



MANAGEMENT CONSULTING • INVESTMENT BANKING
for the ENGINEERING and CONSTRUCTION INDUSTRY

FMI SPECIAL REPORT

2011 SURETY PROVIDERS SURVEY



MANAGEMENT CONSULTING • INVESTMENT BANKING
for the ENGINEERING and CONSTRUCTION INDUSTRY



Timothy R. Sznewajs

is a Managing Director with FMI Corporation's Investment Banking practice, focused on buyer and seller representation and the structuring of internal ownership transfer plans.
303.398.7214 ■ tsznewajs@fminet.com

Curt M. Young

is a Vice President in FMI's Investment Banking group and manages FMI's business valuation practice.
303.398.7273 ■ cyoung@fminet.com

Philip Warner

is a research consultant with FMI Corporation.
919.785.9357 ■ pwarner@fminet.com

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Introduction

As providers of essential credit instruments to contractors, sureties are a critical partner in the success of construction firms. While a healthy partnership with one’s surety provider has always been important, access to surety credit in today’s challenging and uncertain construction environment has never been more crucial. Surety credit not only signifies the strength of a contractor’s financial position—which helps to evoke the confidence of project owners - it also acts as a competitive differentiator in a field weakened by the nearly three-year recession affecting the building markets.

Successfully managing the partnership between surety underwriter and contractor depends upon understanding the viewpoint and position of each side. These viewpoints are, of course, much more nuanced than the common perception that “contractors are numb to risk” and “sureties only underwrite a sure thing.” This edition of FMI’s *Annual Surety Providers Survey* is intended to provide contractors, sureties and those who serve them with construction industry perspectives directly from those surety underwriters most active in the marketplace. Hopefully, these survey results are a helpful resource in navigating the difficult and uncertain conditions which dominate the construction industry of 2011-2012.

SURETY INDUSTRY OVERVIEW

Despite the challenging fundamentals facing the overall construction industry, the surety market results demonstrate a sector relatively unscathed to date. The following charts summarize the industry’s direct loss ratio¹:

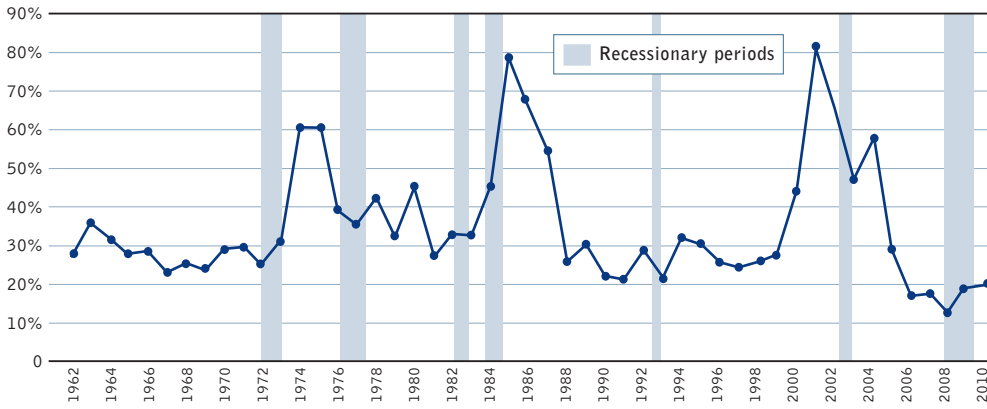
¹ Direct Loss Ratio is calculated as the direct losses incurred as a percentage of the direct premium earned.

Exhibit 1

Surety Industry Direct-Loss-Ratio

Period	Average Direct Loss Ratio
2010	13.2%
2009	19.6%
2008	13.3%
Last 5 Years (2006–2010)	16.4%
Last 10 Years (2001–2010)	36.8%
Last 48 Years (1962–2010)	35.7%

Source: Surety & Fidelity Association of America (S&FAA)
Top surety writers and annual results, 1962-2008, published by S&FAA, Washington, D.C.

Exhibit 2**Surety Industry Direct-Loss-Ratio History**

Source: Surety & Fidelity Association of America (S&FAA). Top surety writers and annual results, 1962-2010, published by S&FAA, Washington, D.C.

As the data demonstrates, 2010's average direct loss ratio remains exceedingly low by historical standards; in fact, it is one of the lowest direct loss ratios on record. While several factors explain this outcome, two of the most obvious explanations include: 1) strong surety underwriting discipline in the marketplace, driven, at least in part, by the large percentage of the market controlled by the top 10 underwriters; and 2) the 18 to 24 month lag in claim (and subsequent loss) activity which typically occurs from the initial trough in construction markets.

