

SURETY MARKET FORECAST

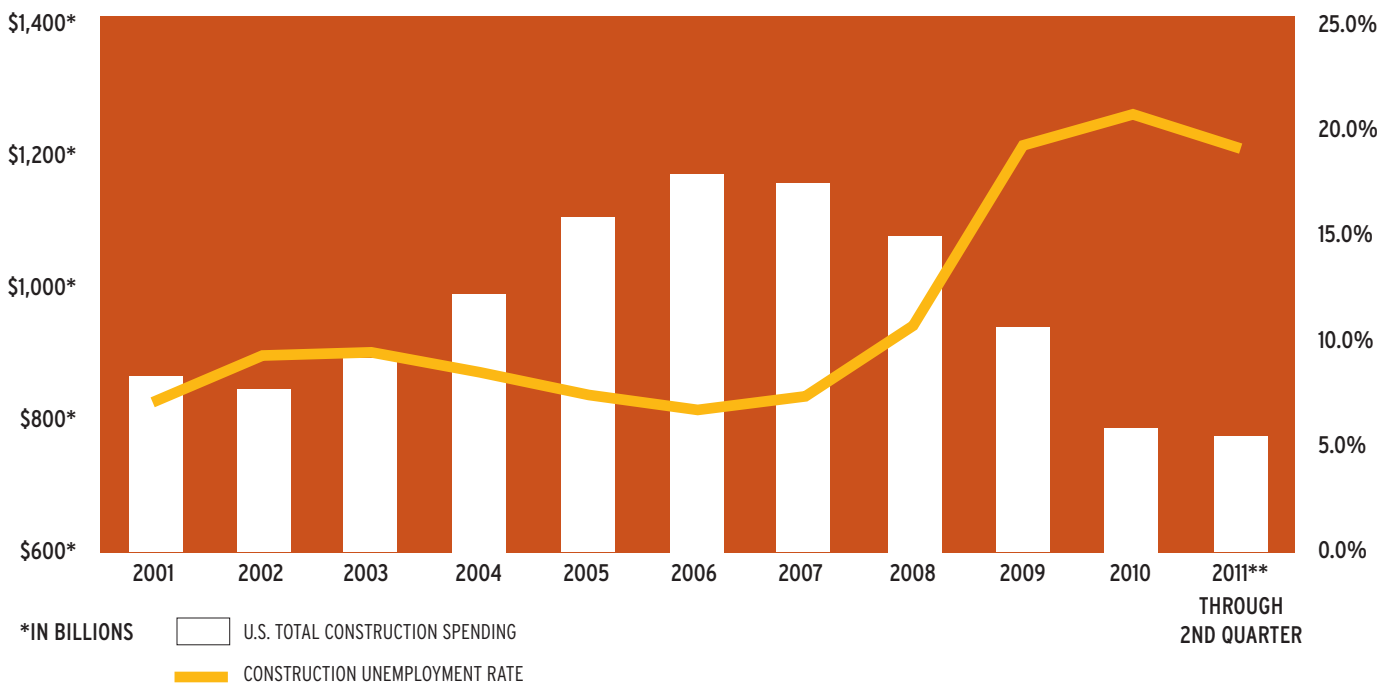
HAS THE STORM BLOWN OUT TO SEA? OR IS IT JUST SLOW TO DEVELOP?

The Surety and Fidelity Association of America (SFAA) continues to report favorable loss ratios for the surety bond underwriting business. As of June 30, 2011, the surety industry loss ratio stands at 11.8%.¹ However, construction economics have stubbornly continued to be down for a prolonged period of time. Construction unemployment, while down this year from 22.5% to 13.6% (as of July 2011), remains at a high average annual rate of 18.2%.² The value of put-in-place commercial construction is down approximately 67% from its 10-year high in 2007.³ There has been no quarterly growth in construction spending since early 2006.⁴ Along with pressures to reduce the deficit and recent market instability relating to the S+P rating downgrade of U.S. debt and European debt concerns, we expect the construction economy to be in a prolonged period of anemic spending. Competition for work will remain intense and margins will reflect this environment. Underwriting executives, brokers, consultants, bankers and contractors have all been discussing coming defaults as a result of the severe market



conditions for some time. *However* – surety results remain highly profitable.

U.S. TOTAL CONSTRUCTION SPENDING VS. CONSTRUCTION UNEMPLOYMENT





SO - FALSE ALARM? OR JUST BREWING OFF SHORE? LET'S TAKE A CLOSER LOOK AT WHAT'S ON THE RADAR...

WE ALL SAW IT COMING AND WE PREPARED

The sudden and dramatic financial events of late-2008, including the 8000-point drop in the DOW, failures and government rescues of several high profile companies, along with the end of the residential boom, sent a very clear warning to all construction executives to make immediate changes to overhead, investments and leverage. As a result of decisive action, construction companies avoided being too over-extended and mitigated future losses.

