Surety Analysis of a Contractor's Financial Statement

How the CPA Presentation and the Surety Analysis Differ

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Outline of Presentation

- FINANCIAL STATEMENTS – Why/How they drive surety credit availability
- ANALYSIS OF A CONTRACTOR'S BALANCE SHEET – Walk through a contractor's year-end statement
- KEY FOOTNOTES – What do they mean? How do they aid or hinder the underwriting process?
- BASICS OF UNDERWRITING – Debunking the mystery of surety underwriting
- DISCUSSION OF CURRENT SURETY MARKET

FINANCIAL STATEMENTS

- Engage With a CPA Who Specializes in Construction Accounting
  - **Surety requires Percentage-of-Completion (POC) statement**
    - Not all CPA's understand the reporting requirements of POC as it relates to construction.
  - **Benefits the surety relationship**
    - Surety companies are more willing to lend credit or provide favorable terms for a surety program if they can rely on expertise of the CPA
  - **Benefits the contractor**
    - Construction accounting experts can help manage tax planning *as it relates to construction entities*
      - POC accounting may not be as advantageous for tax savings as other accounting methods, but some contractors are required to use it due to revenue size
      - Manage balance sheet/estimates of profitability to defer taxes
      - Utilize accelerated depreciation methods
      - Understand Net Operating Loss (NOL) Carryback and Carryforward rules

FINANCIAL STATEMENTS (con't)

- What a Quality Financial Statement Looks Like
  - **"Balanced" Balance Sheet**
    - Total Assets = Total Liabilities + Equity
  - **Income Statement**
  - **Statement of Cash Flow**
  - **Footnotes**
    - Accurate
      - Numbers match from balance sheet to footnotes
      - Present information that is factual and relevant to the contractor
    - Concise
    - Descriptive
  - **Supplementary Schedules**
    - AR and AP Aging Schedules
    - Schedule of G&A
    - WIP/Completed Contract Schedule

Surety Financial Analysis

- Surety Credit is driven by Balance Sheet
  - Goal to assess net quick working capital to cash flow backlog
  - Current assets are cash, close to cash or going to be cash within 1 year
  - CPA statement (as given) vs. surety analysis (as allowed)

Tutor Perini Disclaimer

- #12 on ENR Top 400 list
- $4B revenue - civil and GC projects
- $7B backlog
- NYSE traded, all public info from 10-K
- SAMPLE ONLY – not Travelers analysis – no access to internal info

Analysis of Current Assets

- Cash
  - Almost always analyzed 100% “allowed”
  - JV proportionate share consolidation
- Restricted Cash
  - Held for insurance claim deductibles
  - deferred out of current assets

Analysis of Current Assets

- Accounts Receivable
  - within 90 days and retention “allowed” in full
  - “If not collected in 90 days, why leave current?”
    - If collected subsequent to f/s date it may be allowed
    - Could be deferred or excluded altogether based on circumstances
  - Analysis depends on Aging of A/R schedule

Analysis of Current Assets

- Underbillings
  - –Generally allowed 100%
  - –"If you have performed the work, why not billed?"

Analysis of Current Assets

– Underbillings *could* mean
  - early indication of profit write downs
  - unapproved change orders that can never be billed
  - timing issues governed by contract billing period
– Based on circumstances may be excluded from the balance sheet analysis

Analysis of Current Assets

- Deferred Tax Asset – will not add to cash flow
- Other Current Assets - not scheduled, not allowed
- Income tax refund – allowed with tax filing
- Equity in JV – depends on accounting method

Analysis of Current Assets

- Inventory
  - "How much turning into a billing, and then into cash this year?"
  - Discounted 25-50% based on turnover, make-up, and valuation
  - Footnoting helps analysis

Analysis of Current Assets

- Marketable Securities/Investments
  - Fire sale value?
  - Generally allowed 75% of stated value depending on make-up of securities
    - Common stocks allowed 75%
    - CDs allowed 100%
    - Related company or privately held stock may be excluded from Net Worth altogether

Analysis of Current Assets

- Goodwill and intangibles – generally excluded from Net Worth
  - Accounting entry for balance sheet
  - Not a hard asset contributing to operations
  - No indemnity or loss recovery

Analysis of Current Assets

- Note Receivables – Related Parties
  - “When collected?”
  - Typically not allowed as a current asset
    - Unless demonstrated intent to repay may be allowed
    - Repaid subsequent to the reporting date may be allowed
  - Footnoting is critically important

Analysis of Current Liabilities

- Most Current Liabilities are allowed 100%
- Revolving Bank Line of Credit
  - Fully current
  - Possible exception maturity beyond 18-24 months
- Overbillings
  - "What has been done with the money?"
    - Held in cash, earning interest – good
    - Spent on Fixed Assets, applied to other jobs, or spent outside of the company – not good
  - May indicate good cash management practices
  - Overbillings in relation to underbillings, accounts receivable, and cash

Analysis of Liabilities

- Deferred income taxes
  - Due to method of income recognition - current liability
  - Due to depreciation method - long term liability
  - Footnoting is important for analysis

Analysis of Current Liabilities

- Leases
  - Capital leases require no adjustments
  - Operating and Synthetic leases require further investigation
    - Are total obligations fully disclosed in footnotes?
    - Is it really a capital lease with the exception of a percentage point on the term or other technicality?