Based on these dynamics, what does 2012 hold for the contractor community, given the current state of the surety market? FMI believes that 2012 will be characterized by the following trends:

- Discipline and caution in overall underwriting. Sureties have worked hard to position their businesses over the past several years to withstand the downturn in the marketplace. While Direct Loss Ratios can only increase from their historic lows, the largest sureties will be vigilant in ensuring the losses to their portfolios are minimal through rigorous underwriting standards.
- Pushback from onerous contract terms and conditions. While project owners are anxious to take advantage of the down market to obtain exceedingly favorable contract conditions, sureties will continue to provide a firm backstop to zealous owners on behalf of contractors to ensure the appropriate risk allocation.
- Continued separation of the “haves” and “have nots.” For those contractors with strong balance sheets and healthy backlogs, surety credit remains ample. However, for the weaker contractors struggling in today's market, surety credit will be difficult to obtain and may contribute to a further decline in financial position.

Surety underwriters continue to monitor key indicators of the overall construction economy's health. Particular attention is being paid to the subcontractor community and the negative potential it presents for default or underperformance on jobs. If a spike in business failures should occur in this segment, a rapid tightening of the surety market for all participants would likely ensue. Additionally, it is important to remember that the surety lines of most insurers represent a relatively small portion of the overall company. Changes in other parts of the insurance market, including continued market volatility and low investment returns, natural disaster and catastrophe losses, mergers and acquisitions, and other insurance industry fundamentals, have an impact upon surety market dynamics.

The fundamentals of surety have not changed despite the uncertainty that exists in today's construction environment. For those construction firms looking to obtain surety credit in a difficult economic environment, a continued focus on business basics is paramount. These basics include:

- Manage overhead to be sensible and consistent relative to realistic revenue projections.
- Employ best-in-class estimating processes to ensure accurate bids.
- Manage cash conservatively and minimize debt to ensure strong business liquidity.
- Communicate regularly and openly with providers of credit, including banks and sureties.
A no-surprises strategy will go a long way towards securing trust and support.

CONSTRUCTION MARKET OUTLOOK

What difference does a year make? Not much for nonresidential construction. While there were signs of growth at the beginning of 2011, that optimism has once again been tempered by reality. The FMI Nonresidential Construction Index (NRCI) dropped in the third quarter to 52.4 from 58.7 in the second quarter. U.S. government construction projects are slowing, while private construction projects show only small signs of picking up. Delays and cancellations are about the same as in 2010, less often caused by lack of funding than by lack of starting or delays in the approval process. Federal and state budgets are in a constant state of emergency and uncertainty, and the electioneering is starting again, so we can be certain the uncertainty will continue. That makes the markets nervous and prevents investment in new properties.

Natural disasters don't help the construction outlook either, or do they? Early estimates for damages to the U.S. east coast from Irene range up to \$10 billion. Lives were lost, but many were saved due to good preparation and governmental emergency reports. However, the rebuilding will take a long time, and government funds for rebuilding have been hard to find in the midst of already high budget shortfalls and disagreements in Congress on FEMA funding levels. The damages include roads, bridges, homes and docks in addition to automobiles, boats and loss of business and all-important jobs.

OVERCOMING THE FEAR

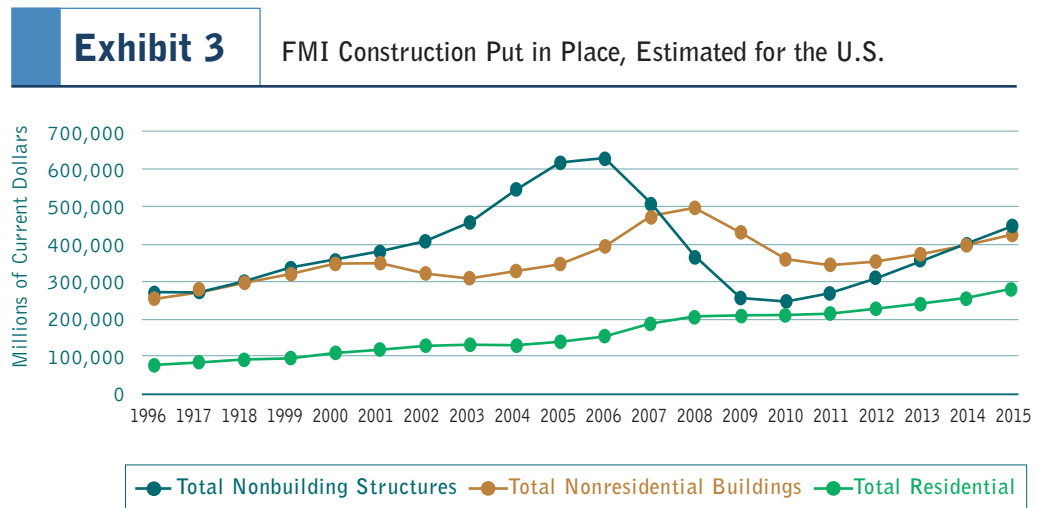
When President Franklin Roosevelt said, "The only thing we have to fear is fear itself," the U.S. and the world were facing even more dire economic conditions than we face today. But Roosevelt recognized the core problem: fear can cause a downward spiral in an already shaky economy.

