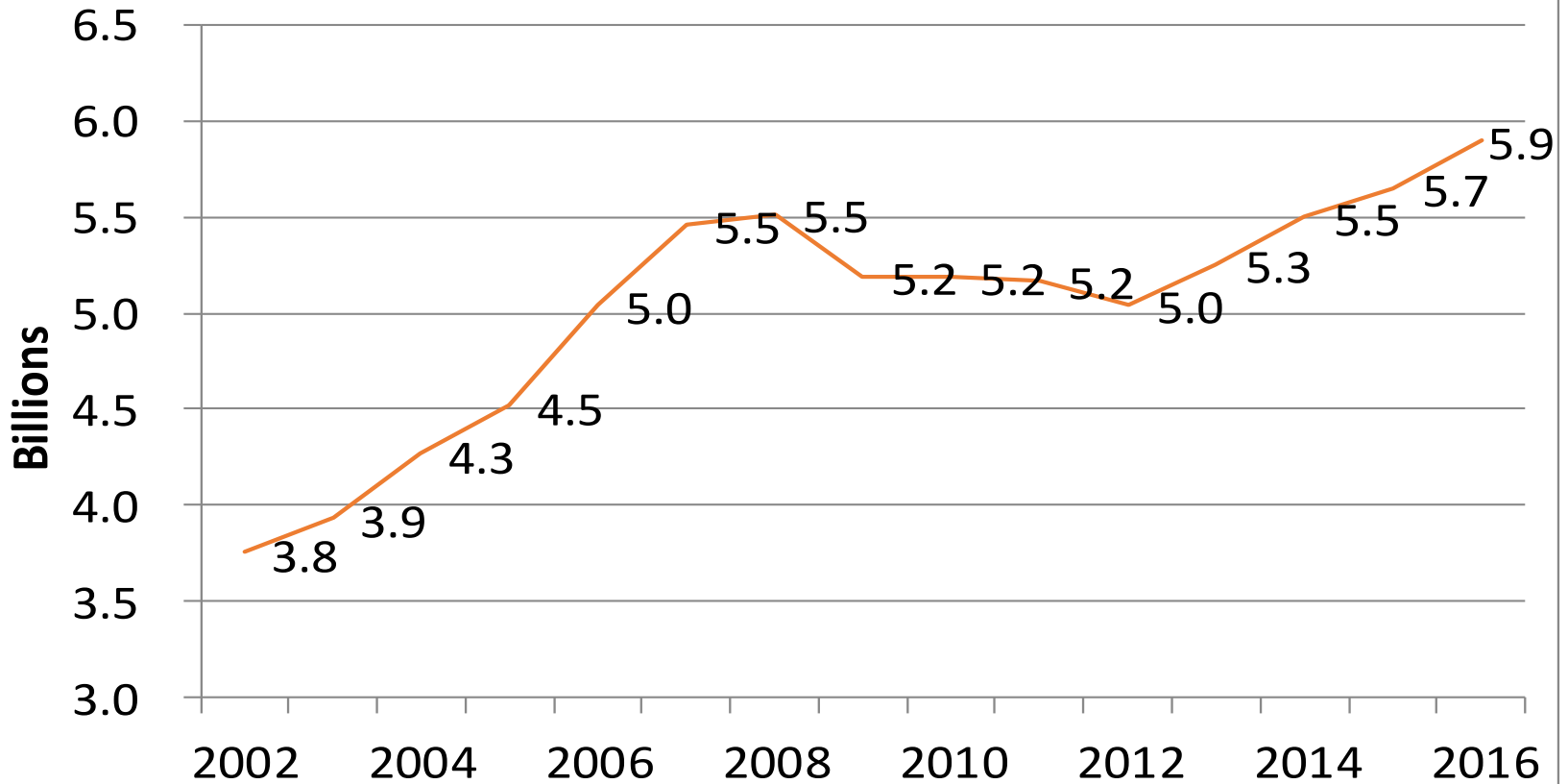


The Surety Industry Continues to be Profitable for the 12th Consecutive Year, Despite Modest Premium Growth.

