



Mitigating the Risk of Subcontractor and Supplier Default

CFMA Massachusetts
November 12, 2013



Agenda

- Introduction
- Default Risk in 2013
- Protecting Yourself from Default
 - Qualification
 - Bid Leveling and Buyout Process
 - Performance Security
 - Managing Payments and Lien Risk
 - Risk Management Plans
- Upstream Default
- Wrap up and Questions



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Default Risk in 2013

- ✓ Economic recovery is proceeding in Construction
- ✓ SFAA Loss Ratios
 - 2013 Q3 – 19%
 - 2012 Q3 – 12%
 - Loss ratio increase of about 60% in last 12 months
- ✓ Subguard[®] Program Results
- ✓ Anecdotal GC experience

“Losses up significantly, but where we expected”

*– Scott Rasor,
President of Zurich Construction*

Factors Driving Increased Default Activity

Economic Cycle is different and multifaceted in construction

- Lower lows and higher highs
- Cycle trails general industry by 6-18 months
- Residential vs. Non-Residential (Building vs. Civil)

Downturn of 2008 - 2011 was a time of **LOWER** default risk

- Most GCs and subs carried large, high margin backlogs out of the boom
- Took on new work on low margins but had strong cash positions
- Bid prices dropped rapidly – replacing a defaulted contractor sometimes involved a profit!!!

“Recovery” of 2011 - Today

- “The Marginless Recovery”
- Culling of the heard
 - Strong → Stable
 - Stable → Weak
 - Weak → Bankrupt
 - “Fade Away”

Summary of Default Risks

Suppliers

- Weak margins
- High competition
- Bad payment terms
- **Customers are weak, unable/unwilling to pay**

Subcontractors

- Weak balance sheets
- Low margin work (improving slowly)
- Increasing risk transfer
- Loss of talent – office and field
- **More work available now**

General Contractors

- **Difficult payment/ contract terms from owners**
- Weaker balance sheets
- Too much overhead kept or talent lost
- One bad job away from...

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What Can You Do to Protect Yourself?

General Approaches

- Qualification – upstream and downstream
- Bid Leveling, de-scoping, awarding and contracting
- Performance Security
- Managing Payments and Cashflow
- Risk Management Plans

Different Perspectives

- Owners vs GCs vs Subs
- Balanced approach generally best
- Look at it from each perspective



Qualification

Why and How to Qualify Subcontractors

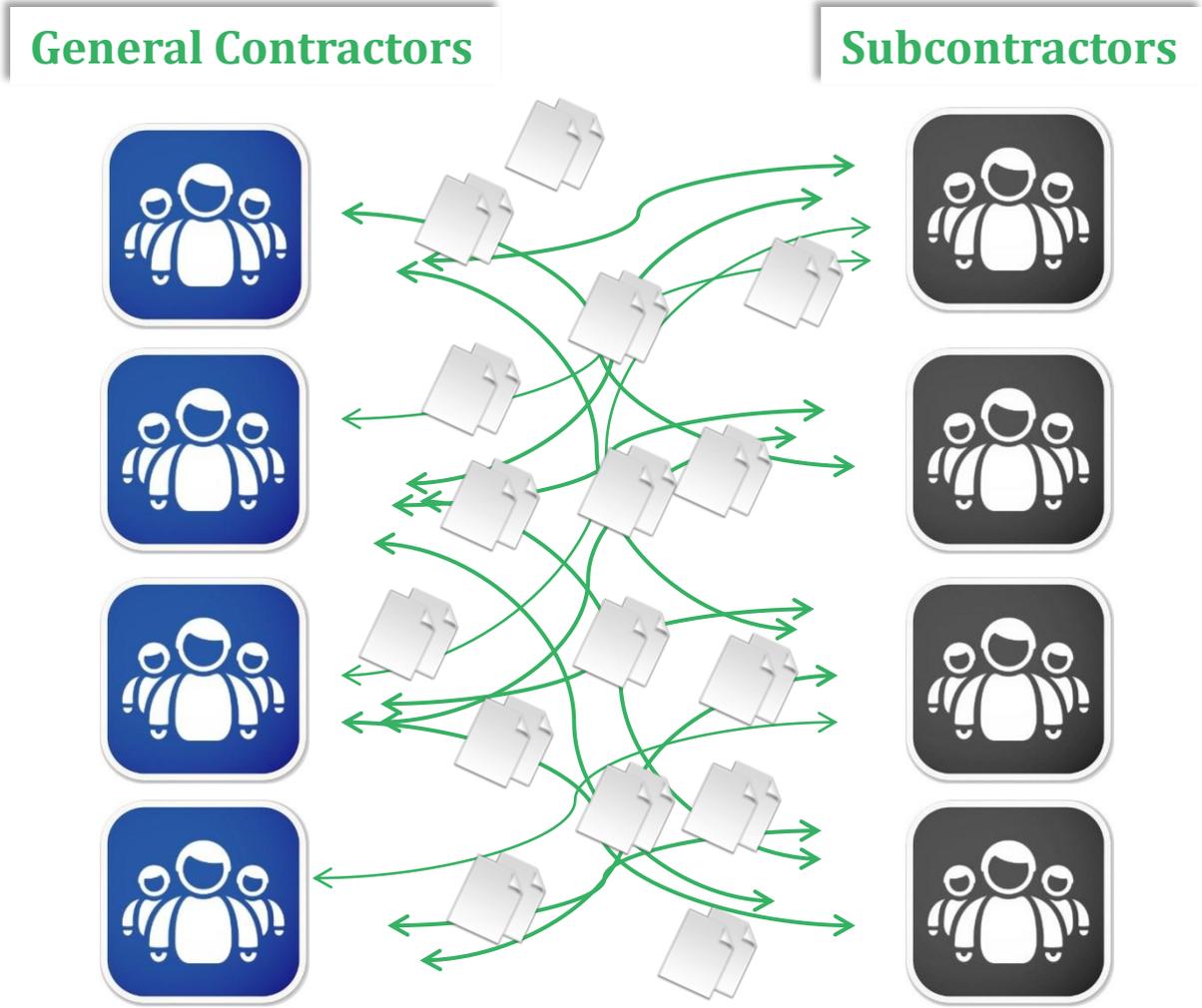
Qualification can lead to better decisions

