

Workshop W9

Wednesday, October 31, 1:30–3:00 p.m. and 3:30–5:00 p.m.

MANAGING RETAINED RISK OF SUBCONTRACTOR NONPERFORMANCE

Presented by



Todd Rowland
Senior Vice President
Zurich North America



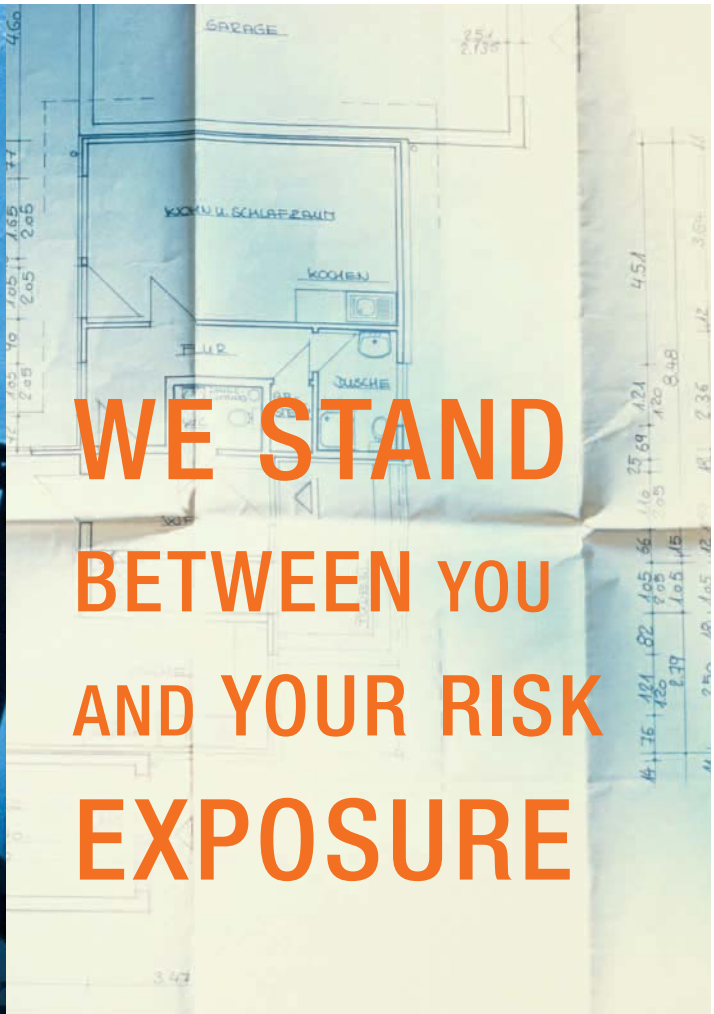
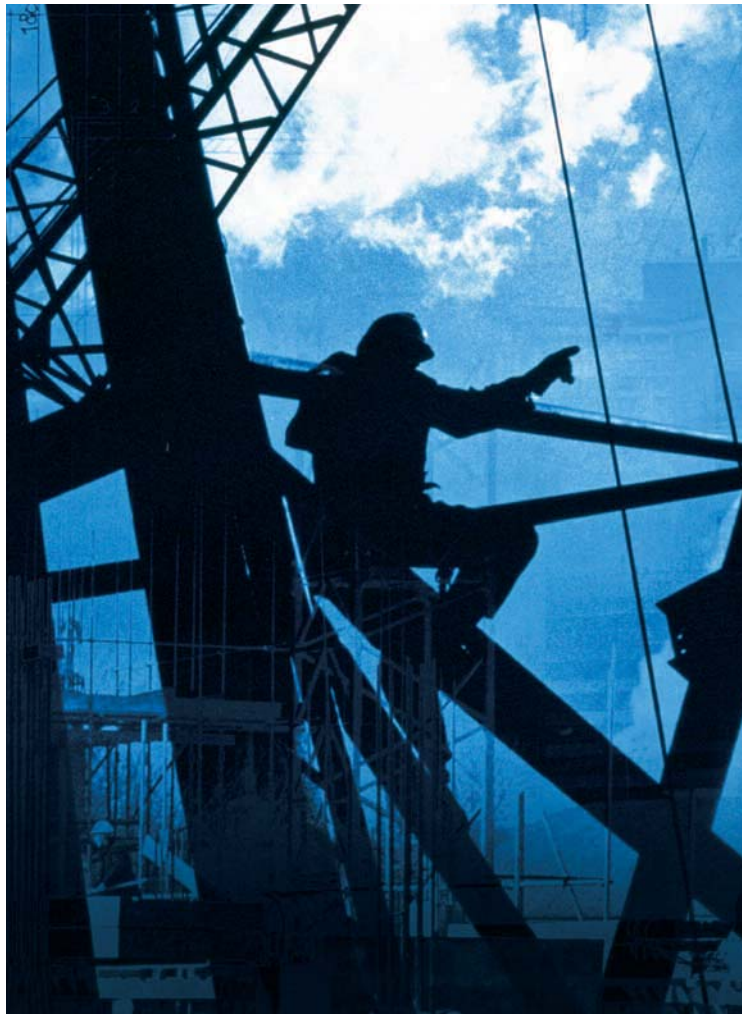
David Hewett
Vice President
Zurich