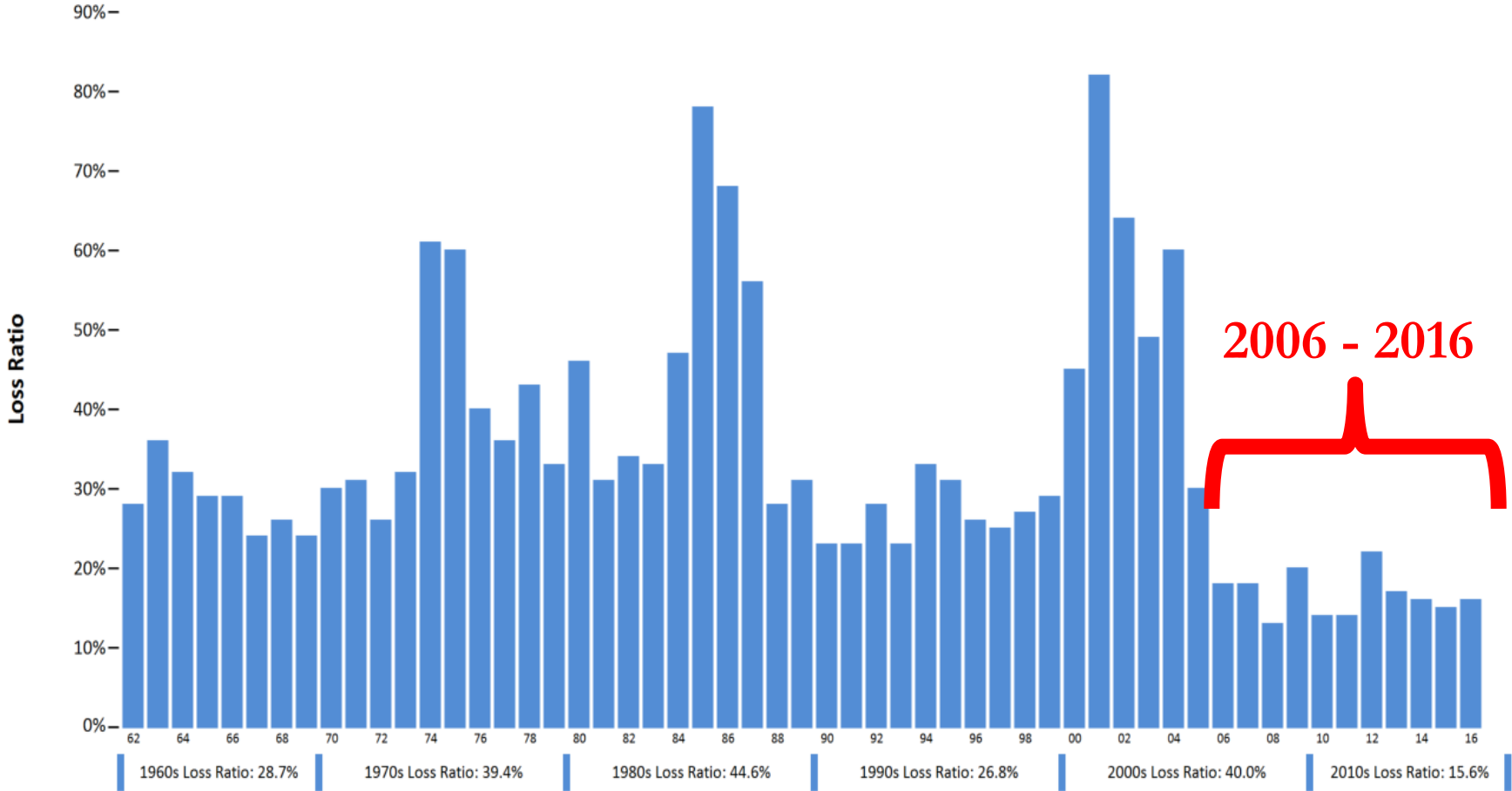
2008 Premium:	\$5.6 billion
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2016 Premium:	\$5.8 billion
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Surety Direct Premium Written 2002-2016