Is there any good news? Like everyone, we are looking for it; but it seems that any good news comes with a footnote. For instance, it appears to be good news that corporate profits and cash holdings are at all-time highs. It is reported in the financial press (Bloomberg, "Use It or Lose It' Should be the Rule on Corporate Cash," August 24, 2011) that U.S. companies are currently holding \$2 trillion in cash. That's about one-seventh of the U.S. national debt or, not coincidentally, about one-seventh of U.S. annual GDP. Moreover, while we are talking in the trillions, \$2 trillion is nearly four years' worth of nonresidential construction at current rates, not accounting for price increases and such.

While there were signs of growth at the beginning of 2011, that optimism has once again been tempered by reality.

The good news of all that cash on hand is offset by the bad news that it isn't being spent on development, new capital equipment, acquisitions or hiring. Why? Business lacks confidence in the economy. The consumer is not spending, because unemployment is high, and, like businesses, consumers are trying to repair their budgets after being devastated in the recession.

Banks are beginning to open up a bit and make construction loans again, but with tougher lending criteria. Like housing, commercial real estate continues to face foreclosures and loans that have been "amended and extended," many of which will fail in the next few years. Problem commercial real estate loans are causing banks to fail now just as bad home loans did earlier in the recession, but at a less dramatic rate. CRE loans outstanding are decreasing, but only by 2% since 2010. According to O'Connell, Bender & Powers (June 30, 2011), nonresidential loans are slowly coming down but still total \$1.07 trillion. For comparison, that is about 2.5 times the current rate of nonresidential building construction or one-half of the cash held by U.S. companies. Things are getting better, but it will take some time to unwind or resolve all that outstanding debt. Until then, we continue to live on the edge of economic stalemate.



RETAIL BELLWETHER

Historically, the housing and retail markets driven by the consumer would lead us out of the recession. If that is still the case, we will need to be more patient. U.S. retail sales rose 0.5% in July, but that was mostly bargain hunting for back-to-school sales. Shopping malls have historically high vacancy rates, and many are going bankrupt and closing. Like Willie Sutton, famous bank robber who said he robs banks "because that's where the money is," the trend for retail construction is going where the money is, which means building or buying malls in more upscale, urban A and B markets. In addition, more urban malls are including big-box chain stores, like Target, rather than competing with them. Big-box stores, such as WalMart Express, WalMart Market, and CityTarget, are reducing their footprints and moving to the city. If the money is in the large cities, we can expect that is where more people will be as that is where the jobs are. Fewer people are looking to own new homes and becoming renters, which leads to an expected growth in multi-family housing.

However, that is not where all the money is. More and more money is going online to shop, as online sales are up 15% or more and competing with traditional storefronts and malls. However, traditional stores are increasing their online presence and offering pickup at local stores. A move that may change the advantage of selling online is a growing number of states seeking to get their fair share of sales tax from online stores, a move contested by Amazon and others.

Other markets, like hospitality and office buildings, continue to wait on the economy to grow and absorb inventory before a new building boomlet will occur. The major activity in hotels in 2011 has been refinancing loans and acquisitions of existing properties. The sector has dropped around 55% since its highs in 2008 and is now at levels not seen since 2004, with about \$12.4 billion in construction expected to be completed in 2011. Office vacancy rates are stabilizing around 16%, and rents are improving slightly. However, net absorption is down, and the market won't make a solid turnaround until the unemployment rate improves.

Utility construction has been one of the brighter spots this year as new power projects are dominated by wind and solar power in an effort to meet President Obama’s call to reduce dependence on offshore oil. At the same time, the White House is calling for a reduction of 20% in commercial building energy use by 2020.

If we take the pent-up-demand view of the economy, there are many reasons and needs that point to a resurgence of construction work in the near future. The question is, Will business strategies continue to be fear-based or forward-based? One can build scenarios on either side of the argument, and businesses should plan for several contingencies.