THE GOOD TIMES CREATED DEEP POCKETS

The construction industry experienced strong growth and healthy margins for an extended period of time during the mid-2000s. From 2000 to 2007 construction put-in-place grew approximately \$350 billion (44% increase) and construction unemployment was in the 7-9% range.^{5,6} Healthy backlogs led to record profits and growth for all types of contractors: specialty, GCs, heavy, residential. Balance sheets grew and the retained earnings created deep pockets to fund growth or to weather a storm. Many of the construction industries' larger firms went into the 2009 recession with healthy margins on longer-term projects, giving them some cushion before needing to lower margins to win work. During this time, as the construction industry thrived, so did the surety industry, growing its top line by about \$2.7 billion (up from \$2.6B to \$5.3B).⁷

IT TAKES TIME

A road job bid today is likely to have a low single-digit margin – if any – for the winning contractor. Often there are no charges to jobs for owned equipment. GCs are taking even lower fees and hoping to buy out the margin from eager subs and suppliers. General conditions and allocation for senior construction management are being under-charged to bids. Contingencies are a luxury of the good old days. Subs are being forced to accept broad contract terms, tight schedules and thin margins. A job like this, bid today, starts working its way through – and negatively impacting – the income statement over the next 24 months. Just as large contractors with multiple-year backlogs were able to report strong profits in 2009 and 2010 by virtue of work priced in 2007 and prior, it will take time before the low margin work won in 2010 and 2011 shows up, resulting in unprofitable jobs and eroding balance sheets. Surety underwriters know this and are not surprised at the current status of their results.

A closer look at the surety industry loss results by company is starting to show loss ratios creeping up for sureties that specialize in writing smaller contractors. These contractors have a shorter backlog duration and are starting to more quickly feel the balance sheet erosion from unprofitable work. We estimate based on conversations with senior surety executives that approximately one-third of contractors are reporting red ink. It takes time for red ink to erode retained earnings and draw the surety into the picture – but the leading indicators suggest this is underway.

UNDERWRITING DISCIPLINES ARE MUCH BETTER

Surety underwriters take some credit for low loss ratios, indicating more discipline in their practices over the last cycle. They have tightened indemnity agreements, charged higher prices (particularly for larger and longer-term jobs), required JVs on large projects, added in-house legal resources to more actively drive owners' contract terms, established credit committees to review their larger credits and made greater use of technology in their financial analysis and credit benchmarking. All true, but all under pressure currently from the competition in the surety business, which is directly related to sustained profitability, under-utilized capacity and new entrants.

Sureties formerly required JVs when projects exceeded \$100 million, and then \$250-\$300 million, and now sole ventures in excess of \$750 million have been approved. The largest single bond the industry could write was in the lower-to-middle \$100 million range a few years back, and now single bonds in excess of \$1.5 billion are possible for the strongest JV teams. Surety companies who used to have maximum capacity commitments to clients in the \$500 million to \$750 million range have more than doubled their available capacity commitments. As predicted in our January 2011 Forecast, competition has caused rates to fall a bit, especially in the major account market. Pricing is down, and risk, measured by margin and size of the bet, is up.

Contractors have also widened their target and are exploring jobs in new geographic markets, different types of owners, emerging project financial structures and other strategies. As a result, surety underwriters are being challenged to understand and support contractors stepping outside their traditional comfort zones. All of these strategies are happening at a time when margins are thin. Thus, while underwriting standards have been better in recent times (versus the underwriting “gone astray” practices of the late 1990s that led to large surety losses in the 2000s, such as Enron), they are being strongly tested today. Some sureties have lost business by sticking to standards established over the last decade. Others see opportunities to grow their market share to offset revenue decline from lower construction activity by taking reasonable risk for good companies based on strong surety profits.

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ARE THERE OTHER SIGNALS TO WATCH FOR THE POTENTIAL SURETY STORM?

COMMERCIAL SURETY

This segment of the industry applies to non-contract bonds and annually represents approximately 20-25% of the surety market. It has been highly profitable in recent years up to present day markets. It is experiencing high levels of competition, and a number of new competitors have entered the business. While commercial surety bonds are not in the direct sight line of contractors who rely on contract surety, this segment's results have dramatically impacted contract surety market activity and capacity. For example, the Enron situation and similar corporate losses hit in the early 2000s which led to dramatic impacts on surety loss ratios, reinsurance availability, capacity limitations and management's outlook for the entire surety line of business. The broader economic pressures also exist for this segment of surety and will need to be closely monitored.