  - FASB rules may change disclosure in the future

Analysis of Current Liabilities

- Note Payable – Shareholder or Related Party
  - Analysis depends on terms and intention
  - May be subordinated to surety with formal agreement
    - increases working capital and net worth for surety analysis
    - stipulates no payments unless first notifying surety

Analysis of Current Liabilities

- Income Tax Liability on S-Corp
  - taxes on earnings are paid by shareholders personally
  - adjustment to financial analysis for distributions to cover taxes due after the financial reporting date
  - surety rule of thumb is 30% of net income

Selected Ratios

- Working Capital Ratio
  - *As allowed* current assets minus *as allowed* current liabilities
  - Ratio = analyzed working capital/total backlog

- Net Worth Ratio
  - Allowed net worth after excluding soft assets or uncollectible items, or adding subordinated Note Payables
  - Ratio = analyzed net worth/total backlog

Selected Ratios

- Net Cash %
  - Cash minus short-term external sources divided by Total Assets
  - Short term sources – bank line borrowing, net payables exceeding receivables, net overbills exceeding underbills
  - Higher is better – typically 20%+ indicates strong liquidity

Selected Ratios

- AR Turnover (AR/Revenue * 360)
  - Average number of days that AR are outstanding
  - Lower is better –typical GC 40-45 days

- Debt to Equity
  – Surety standard varies by trade
  – Over 2.5 : 1 will be discussed further
  – Differentiate revolving debt and equipment debt

Income Statement/Cash Flow Analysis

- Income Statement Analysis
  - Completed Contracts vs. Uncompleted Contracts
  - Gross Profit vs. Net Income
    - G&A Analysis, Other/Interest Expense
  - Distributions/Dividends
    - Distributions/Dividends should not exceed net income
    - Surety Companies prefer that dividends/distributions be used for taxes only
- Cash Flow Analysis
  - Cash Flow from Operations
  - Cash Flow from Investing/Financing
    - Management/Use of Revolving Bank Line, PPE Purchases

Analysis of Work Schedules

- Backlog Definition
  - Backlog = the amount of costs remaining that must be cash flowed
  - Backlog = Work-On-Hand = Aggregate Program Size = Work-In-Progress = Total Cost-To-Complete on all outstanding work
- Key Points of Analysis
  - Over/Underbillings must tie back to the balance sheet (i.e. numbers match on balance sheet and WIP schedule)
  - Revenue Earned on WIP/Completed Contract schedule should tie back to P&L on POC basis
    - Verify earned revenue from Completed Contracts vs. Work-In-Progress
  - Sureties use trend reports to track project profitability over time
  - **JOB BORROW** = Pure (Billings > Costs) in excess of Total Est Gross Profit
    - i.e. Billed more than contractor will earn in total profit, indicating the contractor will have to put money back into a project at some point
      - Underwriter will look for cash balance to cover
      - Can occur when unapproved change order work has been performed without adjusting GP%

Key Footnotes to Financial Statement

- Method of Accounting - Revenue/Cost Recognition
  - Must be Percentage of Completion
- Scheduling of N/P and N/R
  - Footnotes should include:
    - Maturity Date
    - Secured By (i.e. equipment, collateral, real estate?)
    - Terms of Payment (Length of Note (i.e. months, years), Payable When?)
    - Interest Rate
    - Total Amount Owed
    - Party that the debt is payable to
  - Underwriters are interested in Balloon Payments, High Interest Rates
- Subsequent Events
  - AR Collections
  - Marketable Securities/Investments Sold
  - Inventory Turnover and Make-Up
  - Underbillings

Supporting Schedules

- Accounts Receivable and Accounts Payable
  - Provide information relating to the cash flow management of a contractor
    - Does the contractor collect/pay in a timely manner?
  - Are receivables/payables hung over consecutive reporting periods? If so, why?
    - If a receivable/payable is delinquent, signals to an underwriter a potential cash flow issue or litigation
- WIP Analysis/Completed Contract
  - Profit Fade
    - Be conservative with estimates of how profitable a project will be. Surety companies become concerned when projects exhibit fade year-after-year
  - Analysis of overhead expenses vs. remaining profitability in backlog
    - Will the current work-on-hand be profitable heading into next fiscal year?
    - Seasonal issues may arise depending on the trade/size of the contractor
- G&A Schedule
  - Allows for both the surety and contractor to review any changes made over a trending period
    - Good to analyze where costs can be cut to increase bottom line profitability