SURVEY OVERVIEW

As shown in the charts below, the respondents to FMI’s survey represent an excellent cross-section of the surety market, with respondents providing services across a number of different geographic regions and with exposure to nearly every sub-segment of the construction industry. The surety producers were asked numerous questions relating to three primary topics: 1) current market conditions; 2) probabilities of success for their contractor clients in the current environment; and 3) business continuity planning for their contractor clients.

Exhibit 4 Geographic Markets Served by Respondent

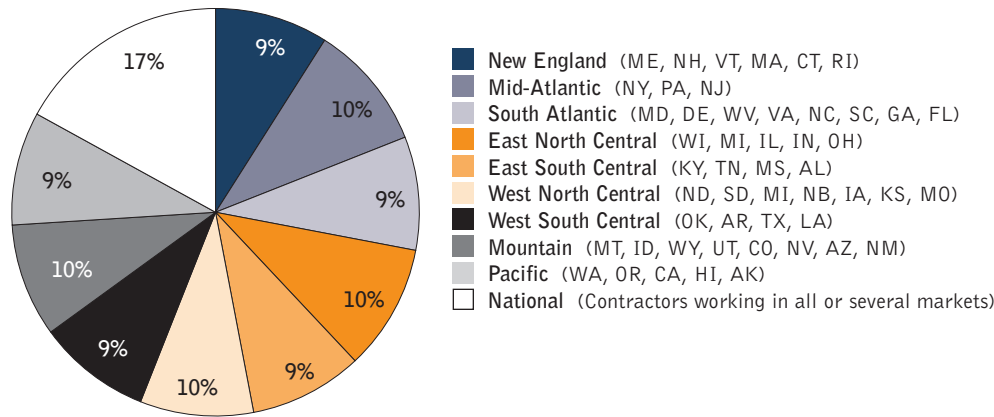
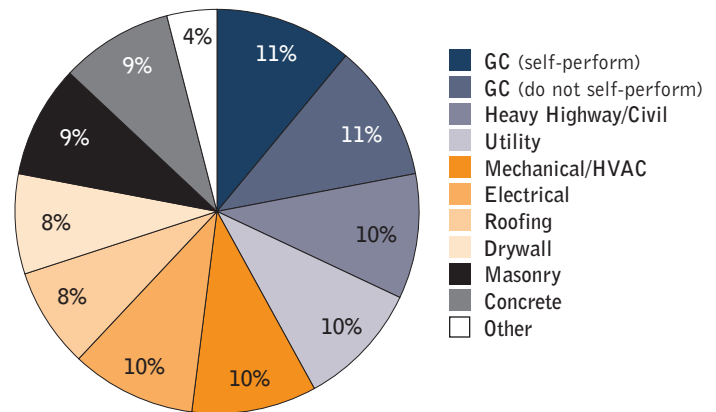


Exhibit 5 Type of Contracting Business Underwritten



SURVEY RESULTS

As displayed in the graph below, respondents were almost despondent about the prospects for growth of the nonresidential construction market. While a relatively small percentage indicated that they are currently seeing or expect to see increased activity by the latter part of 2012, a majority (62%) felt that growth would not materialize until at least 2013. Further, nearly one-fifth felt that the industry would not begin to experience material growth until sometime in 2014. The suggestion of such an extended industry downturn suggests that contractor strategies that are dependent upon a near-term recovery will likely not succeed.

When probed as to their clients' ability to succeed in this market environment, respondents indicated a high level of uncertainty as to possible outcomes. A full 90 percent said that their contractor clients were "tentatively positioned" with "some exposure" to stable or growing markets; notably, only 5 percent stated that clients were either poorly positioned or, conversely, well-positioned.

Exhibit 6

Based upon conditions you are currently observing in the marketplace, when do you expect the U.S. nonresidential construction markets to grow?