Historical U.S. Surety Loss Ratio Data

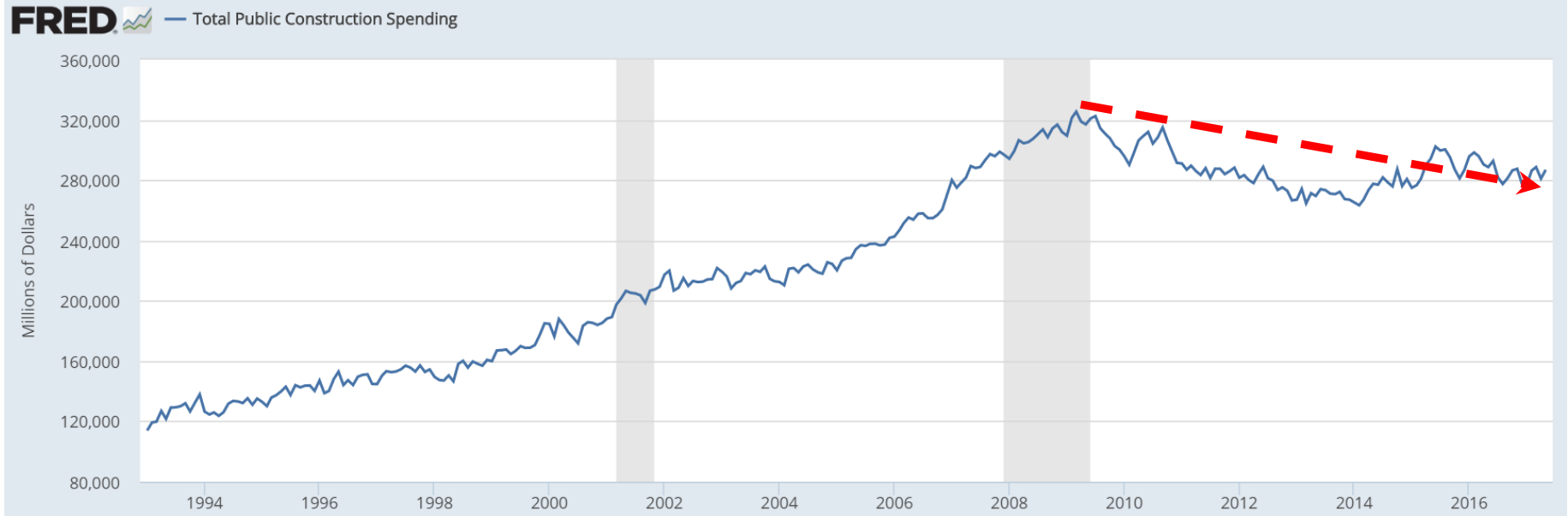


State of the Surety Industry



- Record Number of New Entrants
- Soft Market Conditions
 - But Limited Premium Growth
- Growth Possible if Favorable Federal Infrastructure Spending Bill Approved
- Low Loss Ratios for Last Decade
- Is Loss Cycle Nearing?
- Inflation?