Chris Beck
Vice President
Turner Construction
Company

Performance bonds and subguard are two methods for mitigating the financial impact of subcontractor nonperformance. Regardless what method a general contractor uses, it is virtually impossible to transfer all risk arising out of subcontractor defaults. Inability of a subcontractor to obtain a bond, large SIRs included in subguard, and costs not covered by these instruments all result in retained risk for the contractor. This workshop identifies strategies for minimizing this risk.

- Examines the frequency and most common causes of subcontractor nonperformance.
- Reviews methods surety underwriters utilize to evaluate a subcontractor's financial position.
- Provides technical strategies for prequalifying subcontractors and mitigating the risk of nonperformance.



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Todd Rowland
Senior Vice President
Zurich North America

Mr. Rowland is one of the presenters for Workshop W9, "Managing Retained Risk of Subcontractor Nonperformance," on Wednesday afternoon. As Senior Vice President—Construction Specialty Products and Services, he is responsible for directing underwriting and services for Construction Specialty Products, including Subguard, Project Risk, Homebuilder's Protective, Professional Liability, and Alternative Risk Transfer, for Zurich North America's Construction Business Unit. During his 30-year career, Mr. Rowland has had diverse experience in the engineering, construction, and insurance industries in the roles of profit center management, risk management, construction management, labor relations and safety, and insurance underwriting management.

He came to Zurich from Ulico Insurance Group's construction operation where he was Senior Vice President. Prior to joining Ulico, Mr. Rowland spent 4 years with the Brand Companies, a specialty contracting subsidiary of Waste Management International, where he served in several capacities including Business Unit President. He spent 16 years prior to that with the Bechtel Companies assigned to various domestic job sites and regional offices, where he performed increasingly responsible duties, culminating with an assignment as a business unit Operations Vice President.

Mr. Rowland attended California State University and Butte College where he studied Public Administration and Fire Engineering Technology. He was a member of a U.S. Department of Energy Benchmarking Task Force, a national management trustee for the Laborers and Employers Cooperation and Education Trust, a founding board member of the Environmental Management Employers' Association, and a former Vice Chairman of the Texas Safety Association. He is a current member of the Construction Financial Management Association, National Association of General Contractors Risk Management Steering Committee, and the Construction Industry Institute Board of Advisors. He is also an active participant in Stanford University's Collaboratory for Research on Global Projects.

David Hewett
Vice President
Zurich

Mr. Hewett is one of the presenters for Workshop W9, "Managing Retained Risk of Subcontractor Nonperformance," on Wednesday afternoon. He is Vice President of Zurich and is responsible for management of the Contract Surety Core Account Unit, firms with backlogs typically less than \$150 million. He has worked for Zurich since 2003, having been Vice President—Surety for a large regional broker and holding various home office and field positions with a major surety.

Mr. Hewett is a member of the Associated General Contractors of America (AGC) as well as active in the National Association of Surety Bond Producers (NASBP), CFMA, and the Surety and Fidelity Association of America (SFAA).

Mr. Hewett received his B.S. in Business from Indiana University and obtained an M.S. in Finance from Johns Hopkins University.