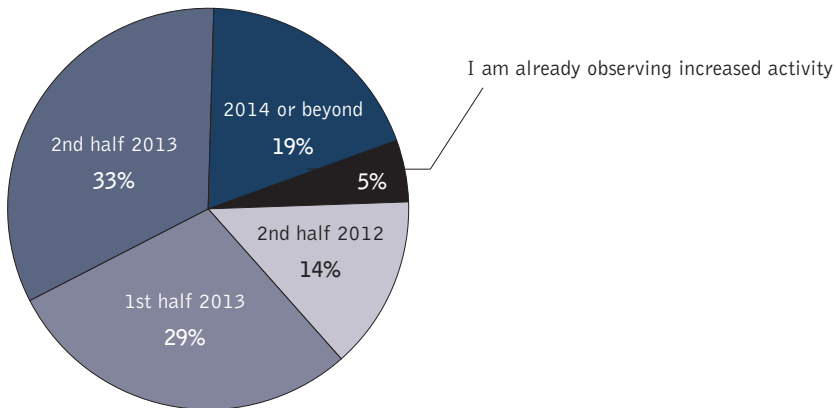
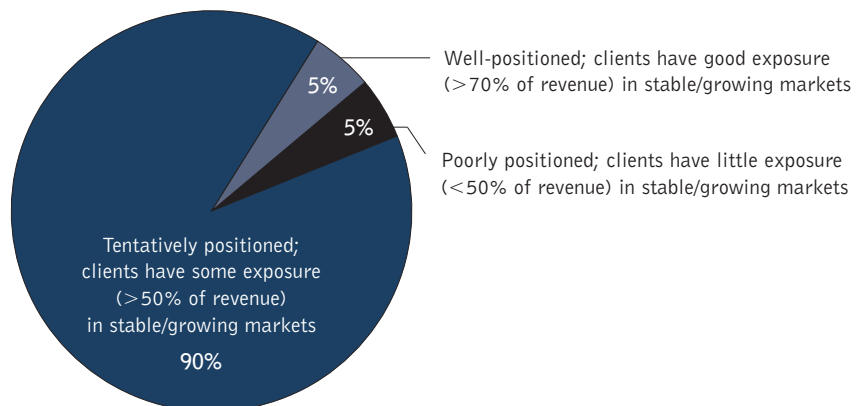


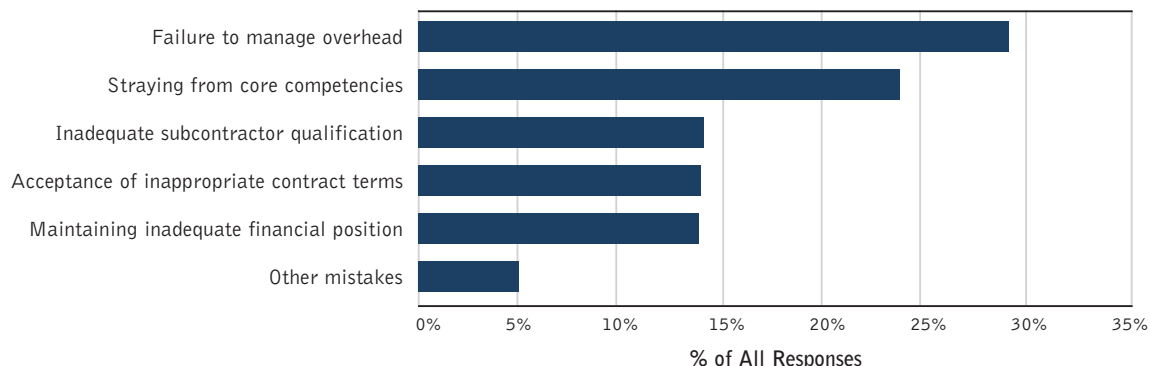
Exhibit 7

How well-positioned are your contractor clients regarding forecast construction activity over the next two years?



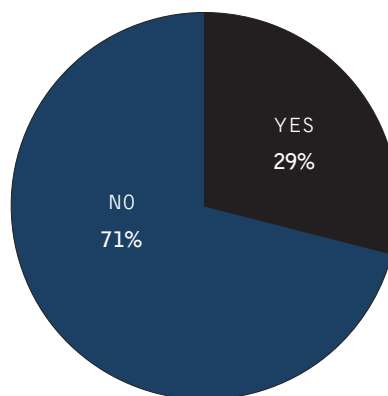
Consistent with responses provided last year, surety industry respondents generally felt that contractors who are poorly or tentatively positioned have most often committed two mistakes – either they failed to bring down overhead commensurate with declining revenue, or they have strayed too far from their areas of competency. Full results for this question are shown below:

Exhibit 8 For those clients that are tentatively or poorly positioned, what are the biggest mistakes that these firms have made as the current market downturn unfolds?



In terms of the market’s impact upon the availability and terms of surety credit, providers indicated the following:

Exhibit 9 Is your firm requiring greater collateral from its contractor clients to underwrite surety bonds?



- Less than one-third are requiring greater collateral from their contractor clients in order to continue underwriting surety bonds, meaning of course that more than 70 percent of surety underwriters have not required additional collateral.
- For those sureties who are increasing collateral requirements, nearly half (47%) are requiring personal indemnification from contractors, while 40 percent require stronger balance sheets in the form of higher levels of equity and/or working capital.
- In today’s market, more than 62 percent of underwriters are seeing an increase in the requirement of subcontractor performance bonds.
- As compared to today, nearly 57 percent of surety providers expect that surety credit will be more difficult to obtain in one year, while a full two-thirds (67%) expect a tighter market in two years.

