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How to Maximize the Power of Surety Credit

By Robert Mercado and Michelle Johnson | Wednesday, March 3, 2021

A contractor's ability to obtain surety credit is a powerful resource allowing them to bid, win and complete projects. Contractors are typically required to obtain a surety bond, which is a useful tool for an owner of a construction project. Surety bonds are specific guarantees that the project owner will receive a finished project at a negotiated price according to the project plans, specifications and contract requirements. It also promises that the project will be free of liens and encumbrances, providing that all subcontractors, suppliers and vendors will be paid for the services and materials provided.

Project owners can also use a bond as a pre-qualification of the contractor's ability to perform. When a project goes out to bid, most likely the project will receive numerous contractor proposals. Requiring a bond at the time of the bid can potentially filter out at-risk contractors. More importantly, it provides assurance to the project owner that the contractor has successfully fulfilled the surety underwriting process. If the surety is willing to provide a bond when the bid is presented, the surety believes the contractor is qualified, based on particular criteria, to meet the requirements of the project contract terms.

The extension of surety credit is riskier than a traditional bank extension of credit. At the time a contractor enters into a bank loan, the bank will take a security interest in any asset that is securing the loan. For surety purposes, the contractor will enter into an indemnity agreement essentially stating that if the contractor fails to perform on a project and the surety is required to pay damages to the project owner, the surety will be reimbursed by the contractor for any amounts paid by the surety. If the contractor fails to reimburse the surety, the surety will then have the right to secure an interest in any assets covered under the indemnity agreement. Prior to the surety acting on the indemnity agreement, the surety in essence is an "unsecured creditor."

The underwriting process for a surety program is extensive. A bond agent will require specific information from the contractor, such as:

- organizational details;
- references from other contractors and owners of completed projects;
- financial statements, including current open projects and past closed projects;

- bank line of credit agreements;
- personal financial statements from the contractor owner(s); and
- a current backlog of work committed to but not yet started.

Once this information is obtained, the bond agent will compile an underwriting package containing review of current and historical work-in-process schedules, detailed scope of the project being bid on, a comparison of the contractor's past projects, the last three years of a Certified Public Accountant's prepared review or audit-level financial statements, and cash flow projections. The bond agent will determine the best surety to support the contractor based on the type of projects and type of contractor that best match the area of surety expertise. Additionally, the surety will request resumes of key personnel at the contracting company and whether the contractor has a completed continuity plan.

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Once the underwriting package is complete, the surety requires what is referred to as the "Three Cs" in order to provide surety credit. The "Three Cs" are character, capacity and capital.

The character of the contractor is a crucial component of the underwriting process. Character is based on the reputation of the construction company's owner and management personnel. Since the surety is considered an unsecured creditor, it is therefore imperative that the surety collaborates with respectable and trustworthy individuals.

Capacity refers to the contractor's skill, experience, knowledge, personnel, and equipment. If a contractor is seeking a bond for a $10 million project but the largest project the contractor has completed to date was $2 million, this presents a more strenuous underwriting process to confirm the contractor's capacity to undertake and deliver a substantially larger project. In addition, the surety will want to make sure the contractor has the equipment and personnel to complete the project, and will also take into account the contractor's existing or potential backlog during the project that is expected to be bonded.

Capital refers to the equity and surety-adjusted working capital as shown on the contractor's financial statements. Equity, also referred to as the book value of a contractor, is the difference between the contractor's assets and any liabilities owed by the contractor. The surety-adjusted working capital is the difference between current assets and current liabilities on the financial statements, adjusted by certain items determined by the surety. Examples of adjustments that reduce working capital are:

- receivables over 90 days past due, excluding retainage;

- accounts and notes receivable to officers, employees and owners;
- notes receivable from unrelated parties, based on credit-worthiness of the unrelated party;
- 50% to 100% of inventory held by the contractor; and
- prepaid expenses included in working capital.

These adjustments relate to cash flow. The surety's focus is on cash and what can be converted into cash quickly, e.g., the cash surrender value of life insurance owned by the contractor is considered part of surety-adjusted working capital but normally is shown as a long-term asset.

The items above that reduce working capital are considered drains on cash flow. The cash surrender value of life insurance is usually shown as a long-term asset, but because the contractor has the ability to draw on the cash value of the life insurance policy, the surety considers this as a part of adjusted working capital.

It should be mentioned that equity maybe adjusted by the surety as well. Equity is impacted by the company's entity structure for tax purposes. Many contractors are pass-through entities for income tax purposes. This means that any tax liabilities based on the profitability of the company will flow through to the owner(s).

Many contractors use various tax methods that allow for the deferral of taxes into future periods. As a result, the tax effect of these deferrals needs to be considered by the surety in order to understand the true equity. This adjustment is commonly referred to as the "tax plug." It is recommended that the contractor include a disclosure in the accompanying financial statements specifying the amount of tax that would have been incurred had the contractor not been a pass-through entity, i.e., had it paid income tax at the company level, not the individual stockholder level. Usually, the disclosed amount is lower than the amount the surety will calculate.

MAXIMIZING SURETY CREDIT

Typically, surety credit for a single project is based on approximately 10 times the surety adjusted working capital. If the contractor has $1 million in surety-adjusted working capital, it should be able to obtain a bond for a single project in the range of $10 million. This sample calculation is based on a formula; however, as mentioned above, the surety will still factor in the capacity and character of the contractor.

In addition, there is a second calculation taken into consideration called the total bond program, or total surety credit program. This is the total amount of surety bonding that can be outstanding for one contractor concurrently. This amount is equivalent to 10 times the total equity of a contractor.

It's important to note that the 10 times multiples on both the single and aggregate program for surety credit can be adjusted based on the composition of the working capital and equity of the contractor. If most of the working capital is in liquid assets, such as cash and cash equivalents, the surety may provide more credit, compared to a contractor that has a large amount of the working capital in outstanding contracts receivables.

In order to maximize potential surety credit, contractors should prepare in advance for the underwriting process. Surety credit relies heavily on the contractor's year-end financial statements. Knowing this and understanding the adjustments discussed above, contractors can be proactive to reduce items that have a negative impact on surety-adjusted working capital before the contractor's year-end. Doing so will maximize the surety working capital and in turn, ultimately maximize the surety credit.

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