- Avoid buying out subcontractors likely to default
- Understand who you are doing business with
- More transparency into purchasing decisions
- Build risk management plans around weaker subcontractors
- Manage aggregate risk to subcontractors and suppliers

Things to consider in a qualification program

- Think about the upstream risk as well as downstream...
- Pre-Award, Pre-Bid, Ongoing
- Centralized/Decentralized
- Subcontractor's perspective
- 80/20 Rule
- Technology and outsourcing
- Gathering information or reviewing it?

Qualification in Construction Today



Challenges with Qualifying Subcontractors

Qualification is not yet accepted across the board in construction

- Sureties long provided “prequalification” service
- Subguard® and owner requirements raised the bar
- Qualification is spreading but still only 15-25% of contractors qualify subcontractors

Getting subcontractors on board

- Communication via e-mail, phone calls, faxes cumbersome
- Frequent follow up required
- Information provided is seldom complete (requiring more follow up)
- Without an imminent contract, often little interest from subs
- Recovery means subs are getting more selective on bids

Keeping the database current

- Paper forms generally end up in file cabinets
- Excel spreadsheets have busts and hard to keep up to date
- Low visibility creates cracks and tracking compliance is hard

Resources are limited

- Qualification generally an overhead cost
- Qualified evaluators are also busiest team members (finance, operations, purchasing)

Overcoming the Challenges

Do Not Overcomplicate it

- Developed a program is not rocket science but...
- Off the shelf solutions available
- Don't let the "Great" be the enemy of the "Good"

Consider outsourcing subcontractor onboarding and management

Look at your technology options

- Web-based technology provides real time access to all data
- Find a workflow engine to drive the process – don't rely on people
- Look for automation for both subcontractors and you

Think about what is best done by your team and what is best done by others

- Focus your resources on value added process: subcontractor review and selection
- Consider technology and outsourcing for other parts of the program

Building a Qualification Program

Some of the main aspects of a successful qualification program:

- Program **mission statement** and goal development
- High level program design (pre-award, pre-bid or ongoing; centralized/decentralized review, etc.)
- **Communication planning** and execution (internal and external)
- Detailed program and **form design**
- Subcontractor **onboarding**
- Monitoring & Evaluation
- Periodic **redesign** and redevelopment