Public Construction

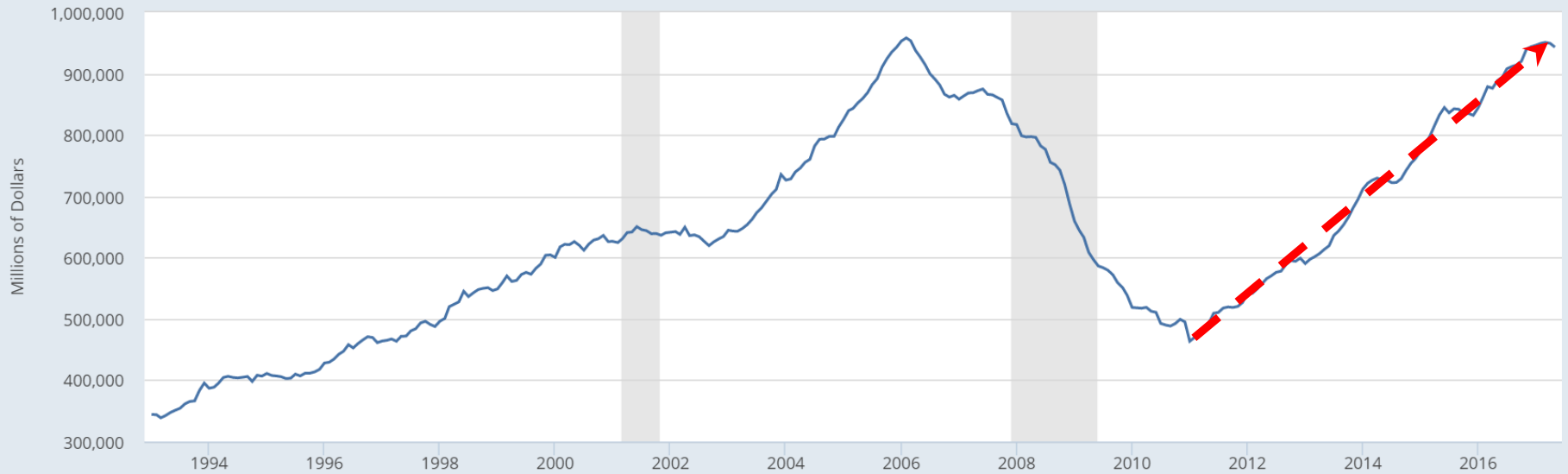


Private Construction

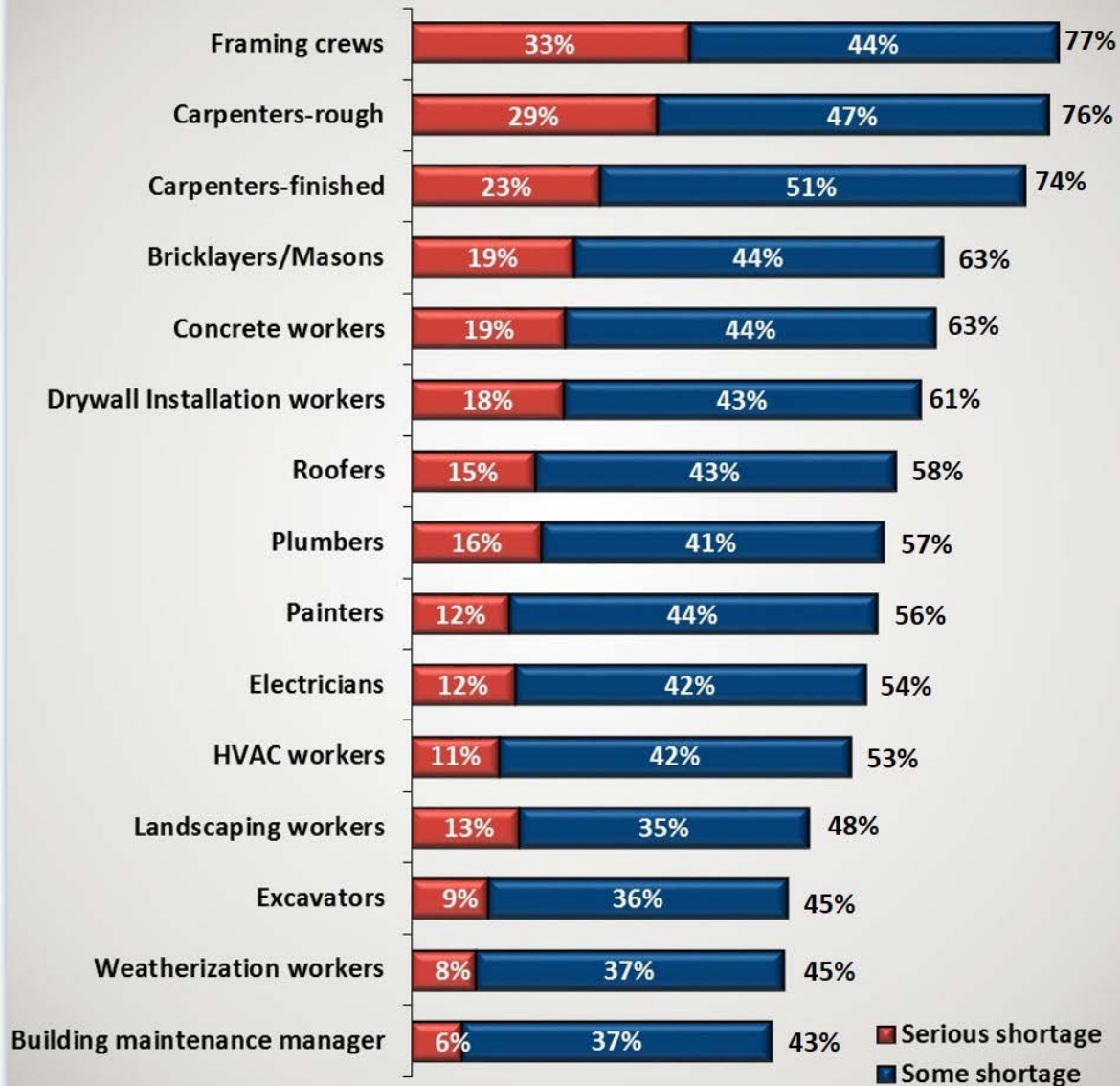


FRED

— Total Private Construction Spending



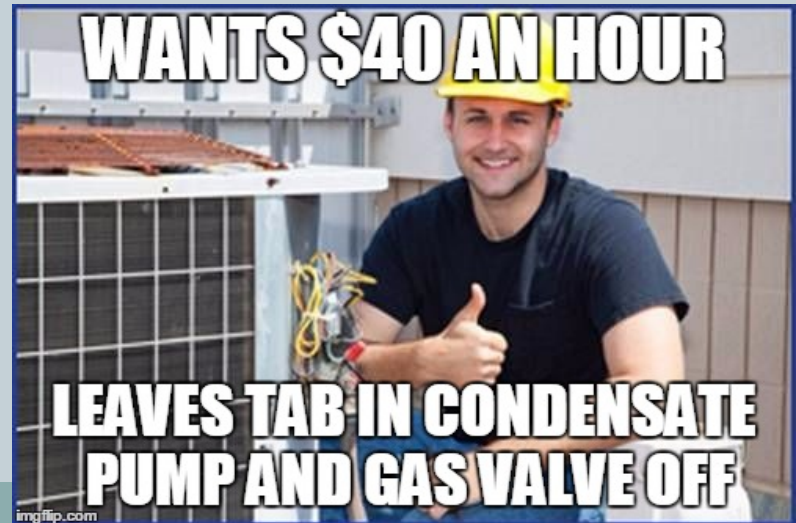
PERCENT OF BUILDERS REPORTING LABOR SHORTAGES IN 2017



State of the Construction Industry



- Robust Private Sector
- Flat Public Sector
- Lack of Skilled Workers
- Material Escalation / Thin Margins



Advice for Today's Market



- Stay within capabilities
- Manage growth & overhead
- Learn causes of contractor failure
- Communicate

Advice for Today's Market



- Scrutinize contract terms & bond forms
- Use construction-oriented CPA
- Don't "buy" jobs
- Bank line of credit
- Conserve capital
- Bond subcontractors

Advice for Today's Market



- Protect key 'personnel assets'
- Deferred compensation
- Key man life protection
- Review estate and business continuation plans with emphasis on funding

Advice for Today's Market



The Surety Relationship

- Producer and Underwriter
 - Essential partners
 - Valuable resources
- 3 stages to a long-term surety relationship:
 1. Meeting
 2. Maintaining
 3. Maturing

LEARN HOW TO SET YOUR DIAL ON LOW



KEY AGENDA ITEMS:

- *Distracted Driving/MVRs*
- *Hiring, Screening, Retaining Employees*
- *Family and Business Succession Planning*
- *Claims Management*
- *Employment Practices Risk Management*
- *Implementing a Drug- and Alcohol-Free Workplace*
- *Managing Your Workers Compensation*
- *Federated's Shield Network®*
- *Loss Keys*
(major loss areas in your industry)



Attendance
is limited

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Questions?