Exhibit 10

If your firm is requiring greater collateral from its contractor clients to underwrite surety bonds, what form is it taking?

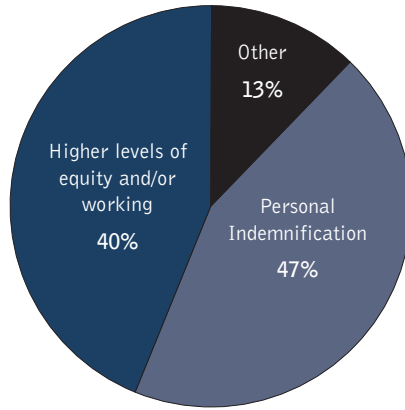


Exhibit 11

Are you observing an increase in the requirement of performance bonds from subcontractors by general contractors?

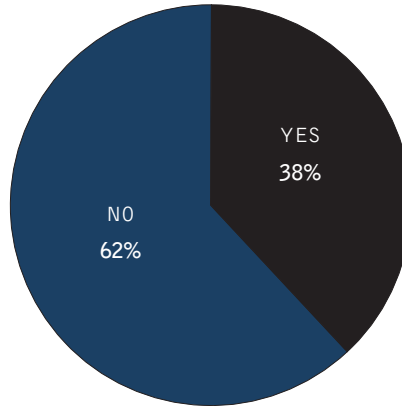
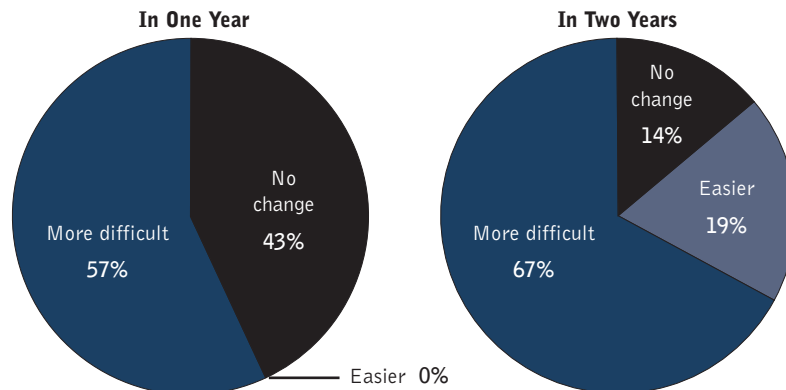


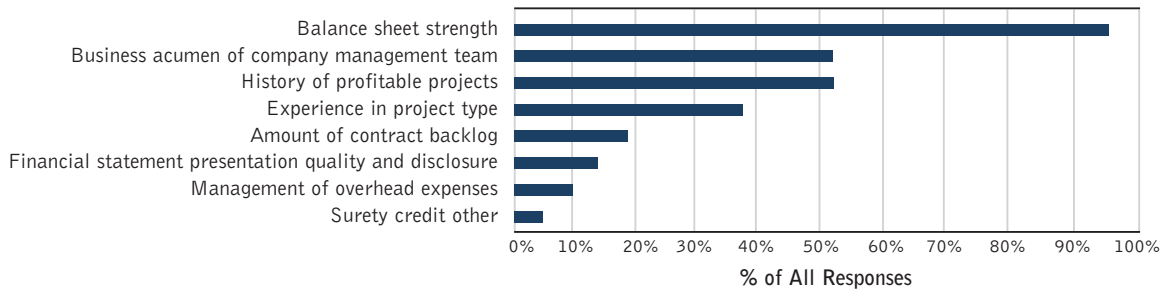
Exhibit 12

Compared to today, do you expect your clients will have an easier or a more difficult time obtaining bonding?



