

# Surety Market Update

Willis

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## Smoother Waters...For Now

Contractors continue to confront the challenges of schedule and staffing while pursuing opportunities presented by the construction marketplace. Despite the recent drop in prospects for the residential sector, the demand for construction services is vibrant, with both the commercial and public construction sectors projected to remain robust into 2008. For sureties, 2006 was the second consecutive year of underwriting profitability and, for many, the profitability was of record or near-record levels. The early indications are that this performance has continued through the first two quarters of 2007 for the vast majority of surety writers. Surety executives credit both the increased demand for surety bonds in the construction marketplace and maintenance of the underwriting and pricing discipline major surety writers implemented in response to the unprecedented losses of 2001-2004.

## The Marketplace for Users of Surety

### Industry Performance

The Surety & Fidelity Association of America® (SFAA) results for 2006 show that the surety industry incurred approximately \$0.50 – \$0.60 in losses and expenses for every dollar of premium earned. This contrasts dramatically with the \$1.30 – \$1.40 absorbed by the industry in 2001 and 2002 and the \$1.10 – \$1.20 lost in 2003 and 2004. Sureties remain subject to strict return on capital (ROC) hurdles from their management and shareholders. The results of the past two years have begun to replenish needed capital to the industry, but full confidence of capital providers in the surety line has not yet been regained. This is evidenced by the fact that, despite improved performance, there has not been a major new entrant to the primary side of the business in more than five years.

Ironically, the robust construction economy presents sureties with another challenge to their ROC targets. In the case of surety losses today, costs of completing work for a defaulted contractor have risen dramatically. In the past, the surety industry's probable maximum loss (PML) – the amount required to complete a defaulted contractor's remaining bonded liability – was generally in the range of 30% – 45% of the contractor's outstanding bonded backlog. Today, sureties are finding this cost has increased by as much as 100% or more. Since the aggregate PMLs assigned to a surety's portfolio of business impacts the setting of its reserve levels, this increased prospective cost affects both profitability and ROC. Willis expects that this phenomenon, combined with higher levels of retained surety risk and other factors, will extend the current period of relatively disciplined underwriting well into 2008. Well-managed contractors will benefit from this surety environment.



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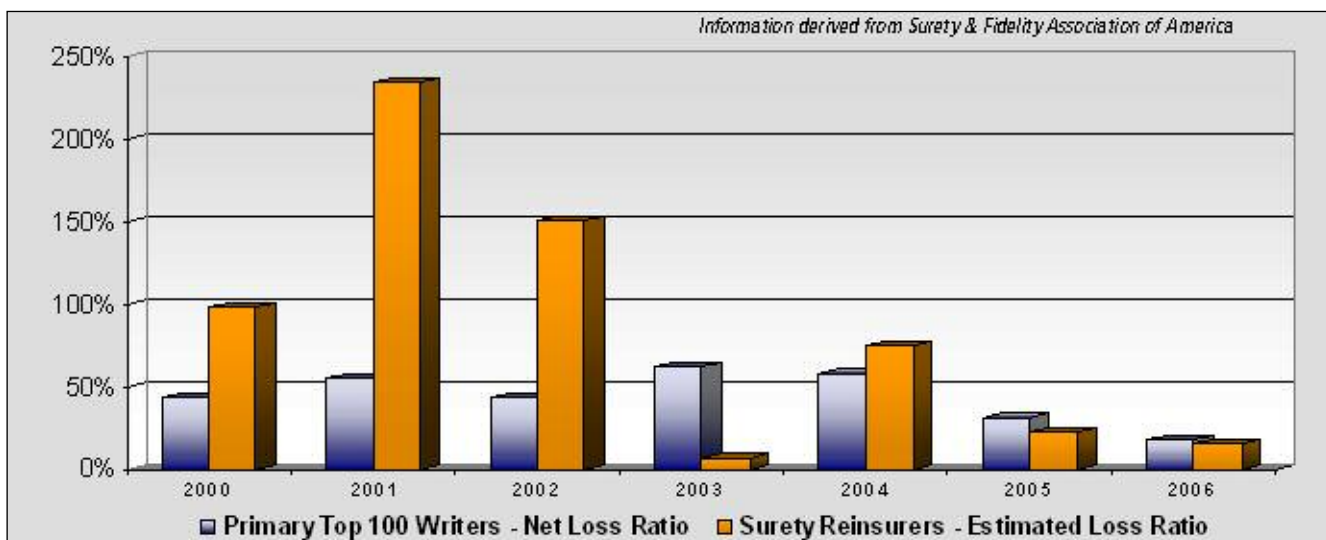
Overline requests and 'special acceptance' offerings to surety reinsurers have become easier to obtain, and overall industry capacity has modestly expanded. Even so, in the past three years the economics of the business are such that at least two major sureties have chosen to write their business without any meaningful participation of surety reinsurers. Also, the excellent underwriting results of 2005 and 2006 do not mean the surety industry has been loss free. In fact, according to the SFAA, Direct Incurred Losses totaled \$2.51 billion for this two-year period. In our view this will test the patience of new surety capital that saw opportunity in the industry turmoil of 2001-2004. Some of this capital has already exited the business. That which remains is now maturing in the marketplace and finds itself exposed to the quality of the underwriting decisions made during the first 2-3 years of its allocation to the surety line.