Chris Beck
Vice President
Turner Construction Company

Mr. Beck is one of the presenters for Workshop W9, "Managing Retained Risk of Subcontractor Nonperformance," on Wednesday afternoon. As Vice President & Business Manager, he is responsible for coordinating Turner Construction Company's risk management group, Turner Casualty and Surety, with Turner's operational business units across the nation. The Casualty and Surety division is responsible for traditional insurance and bonding programs as well as Turner's Contractor Controlled Insurance Program (CCIP) and Subcontractor Default Insurance Program (SDI). All claims, litigation (both insured and noninsured), and safety are overseen by the professional staff of the Casualty and Surety group.

Prior to his current role, Mr. Beck held various positions on the construction operations side of the business such as Manager of Interiors, Purchasing Manager, and Project Superintendent. He holds a Bachelor of Science degree in Civil Engineering from Lafayette College.

Managing Retained Risk of Subcontractor Nonperformance

IRMI Construction Risk Conference
October 31, 2007
Orlando



Workshop W9

Managing the retained risk of subcontractor nonperformance—Panelists

<p>Todd Rowland Senior Vice President, Construction Zurich North America Commercial</p>	<p>What are the issues?</p>
<p>David Hewett Vice President, Surety Zurich North America Commercial</p>	<p>Assessing a subcontractor's financial strength</p>
<p>Chris Beck Vice President, Risk Management Turner Construction Company</p>	<p>Mitigating subcontractor default</p>

Managing the retained risk of subcontractor nonperformance—Default truisms

- Subcontractors perform 85 percent to 90 percent of all the work on general building projects.
- Past experience tells us that some of these subcontractors **will** default.
- These defaults will cost the general contractor more than was budgeted for the work.

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Managing the retained risk of subcontractor nonperformance—Contractor failures

- According to *BizMiner*, only 649,602 of the 850,029 contractors in business in 2004 were still in business in 2006, a failure rate of 23.6%
- For contractors in business for less than one year, the failure rate is 36.8%
- According to the SFAA, sureties have paid more than \$10 billion in contract bond claims in 1992, and the incurred amount between 2000 and 2005 is \$12.5 billion.

Failure rates	
Contractor Type	2004–2006
Trade contractors	24.4%
Heavy highway	21.6%
Nonresidential buildings	17.5%
Industrial	14.6%

Source: *Bizminer*

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Managing the retained risk of subcontractor nonperformance—Direct loss costs

- The actual costs of completing the work of a defaulted subcontractor
- Average surety bond loss is 40 percent of the contract value
- Full penal sum losses are not unusual
- Average subcontract cost of a defaulted subcontract is 175 percent of the original subcontract under Subguard®

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Managing the retained risk of subcontractor nonperformance—Impacts other than direct costs

- Delay cost—critical path activities
- Loss of productivity from impacted subs
- Supplementary cash flow interest charges
- Unabsorbed home office overhead—general and subs
- Lost opportunity cost
- Reputation cost

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Managing the retained risk of subcontractor nonperformance—Loss lessons

- In the aggregate loss dollars paid out in Subguard® claims,
 - 15 percent due to inadequate prequalification
 - 75 percent due to inadequate subcontractor management
 - 10 percent due to inadequate management of the default process

Managing the retained risk of subcontractor nonperformance—Causes of default

- Cash flows—collections
- Unrealistic growth
- Business change
 - Type of work
 - Project size
 - Geography
 - Ownership changes
 - Staff turnover
- Mismanagement of bank line
- Mismanagement of the work—poor project controls

Managing the retained risk of subcontractor nonperformance—Risk management alternatives

Alternative	Issues
<ul style="list-style-type: none"> Bond your subcontractors 	<ul style="list-style-type: none"> Not all subs can obtain a bond All costs may not be covered Financial rating of the surety Fraudulent bonds (http://www.surety.org)
<ul style="list-style-type: none"> Implement Subguard® 	<ul style="list-style-type: none"> Large deductibles may apply In-house prequalification Works better for large GCs Best on non-public work Some coverage limitations
<ul style="list-style-type: none"> Self-insure subcontractor performance risk 	<ul style="list-style-type: none"> No balance sheet protection No technical guidance for sureties or insurers Betting on perfection Funding the occasional default

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Managing the retained risk of subcontractor nonperformance—What else can a GC do?