SURETY REINSURANCE

Surety reinsurance capacity is plentiful and we expect that an over-supply of capacity is looking for a home. This will facilitate availability of large bonds and capacity commitments as well as continued pressure to lower rates. Reinsurers have reported an increase in payment bond loss activity but very limited large surety losses. Over the last several years the large surety companies have taken more risk in-house (i.e., bought less reinsurance and/or have taken higher retention levels) based on their larger balance sheets, profit dollars and natural geographic and size-of-account diversification. As a result, a tightening in the surety reinsurance market is not likely in the short term if driven by frequency of smaller losses. A large catastrophic type loss from a default by a major, well known firm is more likely to bring about a change to surety reinsurance availability.

SUBCONTRACTOR DEFAULT INSURANCE

The market landscape for this coverage has seen some changes over the last couple of years with the entrance of another player in addition to the Zurich Subguard product. Construction Risk Underwriters is now into its second year writing subcontractor default coverage as a Managing General Underwriter with Arch paper. Their risk appetite is primarily focused on smaller general contractors that need more flexibility in using the product in a manner that allows them to fund retention requirements over a longer period of time. In the last 18 months, they have bound approximately a half dozen programs. In addition, XL is now offering subcontractor default coverage as of this fall. XL's product, "ConstructAssure," offers limit capacity and similar features to compete with Zurich for larger contractors. The loss experience for this coverage remains favorable, despite the current pressures on subcontractors. While this coverage remains an alternative to manage subcontractor default risk in the marketplace, we expect that over a period of time the enhanced competition in the marketplace will provide an environment of improved terms, conditions and pricing.

IT IS STILL COMING TO SHORE

As we mentioned in our January 2011 Forecast, we expect contractors to have a prolonged market of lower construction spending, over capacity in the contractor ranks and tight margin work. Commodity inflation (e.g., through the 2nd Quarter of 2011, prices for all construction materials increased 8.3% over the prior 12 months^{8,9}) is often not covered by contingencies. These conditions will not spell doom for all, but defaults will rise over the next 24 months. Some contractors will bounce between small profits

and manageable losses, but others will find real trouble as tight jobs turn into problem jobs, which can result in overall unprofitable backlogs. There has been just too much work contracted, including future projects, under these conditions and across the industry for defaults not to occur. Construction contracts are full of risk and deserve margins higher than the competition allows. Losses will develop in the 2012-2014 time period.

SO HOW DOES THIS AFFECT YOU AND HOW CAN YOU PREPARE?

Do not surprise your bonding company and do not sugar coat the message. They understand the market is tough and they will be more concerned if you do not acknowledge the environment. They expect that contractors, even *good* companies, will not escape without some red ink on jobs. They want to know how you are mitigating against market risks.

Have a back-up surety in place, or at least some contingency relationships for bonding. Know who is out there, and more importantly, make sure they know your company, so you may respond and adjust quickly to changes in risk appetite, classes of business or personnel movement.

Carefully manage the risks around you; GCs need to manage their subcontractor default risk, suppliers need to be sure they get paid and everyone needs to understand the project funding and cash flows. Construction is a highly interrelated business; risk from one gets passed on to another. You may do everything right but feel the impact of someone else's wrong. Pricing risk too low can lead to losses, but taking risk that is too great can lead to default.

Expect consolidation to continue with firms using capital/cash they do not need to fund backlog in order to acquire backlog and gain access to markets for the longer term. Non-U.S. global firms are keenly interested in getting a foothold in the U.S. construction market, seeing long-term potential and a short-term buying opportunity. There is some expectation that procurement methods, such as Public Private Partnerships that have long been more common outside of the U.S., will finally become a more widely used approach to fund U.S. public infrastructure work. Strapped state and federal budgets have already caused increased discussion around P3s. The global firms see this as motivation to improve their U.S. presence to be part of this trend and not be viewed so much as a foreign company owning U.S. public infrastructure. A few surety markets are well along in developing surety products uniquely for P3 projects. They include an LC (letter of credit) demand type component for a low percent of the contract (e.g., 10%). This is to help the surety industry compete against bank letters of credit, which have been a common requirement of P3 lenders.

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There is no magic solution but there will be opportunities for the best managed companies to survive the marketplace and emerge stronger. The U.S. market will rebound – but not ‘till this storm blows through. Willis is ready to help you navigate the marketplace.

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For information on other surety and construction issues, please visit our site on **willis.com**.

¹ The Surety & Fidelity Association of America

² U.S. Bureau of Labor

³ U.S. Census Bureau

⁴ U.S. Census Bureau

⁵ U.S. Census Bureau

⁶ U.S. Bureau of Labor

⁷ The Surety & Fidelity Association of America

⁸ Reed Construction Data

⁹ Associated General Contractors (AGC) of America

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