## Underwriting and Capacity

Underwriters are trying to maintain a balance of serving their clients' needs while remaining on guard for the risk posed by expanded contractor backlogs. Clients need to be prepared to address these risks when meeting with their surety. Business plans outlining the availability of qualified labor and project management staff (including subcontractor selection and management), the controls in place to review specs and contract terms, and the evaluation of credit risk from owners are some of the key components sureties will evaluate.

## Pricing

Many sureties continue to utilize credit modeling to determine account-specific and individual project pricing. Preferred credits are receiving preferred pricing, relative to the market, but not at the pricing levels contractors experienced in the 1990s. Generally, contractor rate levels were stable in 2006, absent a project-specific or financial performance issue. In the near term, Willis sees no evidence of rates hardening in the surety marketplace. Middle-market contractor surety rates remain competitive due to a broader array of carrier choices available to clients than is the case for large contractor programs. Surcharges for capacity, extended contract duration, or other contract-specific terms, however, are still common in the marketplace.



This table shows incurred losses as a percentage of surety industry premiums earned by the primary surety writers and estimated earned premiums for the surety reinsurance industry. The improvement in results from tighter underwriting and more disciplined pricing since 2002 is evident. Neither chart reflects overhead and other operating expenses. The reinsurance result for 2003 was due entirely to the net effect of reductions in prior year loss reserves and not to the absence of loss activity. By Willis' estimate, reinsurance premiums consumed approximately 17.5¢ of every surety premium dollar in 2006, a substantial drop from the average of 22¢ in 2005. This figure does not include the internal cost of capital to cover higher retentions required of the primary sureties. In the past, such softening of reinsurance pricing was a precursor to an easing of surety marketplace conditions. Today, with major sureties' overall reliance on reinsurance lessened, past history may not be an accurate predictor of future trends.

## Rating Agencies Don't Give a 'Heads Up'

Just as sureties have sought to maintain the discipline in their business models, rating agencies have maintained a higher level of diligence in monitoring and reacting to corporate performance. As the broader insurance marketplace continues to soften, Willis expects reserve adequacy and underwriting results to be closely scrutinized by the industry's rating agencies. Surety executives may be impacted by actions assigned to their parent groups that challenge their ability to continue to deliver required capacity.