Basic Rule of Underwriting

- Rule of Thumb: **10% of Working Capital/Net Worth = amount of surety credit available.** Can be higher or lower dependent upon:
  - Surety Market/Underwriter
  - Class of Business
    - Sub vs. General
    - Hazardous Work (i.e. environmental)
    - Heavy Highway vs. Civil Engineer
    - Size of Contractor
  - Length of Time in Business
  - Personal Financial Wherewithal/Indemnity Pledged
  - Business Model/Financial Ratio Analysis
  - Surety Appetite
    - Net Worth driven companies (pre-recession)
    - Some sureties are not “sub-contractor” friendly
    - Some surety companies will give credit to “off-balance sheet” worth (i.e. PPE, personal worth)

Current Surety Market

- Surety Industry Profitable for 7 straight years
- Continued Consolidation in surety market:
  - 50% of surety market written by Top 5 surety companies (measured by direct premium written)
  - 80% of surety market written by Top 20 surety companies (measured by direct premium written)
- Loss Ratios are steady among Top 20 Surety Companies
  - Loss ratios increase significantly among smaller surety markets
- New entrants to the surety market
  - Berkshire Hathaway Group
  - Aspen
  - Philadelphia

The Surety & Fidelity Association of America

Top 100 Writers of Surety Bonds
United States & Territories, Canada & Aggregate Other Alien
Calendar Year 2013
(Preliminary)