Example of Using Technology in Decision Making

Revenue	20,092,846	19,736,511	19,000,000
Construction Revenue		19,736,511	19,000,000
Cost of Revenue		0	0
Other Direct Costs		0	0
Backlog Under Contract		0,000	11,000,000
Gross Profit		0	0
Gross Profit Before G&A		19,902	5,000,000
Net Income		19,509	2,200,000
Operating & Other Expenses		0	0
Net Profit		0	0
Unused Portion of Revolving Credit (LOC)	0	0	0
Yearly Shareholder Distributions	-1,304,225	-1,204,463	0
Largest Project Completed to Date	3,750,000	2,750,000	1,750,000

Submitted Value

Comment
Sub submitted construction revenue vs. revenue

Last Modified By
Dan Coleman

Last Modified On
10-May-2012 3:30:18 PM

Refresh Calculations

CALCULATION	WEIGHT	SCORE	31-DEC-2012	31-DEC-2011	31-DEC-2010
Backlog To Equity		1	3.65	2.82	2.62
Current Ratio			0.13	-0.06	0.05
Equity to Unbilled Work			7.84	-16.78	21.00
Working Capital			-3,111,673.00	-4,509,336.00	-4,000,000.00
Revenue To Equity		1	5.63	4.64	4.52
Debt to Equity		5	1.00	1.00	1.00
Single Contract Limit			3,566,291.00	3,800,000.00	Unavailable
Project Limit			5,349,436.50	5,700,000.00	Unavailable
Total Score		2.00 0.00			

	CONTRACT LIMIT
Current Value	5,349,436.50
Recommended Value	5,349,436.50

Subcontractor's Perspective on Qualification

Please keep it simple

Will provide data if contract is imminent

Please do not waste my time if we will never do business together

Protect my information



Performance Security

Some Performance Security Options

Owner Options

- Bid bonds
- Performance and payment bond
- Parent company guarantee
- Letter of credit

GC Options

- Subcontractor bonds
- Subguard®/SDI
- Letter of Credit
- Personal Guarantee/Idemnity
- Owner indemnity
- Lien rights (upstream)

Subcontractor Options

- Material supply bonds
- Lower tier sub bonds
- Lien rights (upstream)



Bid Leveling Awarding Contracting



Bid Leveling, Awarding Work and Contracting

Bid Leveling and Analysis

- Getting enough bidders but not too many
- What is it?
- Why level bids?
- Bidder de-scoping best practices
 - When
 - How

Selection and Awarding Work

- Lowest vs. best value
- “Just in time” qualification
- Letters of Intent

Contracting

- Standard Terms
- Scope of Work
- Before you start...



Managing Payment Risk

Managing Payment Risk

Risk exists on all sides of the construction invoicing and payment process

- Over and underpayment risk at all levels
- General lack of transparency
- (Archaic) exchange of paper documents for paper checks

Getting it wrong can be catastrophic

- Overpayment to a subcontractor who defaults
- Owner or GC bankruptcy leave unsecured creditors
- Fraud is (unfortunately) common
- Costs of monitoring and compliance are substantial on all sides

Using a Detailed SOV to Manage Payments

The Importance of the Schedule of Values

- Getting enough detail
- Look for front end loading and overloading specific items
- Agreeing to an SOV and signing it off