- Don't look to risk transfer alternatives as a panacea
- Prequalify your subs financially and technically
- Manage your subs financially and technically
- Expect defaults
 - Plan for them
 - Manage them
 - Mitigate them when they occur

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Assessing Subcontractor Financial Strength and PML

David Hewett
Surety



Surety loss mitigation strategy

How do sureties approach client/risk decisions?

- Contract surety—account-driven relationship business
- Client selection—first and most important element in the process.
- Review of accounts—based on three areas of focus (three Cs); all are integral parts of the underwriting process and developing PMLs.
 - **Capital**—Financial statement composition, financial analysis, liquidity, historic profitability and cash flow. With privately held companies, ownership transition remains a focus, with the key of capital retention as ownership transitions.
 - **Capacity**—The ability of the firm to complete the type and size of work undertaken, including historical job experience and project risk assessment. The qualifications of the management team in place as well as management support.
 - **Character**—Organization management team, integrity, honesty, reputation.
- Surety underwriting—an active process, including continual review of financial information and project review.

Capital—Key financial information for review

- Key aspects for review
 - Working capital composition
 - The amount of working capital not from cash, accounts receivable and retainage, i.e. underbillings, affiliate receivables, claims
 - Liability measures
 - The amount of interest bearing debt to net worth; should not exceed 1:1
 - The amount of short-term bank borrowing. Any covenant violations?
 - Work in process
 - The ability to successfully complete projects as good as or better than originally projected
 - Profitability on the type of work performed

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Capital—Key financial information for review

- Analysis of the financial information
 - Obtain an analyzed working capital figure. Defer slower turning assets such as hung receivables, claims, etc.
 - Obtain an analyzed net worth figure. Remove officer and/or affiliate notes that will not be collected.
- Red flags
 - Operating losses two out of the last three years
 - Debt/net worth > 4:1
 - Working capital less than 3 percent of work on hand (should be closer to 10 percent for a subcontractor)
 - Net worth less than 5 percent of work on hand (should be over 10 percent for a subcontractor)

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Capacity—Experience/character

- Character
 - Prior bankruptcies?
 - Performance issues in the past?
 - Prior surety losses?
 - Sit down and assess the organization and the people
- Capacity
 - Being pushed more today than at any time in the recent past
 - Do they have access to the labor needed to complete the project?
 - Do they have the experience to manage this project as well as other projects ongoing?
 - Do they have the internal cost systems to manage the work on hand?
 - Does management have a strong risk review program?

Introduction to Probable Maximum Loss (PML)

- Most sureties measure their outstanding liability on an account by the contractor's uncompleted portion (cost to complete) of bonded projects.
- The surety then determines, based on certain key factors and guidelines, what their projected PML may be in the event of contractor failure.
- The resultant PML figure, which is a percentage of the contractor's uncompleted bonded work, is then quantified in dollars.

Industry segment—work on hand

- 1 General Contractor - Building
- 2 General Contractor - Other
- 3 Heavy/Highway - Road
- 4 Heavy/Highway - Other
- 5 **Sub-Contractor - Building**
- 6 Developers/Sub-division
- 7 Other/Specialty

	Type of Contractor							Totals
	1	2	3	4	5	6	7	
Industry Counts	250	50	47	62	127	5	83	624