	GROUP/COMPANY	Direct Premium Written	Market Share	Direct Premium Earned	Direct Losses Incurred *	Direct Loss Ratio	DCCE	DCCE Ratio	Loss+DCCE Ratio	Net Premiums Earned	Net Losses Incurred	Net Loss Ratio
1	TRAVELERS BOND	778,689,161	14.8%	779,834,246	(81,104,048)	-10.4%	(32,839,436)	-4.2%	-14.6%	726,091,491	(70,294,032)	-9.7%
2	LIBERTY MUTUAL GROUP	738,271,612	14.1%	728,010,646	248,978,084	34.2%	26,545,876	3.6%	37.8%	721,366,580	251,734,543	34.9%
3	ZURICH INSURANCE GROUP	492,737,467	9.4%	478,892,261	116,217,008	24.3%	15,652,296	3.3%	27.5%	310,931,132	59,478,051	19.1%
4	CNA INSURANCE GROUP	408,605,990	7.8%	403,673,851	73,481,675	18.2%	(12,597,687)	-3.1%	15.1%	393,005,373	53,659,446	13.7%
5	CHUBB & SON INC GROUP	210,242,628	4.0%	214,183,692	5,151,889	2.4%	(614,842)	-0.3%	2.1%	288,885,054	9,797,865	3.4%
6	IFIC SURETY GROUP	167,316,158	3.2%	169,499,340	18,729,999	11.1%	4,645,063	2.7%	13.8%	135,888,504	13,454,710	9.9%
7	HCC SURETY GROUP	166,419,402	3.2%	165,165,349	8,148,854	4.9%	13,495,732	8.2%	13.1%	148,463,144	4,961,127	3.3%
8	HARTFORD FIRE & CAS GROUP	160,693,912	3.1%	160,352,691	38,280,140	23.9%	6,359,721	4.0%	27.8%	151,907,818	34,410,219	22.7%
9	ACE LTD GROUP	143,061,872	2.7%	136,107,632	26,291,852	19.3%	7,251,985	5.3%	24.6%	83,899,441	1,824,173	2.2%
10	RLI INSURANCE GROUP	110,594,591	2.1%	110,565,524	12,573,088	11.4%	2,447,336	2.2%	13.6%	104,176,191	9,788,113	9.4%
11	GREAT AMERICAN INSURANCE COMPANIES	110,364,998	2.1%	103,887,714	26,157,739	25.2%	6,871,094	6.6%	31.8%	101,035,810	26,371,451	26.1%
12	LEXON/BONDSAFEGUARD INSURANCE COMPANIES	96,206,499	1.8%	97,505,292	36,998,331	37.9%	5,073,536	5.2%	43.1%	88,173,939	36,303,918	41.2%
13	NAS SURETY GROUP	79,919,971	1.5%	79,342,787	1,157,520	1.5%	2,190,293	2.8%	4.2%	44,473,740	5,074,286	11.4%
14	THE HANOVER INSURANCE GROUP	77,266,258	1.5%	78,634,850	52,735,185	67.1%	5,867,911	7.5%	74.5%	70,294,550	38,582,541	54.9%
15	MERCHANTS BONDING CO GROUP	76,211,560	1.5%	74,666,330	9,213,258	12.3%	4,836,845	6.5%	18.8%	49,475,152	4,475,589	9.0%
16	ARCH INSURANCE GROUP	74,743,277	1.4%	68,559,648	4,570,794	6.7%	8,139,786	11.9%	18.5%	27,320,807	7,076,647	25.9%
17	AMERICAN INTERNATIONAL GROUP	64,309,162	1.2%	72,806,616	(6,144,806)	-8.4%	5,397,743	7.4%	-1.0%	58,691,708	44,876,998	76.5%
18	WR BERKLEY CORP GROUP	64,215,578	1.2%	62,374,935	17,507,474	28.1%	2,290,111	3.7%	31.7%	57,816,630	14,272,314	24.7%
19	SURETEC INSURANCE COMPANY	54,730,489	1.0%	54,306,401	7,055,867	13.0%	2,627,209	4.8%	17.8%	46,443,697	5,776,418	12.4%
20	ALLEGHANY GROUP	53,568,205	1.0%	51,897,509	9,984,805	19.2%	592,339	1.1%	20.4%	49,528,377	6,919,832	14.0%
21	WESTFIELD GROUP	50,766,514	1.0%	52,181,482	2,969,156	5.7%	6,571,150	12.6%	18.3%	46,669,054	2,639,268	5.7%
22	ARGONAUT GROUP	47,785,967	0.9%	42,793,338	6,285,408	14.7%	3,018,976	7.1%	21.7%	21,592,918	842,018	3.9%
23	CRUM & FORSTER GROUP	43,403,486	0.8%	42,174,583	18,868,378	44.7%	4,548,421	10.8%	55.5%	40,387,463	31,325,053	77.6%
24	GRTE COMPANY OF NORTH AMERICA USA	42,630,130	0.8%	39,957,736	8,252,317	20.7%	1,163,265	2.9%	23.6%	28,793,210	5,043,338	17.5%
25	PHILADELPHIA CONSOLIDATED HOLDING GROUP	42,596,415	0.8%	39,222,791	9,987,991	25.5%	1,021,588	2.6%	28.1%	36,347,045	9,087,861	25.0%
26	CINCINNATI FINANCIAL GROUP	42,270,035	0.8%	42,180,448	9,317,869	22.1%	282,563	0.7%	22.8%	35,543,544	6,277,858	17.7%
27	INSCO DICO GROUP	38,271,506	0.7%	38,608,083	578,300	1.5%	(97,988)	-0.3%	1.2%	35,468,308	1,891,772	5.3%
28	ASSURANT INC GROUP	37,735,102	0.7%	37,718,816	22,022,834	58.4%	(2)	0.0%	58.4%	36,719,136	22,018,461	60.0%
29	OLD REPUBLIC GROUP	37,524,916	0.7%	35,158,348	4,494,342	12.8%	906,416	2.6%	15.4%	32,456,763	2,391,288	7.4%
30	EVERGREEN NATIONAL INDEM COMPANY	33,216,170	0.6%	32,279,287	(117,775)	-0.4%	(199,006)	-0.6%	-1.0%	11,816,171	(60,312)	-0.5%
31	HUDSON INSURANCE CO	30,492,485	0.6%	28,463,192	10,224,979	35.9%	3,527,080	12.4%	48.3%	8,217,270	2,848,649	34.7%
32	MUNICH AMER HOLDING GROUP	25,616,600	0.5%	25,544,819	6,882,219	26.9%	18,986	0.1%	27.0%	284,150	82,666	29.1%

Current Surety Market

- “Soft” Market for Well-Capitalized GCs, Best-in-Class Subcontractors
  - Competition remains steady between various surety markets
    - Excess capacity available for contractors who wish to grow
    - Competitive rates, indemnity terms are available
- “Hard” Market for many subcontractors
  - Balance sheets impacted during the recession due to lack of work and tighter margins
- Historically, economic recovery signals additional losses in the surety industry
  - Many contractors load up on work due to availability, but not priced correctly
    - Labor, Material
  - Contractors do not have the resources to complete work (i.e. not enough cash flow, labor, PPE)
- Contractors must prequalify subcontractors/suppliers
  - Subcontractor/Supplier Prequalification Packet
    - References (suppliers, owners, bank, and surety), Corporate Credit Report, Financial Review
  - Subcontractor Bid or Performance/Payment Bonds
    - Prequalification Letters and Bid Bonds are a start, don’t necessarily guarantee bonding availability
  - SubGuard/SDI