SOV and Payment Applications

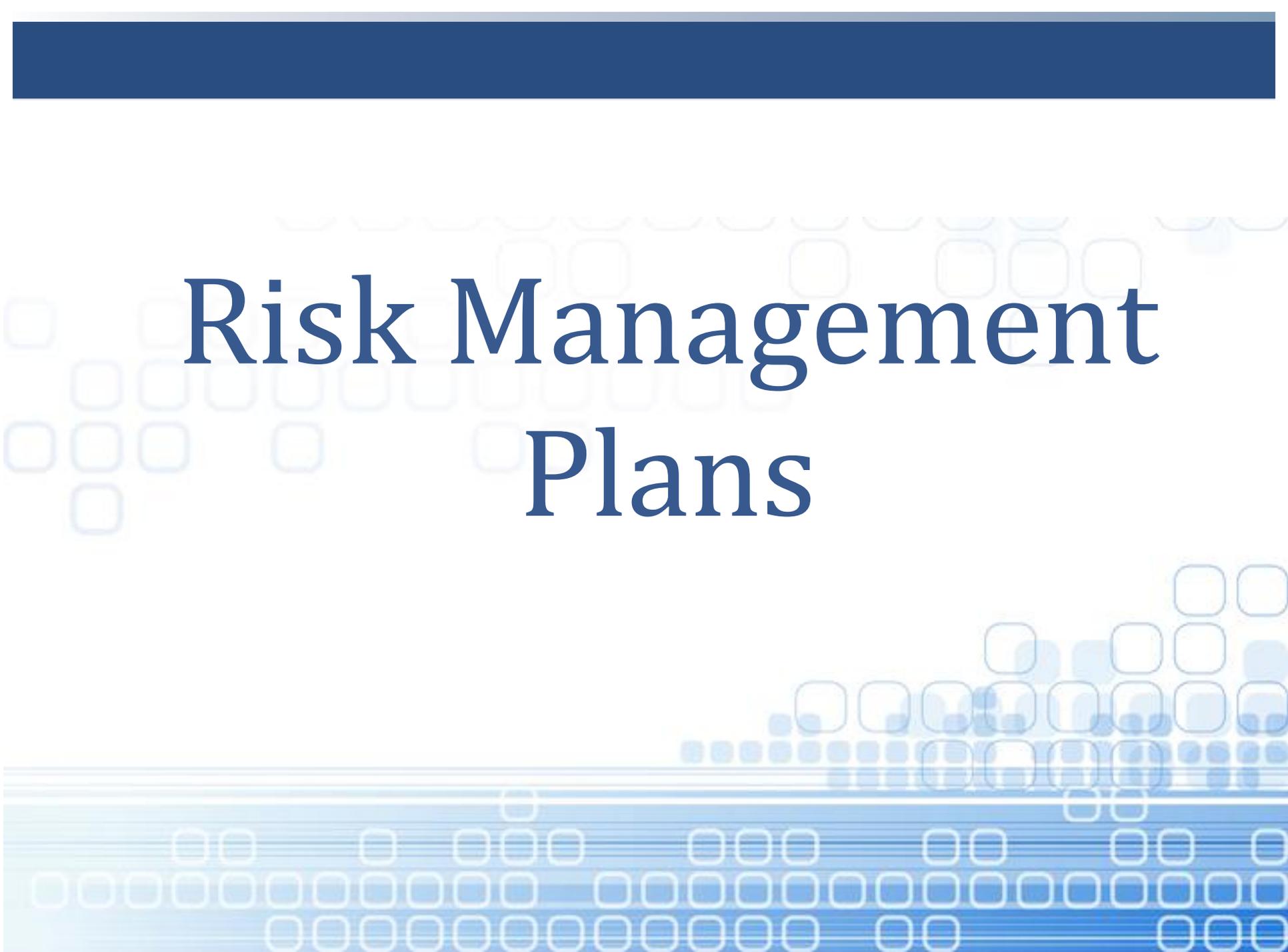
- PM's role vs. Superintendent
- Communication
- Reviewing the monthly pay application
- The pencil copy and revisions

Communication between the field and office

- Superintendents generally are best judges of field installation progress
- Percentage complete should be spot checked by HO ops
- Are PMs rejecting/negotiating invoices or just passing them up?



Risk Management Plans



Risk Management Plans

What is a Risk Management Plan?

Downstream RM Plan

- Security (Bond, LC, PCG, PI, OI)
- Payment Management
 - Additional Retention
 - Joint Checks
 - STLW
 - Early Pay/Reduced Retention
- Project Management
 - Additional Supervision
 - Weekly Meetings
 - Weekly/Monthly Schedule Review/Sign of
- Safety Management

Upstream RM Plan

- Actively manage lien rights
- Direct payment from owner/GC
- Reduced retention

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Default Risk Cuts in Both Directions

Why do owners default?

- Cost overruns
- Disputes
- Mismanagement
- Financing Issues

What happens when an owner defaults?

- Payments
- Profit
- Unpaid vendors
- Reputation

Avoiding Owner/Lender Default

- Contract terms – right to profit
- Owner/Project qualification
- Managing payments
- Maintain open communication
- Maintain lien rights

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When a Default Occurs Options are Limited

Turning a Default from Gray to Black and White

- Always start with the contract
- Getting commitments in writing
- Notice to cure

Post Default Options

- Default and terminate
- Default and reduce scope
- Default and supplement
- Default and hire workforce/management

Managing Replacement Work

- Time and material vs. lump sum
- Keeping track of costs
- Keeping the project on schedule

Other Considerations

- Performance security and default
- Default and the owner

Summary

- Default risk will be elevated for next 18 months
- All parties are at risk
- Known risk can be better managed than unknown
- Some key steps to reducing risk
 - Qualification program
 - Bid leveling and contracting
 - Performance security
 - Managing payments and cash flow
 - Risk management plans
- Risk is there – Manage it!



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