“Pre-qual, Re-qual”…
More Valuable Than a Performance Bond or Default Insurance?

by Glenn Matteson, President of Contractor Score LLC

Pre-qual, re-qual…Industry jargon with a lot more importance today than the simple check-off box of the heady go-go days prior to 2009. Official department of labor statistics claim a twenty-five percent unemployment rate in the construction industry. Reuters cites nonresidential construction spending has dropped over twenty percent in 2011. Office construction is down twenty-nine percent, hotels, forty-three percent and the recovery is expected to be slow and meager. Construction, being a mature industry in the U.S., has always been competitive but there is a new fundamental shift in all contractors’ market perspectives. Experts agree, this is a “new normal” with smaller volumes, tighter margins and even more cautious owners.

Many contractors’ balance sheets have been decimated. Excepting a small minority of the clever or the lucky, commercial and institutional contractors have downsized and lowered expectations. Reputation and years in business count for little when a GC can’t pay his subs, the trades can’t afford to fully man a project or pay their vendors. There is a new real-time urgency in gauging the ability of a contractor to fund work. Traditionally, performance bonds and subcontractor default insurance mitigated the worst case scenario, default. They still do, but that comes with a cost and when the stats are done, the probability of a contractor default on any one particular job is still quite small.

The reality is that a financially weak contractor can probably limp through nine out of ten jobs and finally succumb on the “last one”. Its only then the bond or SDI come to the rescue and still with additional cost in delays and headaches. What about those other nine jobs…a ninety percent probability, one of which is your job? It’s a known fact that when a contractor gets into financial difficulty, they cut overhead, delay payments, re-structure debt (if possible), stir up change orders and stretch out jobs as long as possible. It’s a fiscal retreat, *“run away today, hope to build another day.”* The end result on your project is probably a shattered schedule and arduous change order, close-out negotiations. You may not have a default, but it can be almost as painful.

Here are some telltale signs your contractor could be heading down this slippery slope:

- **You get a really, really low price.** When the contractor is by far and away the lowest bidder on a job or a package and still insists the scope is complete, there’s probably some desperation in that number. The contractor needs this job to fund his previous jobs.

- **Final negotiations are too easy.** They accept all your terms immediately and can mobilize yesterday. That's often another indication of panic and need to start some cash flowing.

- **Base line schedules are late or never are produced.** Not always a harbinger of financial problems as many contractors are not sophisticated at scheduling. It can, however, be a set-up for eventually extending the job within the contract terms.

- **The initial payment submittal is obviously heavily front loaded.** Some assertive billing is just good business on the contractor's behalf, but when it looks way out of proportion to what's been done, keep a closer eye on the job.

- **The project superintendent is usually the first to notice a troubled trade contractor.** The sub promises x number of men that week but never gets that many there and they are slipping behind.

- **The owner starts hearing from the subs.** First rumors followed by phone calls or "lunch" followed by letters. The GC is not paying his subs on time or completely, back charges seem beyond the norm. The same indicators can come from material vendors about a trade contractor to the General Contractor. Listen to the street.

- **RFIs start to fly.** Again, not always a symptom of financial stress, but if the design professionals have their work products adequately done, this could be a stall tactic or a "margin enhancement opportunity".

- **All RFIs lead to formal change requests.** An extension of the point above.

- **You see your contractor landing a disproportionate number of other jobs.** You are not the only cash source in town. They employ the same tactics everywhere now. Additional work is arguably the last thing a financially stressed contractor needs.

- **Delays, delays, delays.** The contractor is stalling. They can't pay their current obligations, so they will stretch everyone out.

These are some clues to help identify a problem in the making. What to do about them? First, a performance bond and/or SDI will mitigate the worst case scenario of default. You will have to weigh the cost versus your risk tolerance. Second, and the theme of this article, is employ good, solid pre-qualification.

Certainly not a guarantee to a trouble-free project, but a thorough qualification process cuts way down on these costly issues. As an owner, make sure your rep or GC/CM has a formal pre-qual process in place and uses it religiously. Examine their check list and criteria. Beyond the normal insurance requirements and project experience levels, ensure there is a sound financial vetting of all key subcontractors. Your general contractor should sort the trade contractors' proposals applying the normal scope leveling and pricing criteria. Go one step further and lay down their Contractor Score next to all that. The second lowest price may be the better choice given the difference in the bidders' current financial stability. This is especially pertinent with CM@risk delivery systems where you, the owner is sharing in some of the risk. The CM should counsel the owner on each package selection with this format. This approach has been a key reason why some GCs have been awarded the project. Hard bid, lump sum contracts almost always take the low bidder with little regard to pre-qualification. Score all the "low contractors" during buy-out and you can craft the subcontract terms & conditions specifically to work with a weak or a strong sub.

Another critical aspect often overlooked after the job starts is to keep your contractors scored on a regular and recurring basis. This is especially important with smaller contractors as their financial position can radically change in a few months. Updating their Contractor Score on quarterly basis shows you a trend line and if it is becoming perilously negative, step-in and take pro-active measures. It never hurts to be first in line because it always hurts to be last.

Summarizing, today's market is challenging, but that always opens a door for the creative. There are more contractors in fiscal distress today than ever before. The beginning of a recovery is oddly the most dangerous period as financially starved contractors are jumping at every and all opportunities taking on work they cannot fund. You should know how that affects you and your projects. Bonding and subcontractor default insurance are valuable products, but only after death. A proactive approach is to understand the health of your contractors before starting.

1904 Victoria Road Suite 300, Raleigh, NC 27608
919-758-8700 Phone | 919-782-8376 Fax
GMatteson@ContractorScore.net | www.ContractorScore.net