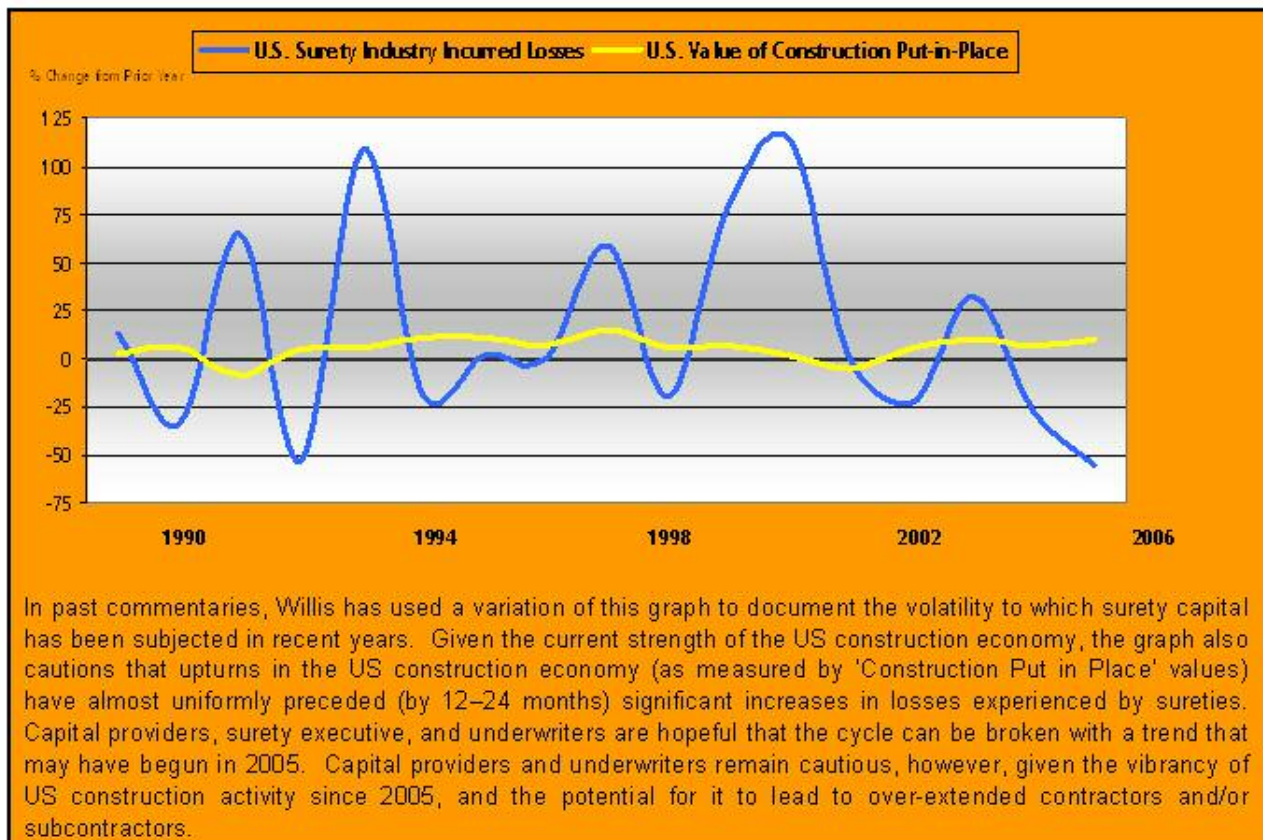
## Surety's Three Cs: Capital, Consolidation – and Change

Surety remains a business that generates less than 1% of the premium writings of the global commercial insurance industry, but requires highly specialized underwriting and significant commitments of capital to support middle-market and large surety programs. Although not without precedent, surety industry M&A activity is unlikely to present clients with an overnight change in their surety support. That said, the surety industry – and its customers – remain subject to continuing consolidation within the financial services world in general, and the insurance industry in particular. Liberty Mutual's recent tender for Ohio Casualty, a transaction not in any way driven by strategic surety concerns, will combine the # 6 and #20 writers

of surety business in the US. The deal is indicative of the scale insurers are seeking in order to remain competitive for capital in today's global market. While today's conditions, relative to recent years, provide a sense of stability, the lessons of the recent past have caused well-managed construction firms to plan for an untimely interruption to their surety capacity. These firms have established stand-by surety relationships that keep them actively engaged in reviewing their financial results and anticipated needs, and in position to respond quickly if capacity is suddenly required.

Surety underwriters will closely compare the actual execution of a contractor's business plan to the projections on which it was based. Overhead levels and the adequacy of present and future cash flows are reviewed, including an analysis of individual project cash flow needs and performance.

The potential for consolidation also exists within sureties' customer base, as evidenced by the recent announcements regarding Balfour-Beatty/Centex and URS/WGI. Such transactions will continue to present post-merger groups and the surety industry with capacity challenges, although the environment today is more favorable. Non-



US groups have demonstrated a revitalized interest in the potential acquisition of US construction companies. While for large surety programs, the availability of market choices has expanded modestly, it remains limited. Five sureties will write aggregate programs of more than \$500 million without a co-surety partner, and capacity continues to be concentrated in the top side of the industry. In December 2006, the four largest writers' market share was 43.0%, and 65.6% of total surety industry premium written by the ten largest sureties.

## Surety Focus

### Financial Performance

Surety underwriters will closely compare the actual execution of a contractor's business plan to the projections on which it was based. Overhead levels and the adequacy of present and future cash flows are reviewed, including an analysis of individual project cash flow needs and performance. Project pricing and estimated margins will be benchmarked against sector performance for a given contracting firm. A client's tangible equity, its operating liquidity and access to outside sources of liquidity are all carefully assessed. Contractors looking for increased surety capacity for near-term opportunities are advised to present easily analyzed and fully transparent financial information. Understanding how your surety analyzes the information provided and the credit models into which it is entered can help guide the development and presentation of underwriting information in a way that increases the chances of obtaining or expanding surety support.