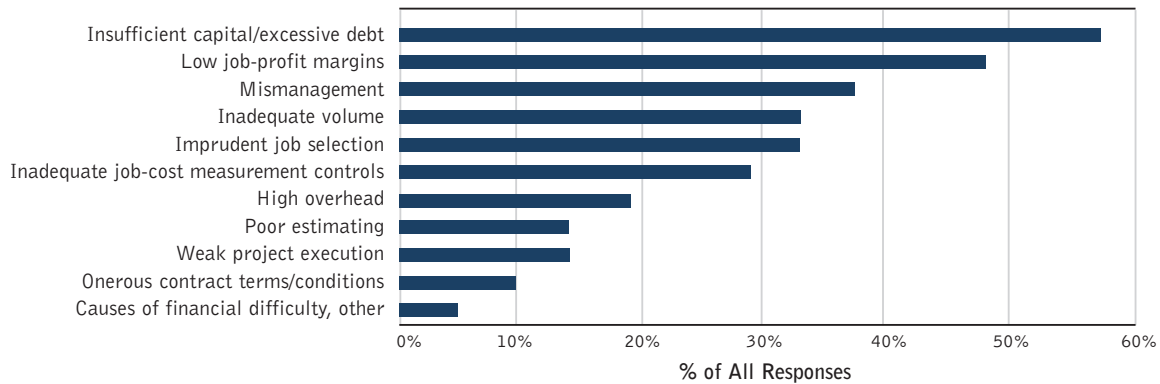
With regard to the criteria which surety providers evaluate in order to provide bonding to contractors, generally it is known that the three “Cs” of character, capacity and capital guide underwriting decisions. The chart below demonstrates a finer point on those items, which sureties consider to be most critical for underwriting in today’s environment:

Exhibit 13 Which three criteria do you view as most important in providing surety credit?



For those contractors working to assemble a strategy to compete in today’s market, surety providers’ perspectives on the major causes of financial difficulty are instructive:

Exhibit 14 Which three criteria do you view as the major causes of financial difficulties for contractors?



MANAGEMENT SUCCESSION PLANNING

Given the demographic tidal wave resulting from the aging of the baby boomer generation, and its impact upon the overall stability of the construction industry, survey respondents were asked several questions relating to their perceptions of succession planning. In FMI's experience, succession planning is often either neglected or mismanaged in the construction industry. Given the facts that construction firms are highly dependent on the effectiveness of their top leaders and owners, and that the average age of firm owners is 55, this is not an area to be overlooked. Management continuity is particularly important during a severe downturn, as disruption can precipitate and magnify organizational and operational stresses. Some key observations by surety executives concerning succession planning are listed below:

- Forty-five percent of respondents' clients have indicated that less than half of their clients have a formal management/ownership continuity plan in place.
- On a scale of 1 to 5, where 1= High Impact and 5=Low Impact, respondents gave an average score of 2.7 regarding the impact a succession plan has in assessing underwriting risk.
- Nearly 80 percent of respondents rated the quality of their clients' succession plans as low or average.

Exhibit 15

What percentage of your clients have a formal management/ownership continuity plan in place?

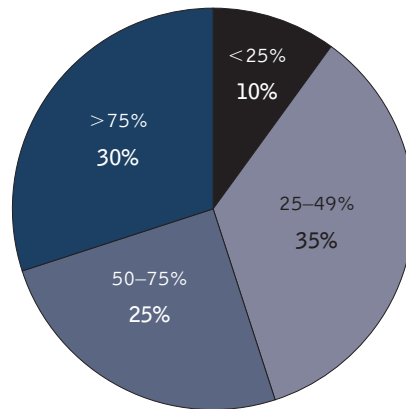


Exhibit 16

For those ownership/management succession plans deemed unacceptable, please describe the reasons. (1=Most Important, 5=Least Important)

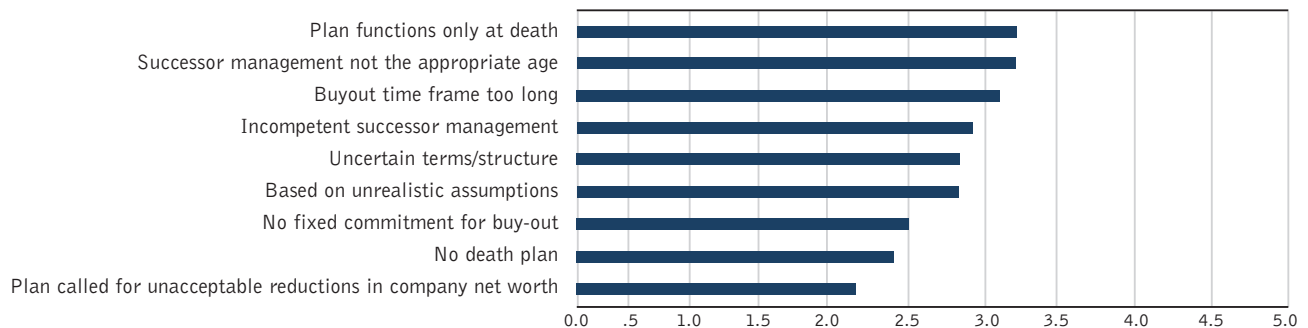


Exhibit 17

For those ownership/management succession plans which were (or are) acceptable, please describe why the plans failed or are failing. (1=Most Important, 5=Least Important)