Average Actual Loss As % of Limit

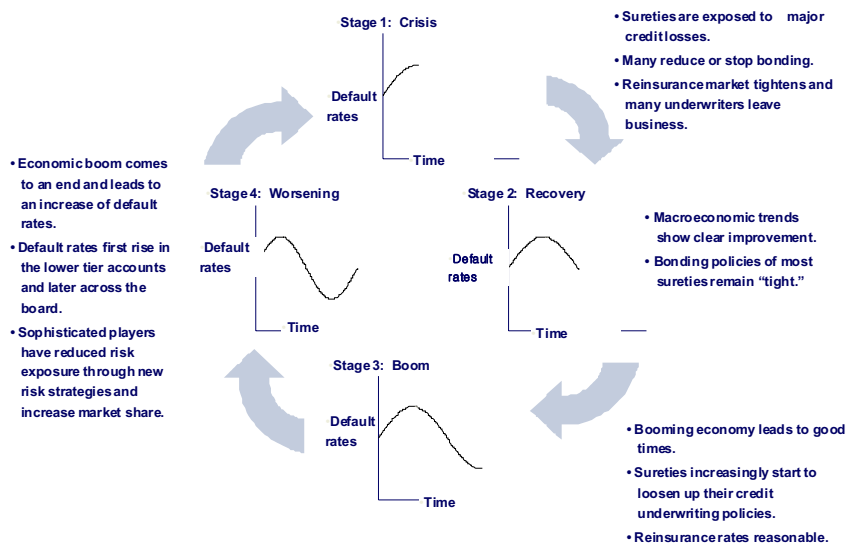
Work On Hand	Type of Contractor							Total
	1	2	3	4	5	6	7	
0 to 1.0M	859%	386%	125%	3348%	1834%	222%	559%	1141%
1.0M to 2.5M	80%	60%	86%	62%	90%	31%	54%	76%
2.5M to 5M	55%	73%	63%	48%	63%		56%	59%
5M to 10M	40%	44%	36%	189%	46%		45%	45%
10M to 25M	65%	62%	32%	28%	39%		55%	54%
25M to 50M	25%		24%	58%	38%		46%	31%
Over 50M	19%	51%	68%	15%	37%	26%	15%	28%
Totals	251%	150%	63%	181%	846%	145%	258%	505%

Zurich Surety's average claim is 67% to 75% lower than the industry average.

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Stages of the surety cycle



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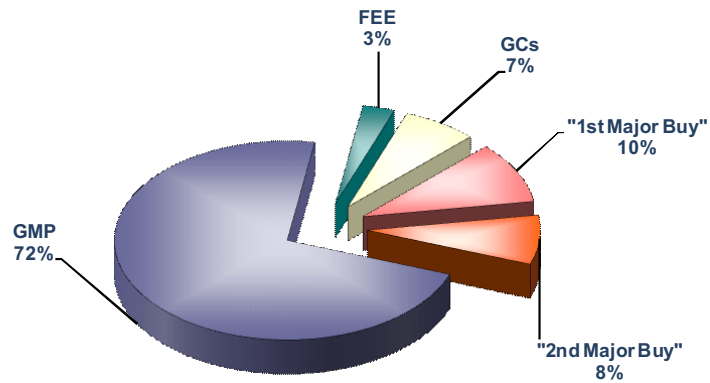
MITIGATING SUBCONTRACTOR DEFAULT

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Chris Beck

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Typical Deal



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Subcontractor Selection—Criteria

- Bondability
- Financial Strength
- Experience
- Safety
- Workscope
- Right Number
- Location
- Senior Management Commitment/Relationship

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Subcontractor Selection—Metrics

- Financial
 - ◆ Ratio (CA/CL) > 1.5
 - ◆ Leverage (TL/E) < 2.5
 - ◆ Subcontract Value < 25% Annual Volume

- Safety
 - ◆ EMR < 1.0

- Proposal
 - ◆ Within 5% of the Pack

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Apply These Principles by Looking in the Mirror

- It all starts with **Purchasing**.
- Followed by a **Risk Management Plan**.
- And ends with **Execution** by all team members.

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Signs of Trouble

- Unpaid Sub Tiers
- Unpaid Benefits
- Unsigned Payroll Checks
- Equipment Leaving Job
- Family Business/Management Change
- Defective Work

= **DEFAULT** = **CLAIM**

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Dragging the Wounded

- Analyze Impact of Replacement Sub
 - ◆ Time/Money?
 - ◆ Is it Cheaper to Drag the Wounded?
- Assign Superintendent to Run Trade
- Dual—Checks
- Supplement Crew
- 3rd Party Quality Inspection

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Default Equates to.....

- Cost Impact
- Time Impact
- Subcontractor Cross-Claims
- Increased Staff Time

= *NEGATIVE IMPACT TO BOTTOM LINE !!!*

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