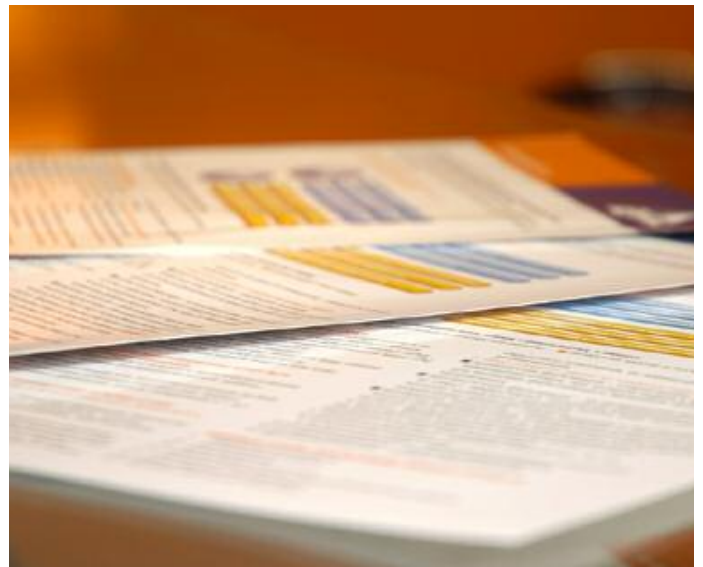
### Subcontractor Risk Management/Contract Review



Surety underwriters are placing increased scrutiny on a client's subcontractor selection controls and performance risk management. For firms that employ subcontractor default insurance as a risk transfer mechanism, some sureties are requiring endorsements granting them coverage and, in some instances, dedicated limits of coverage on bonded projects. For those that use subcontractor surety

bonds, the credit rating and perceived stability of the subcontractor's surety may be evaluated.

Continued attention is paid to the provisions within owners' contract and bond forms (or a GC client's own subcontract forms) for onerous conditions or diminishment of rights. Particular scrutiny is given to Liquidated and/or Consequential Damages. Sureties are seeking to have such provisions capped on bonded work. Clients can also expect the underwriting process to examine contract duration, the credit risk associated with payment terms and holdbacks (retainage) and escalation provisions to hedge against industry inflation. For the first time in many cycles, the demand for construction services has resulted in contractors' success in removing one-sided and onerous conditions from contract documents. New proposed industry contract documents (such as the AIA 201-2007 ed.) are still under review by sureties and construction industry associations.



### Indemnity and Other Credit Security

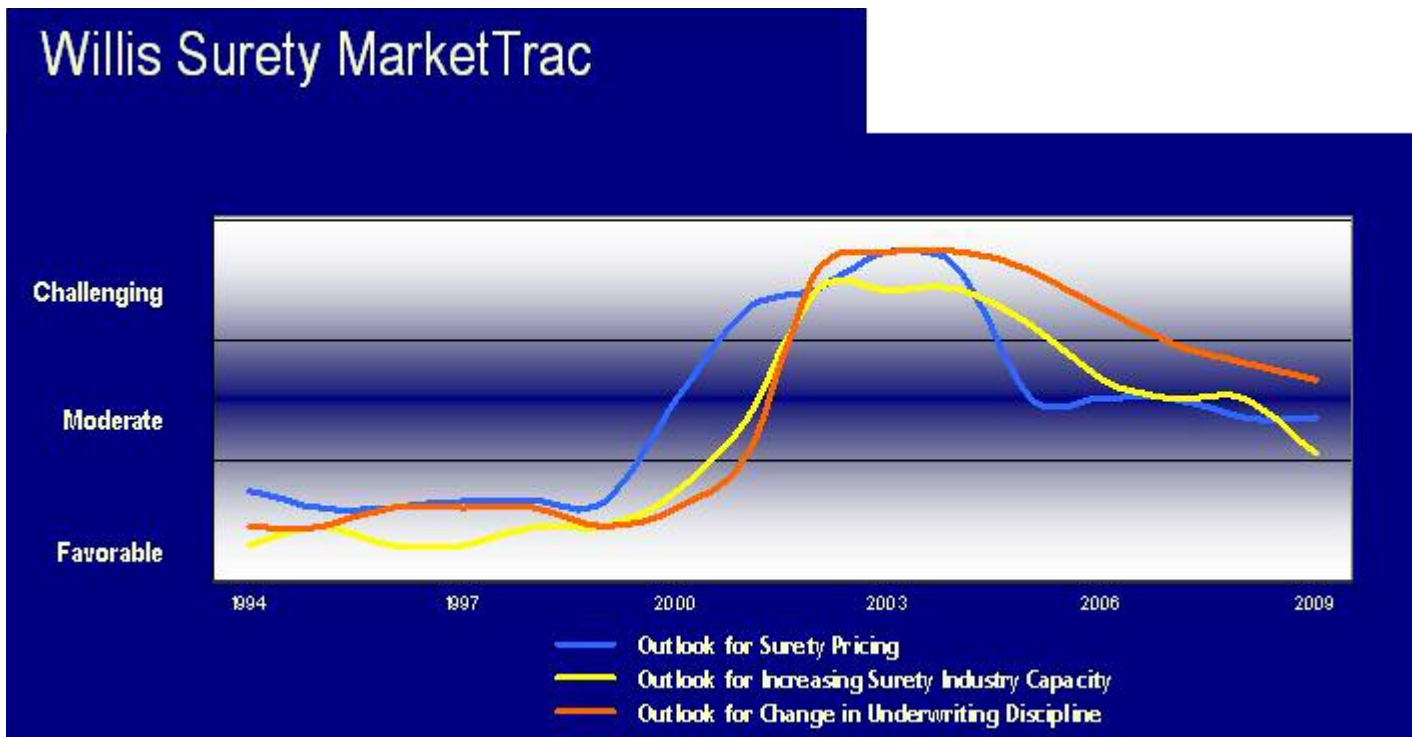
Sureties' support and the terms and conditions of that support are driven, in part, by the indemnity offered by the client. Personal indemnity remains a common requirement for closely held firms, particularly Subchapter 'S' corps. Sureties have increased their focus on the interplay between the indemnity agreement with a client and the security provisions of other banking or credit agreements the client has in place. Underwriters may require wordings that clarify the sureties' access to assets to complete its bonded obligations, if called upon to do so. Contractors are advised to have any new indemnity agreements reviewed carefully by counsel and a professional surety broker to ensure that any potential conflicts with existing credit covenants are avoided.