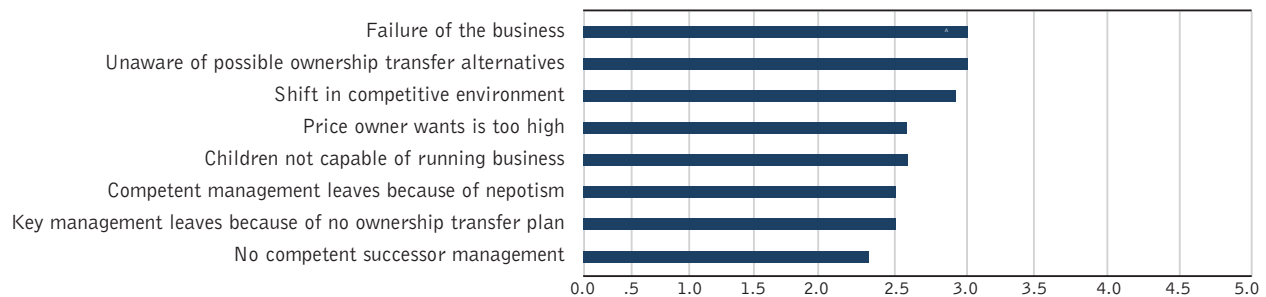
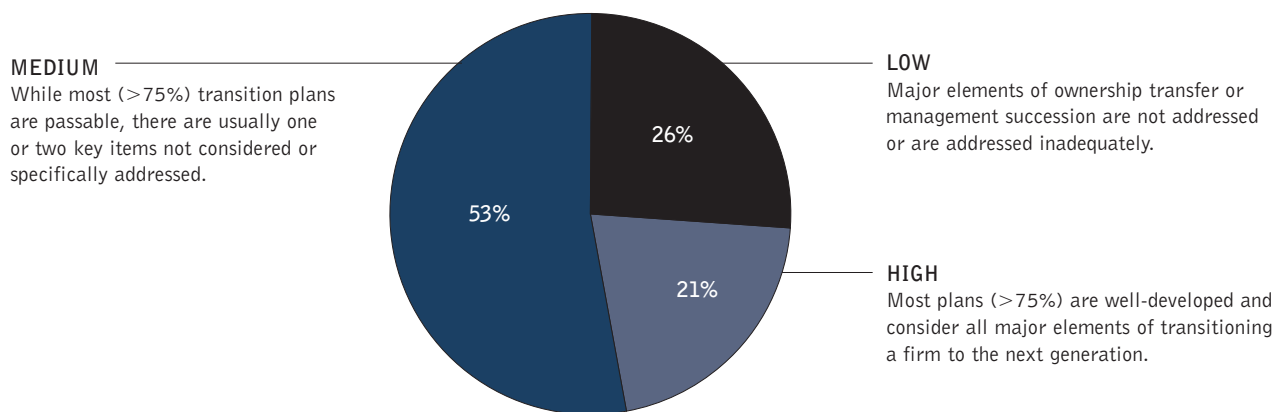


Exhibit 18

On average, how would you rate the quality of your contractor client's existing succession plans?



CONCLUSION

More than 80 percent of the surety industry executives recently surveyed by FMI don't expect nonresidential construction to grow appreciably until at least 2013 or later. While that market outlook may seem more pessimistic than other forecasts, it is the nature of sureties to exercise caution. With work still highly competitive and owners relying predominantly upon low-bid processes to choose their contractors, the risks of bad projects go up. The surety industry not only helps to assure that the owner's project will be built according to the contract, but also helps contractors to maintain good accounting and management practices.

Successful projects and a healthy base of contractors portends well for the entire construction industry. If the continuing recession results in increased surety losses due to poor or uncompleted projects, it will be a loss for the market and create further instability, thereby extending the recovery. However, if the surety industry remains financially sound and maintains its current level of underwriting discipline, it can catalyze the recovery and, as a result, facilitate the healthy growth of the construction marketplace. Regardless of the direction that the pendulum swings, firms that have engaged in good planning and maintained sound business practices, like those highlighted in the survey, will have the strength to make it through these trying times successfully.



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Raleigh

5171 Glenwood Avenue
Suite 200
Raleigh, NC 27612
T 919.787.8400
F 919.785.9320

Denver

210 University Boulevard
Suite 800
Denver, CO 80206
T 303.377.4740
F 303.398.7291

Tampa

308 South Boulevard
Tampa, FL 33606
T 813.636.1364
F 813.636.9601

Scottsdale

14500 N. Northsight Boulevard
Suite 313
Scottsdale, AZ 85260
T 602.381.8108
F 602.381.8228



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