FEATURE

# KPIs: How to dig deeper into contractors' data for more accurate profitability analysis

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**FOR SURETY PROFESSIONALS,** numbers aren't just numbers: they're insights into a business' functionality. Bond producers and underwriters know that the raw data can sometimes be obscured and is always open to interpretation. Every financial statement and each set of figures suggest a strategy, a cause or effect, or the impact of an economic trend. These taken together with key performance indicators (KPIs) form the basis for the analysis on which the surety industry depends, answering the key questions: where are the risks and how is this contractor likely to perform?

Analysts start with the four analytical ratios—profitability, liquidity, leverage, and efficiency. Only the most diligent trace each detail and chase every lead to compile insightful reports highlighting potential risks comprehensively, or as nearly as possible.

Underwriters should get the strongest possible sense of a construction company's historic and anticipated performance by applying the following principles to an analysis of a construction firm's profit performance.

## Make Sense of Working Capital

The formula for bonding capacity generally involves an initial assessment of working capital and then applying a multiple to that figure to arrive at a maximum bonding capacity. But not every figure attributable to working capital is made equal. Some figures often allocated toward working capital may not be holding their weight, so they should be considered differently when figuring into your calculations. For that reason, validating working capital requires dissecting each component item. When tackling assets, be vigilant in looking for chronic underbilling. Underbilling may be relatively common and, under some conditions, even unavoidable. Still, there's a point at which minor administrative issues or inevitable complications occur so frequently they're indicative of deeper systemic problems. Contractors that frequently underbill may not properly value cash, could be creating an inflated sense of profit, and generally risk suffering from short-term financial weakness that can arise suddenly.

## Investigating Equity

Accumulated earnings and the sum of investments since inception make up a statements. There's no
question that a company holding most of its equity looks much safer should funding be required on short notice. But be wary of loans within the business, particularly owners

loaning to or borrowing against the business. Such loans can inflate equity values and are not always quickly or easily repaid. If a company has substantial lending arrangements with an individual, make sure the individual's financial standing is investigated, as well as the company itself.

## Let History Guide Your Projections

When looking at projects under contract to assess future profits, keep one eye on the historical performance. It's prudent to base the profit margin projections of all in-progress work on historical reality. That ensures a solid basis for assuming profit after all the project's expenses and liabilities are settled. In analyzing a contractor's work in progress, if the firm is showing a 10% margin on contracts in progress, but its historical trend is 6% at completion, this must be factored in for better analysis.

## Informing Your Investigation

Hopefully, by applying the principles above, those investigating the profit performance of companies will arrive at more accurate pictures of financial performance. Of course, the investigation doesn't start and end with working capital, equity, or historical profit performance. A closer reading of these key areas will reveal a great deal about the business in question and can inform a more penetrating analysis. What's more, the attention paid to these concerns can lead to equally useful insights into other core financial details, including return on assets and equity, liquidity and leverage ratios, days of cash, asset turnover, and months of work in backlog. It's good practice to be in the habit of digging deeper into the core profit-related KPIs of working capital, equity, and historical performance. It leads to building better financial analyses as well as better analytical habits.

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