## Continuity

In a marketplace of expanding opportunity, contractors are advised to communicate their business continuity planning with the surety for events, whether carefully anticipated (pending retirement of key personnel, etc.) or unforeseen. Sureties focus on both the financial and operational aspects of any continuity planning a client presents. As construction company owners examine exit strategies and their options for realizing the wealth they have created, private equity firms are one alternative when self-funded employee buy-outs or merger options are not viable. The earlier a client engages its surety in this conversation, the more likely it will be that surety support will survive the transfer of ownership. The investment window of the private equity investors, the indemnity support that is made available following the merger, the management retained to run the operations, and the credibility of the post-transaction business plan are primary considerations that underwriters will evaluate.

## The Way Forward

Willis showcases Surety MarketTrac, a guide to near-term marketplace conditions for surety users. The historical data reflects, in hindsight, the characteristics of the surety marketplace from 1994-2006. Our projection for the period from today through 2009 is based on conversations with senior surety company executives, reinsurance participants, and the day-to-day responses received in the marketplace to our clients' needs and new business opportunities. In the table below, the outlook for "Challenging" conditions means users of surety can expect to commit a greater investment of time and preparation to maintain or increase their surety capacity – a hard market. A "Moderate" outlook indicates conditions are expected to remain consistent with those of the most recent 12-18 month period. A "Favorable" outlook means users can expect surety capacity to be readily available to support their needs and the pricing environment is improving – a "soft" market.



## A Client's Surety Best Practices Checklist

Stable surety relationships are an outgrowth of good business performance and, as in most other aspects of a client's business, relationships and communication matter. Elements of strategic planning and pro-active communication are key to a firm's ability to minimize the impact of continuing industry uncertainty. Seeking a surety's counsel and input on prospective business planning and sharing all news – good and bad – in a timely and credible way will reduce the chances of events negatively impacting a firm's surety facility. Accordingly, we again offer our 'Surety Best Practices Checklist'. This checklist is the basis for the surety advocacy work we do on behalf of our clients.

- **Am I completely familiar with my Surety submission?** Did I review my agent's or broker's ongoing work product representing my company to the Surety marketplace?
- **How does the Surety analyze my company?** Review my Surety's financial analysis and credit modeling – it's their scorecard for extending credit. Communicate what we expect of our Surety and clearly understand the Surety's expectations of my company.
- **What are my Surety's underwriting results?** What is their business plan for the coming 12-18 months?
- **On what level of reinsurance support does my Surety rely to service business?** Have there been any changes to my Surety's single project and aggregate program capacity?
- **What are my Surety's financial ratings?** Have there been any recent changes to its or its parent company's ratings?
- **Have there been recent personnel changes within my Surety at the local and/or home office level?**
- **What is the status of my 'Stand-by Surety'?** Do we meet with them on a regular basis?

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