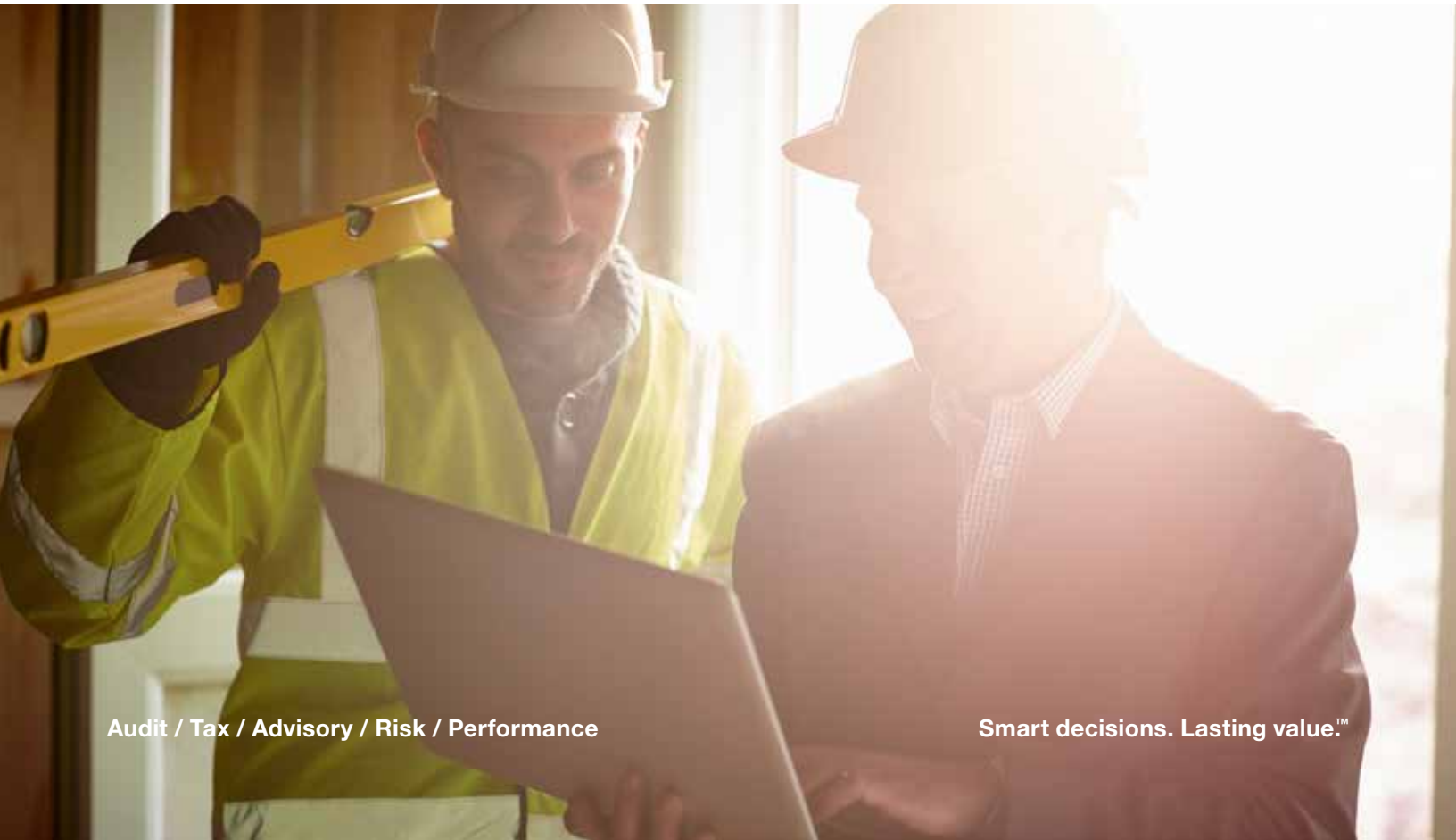


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# The Three C's of Maximum Construction Bonding Capacity

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Across much of the United States, construction projects involving medical facilities, renewable energy infrastructure, schools, and mixed-use properties are on the rise.

Combined with the pressing need for federal infrastructure work and the increasing popularity of public and private partnerships for civil projects, this activity means contractors are poised to take advantage of many opportunities. To best capitalize on such opportunities, contractors need to maximize their bonding capacities.

Regardless of the type of construction project, contractors can improve their capacity by paying close attention to the three “C’s” of bonding: character, capital, and completion.

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# 1. Character

Character refers to the contractor's reputation in the market, and it is a key factor in determining a contractor's bonding capacity. Several factors come into play when ascertaining character:

## **Management Involvement**

How invested are the construction company owners in the business? Are they active in industry organizations such as Associated Builders and Contractors (ABC), the Construction Financial Management Association (CFMA), and Builders Exchange? Do they appear at speaking engagements? Are the owners willing to put cash in the business when needed, or are they passive and interested only in profits? Agents will almost certainly consider these factors when determining capacity.

## **Staff Experience**

Bonding companies prefer companies with experienced estimators and seasoned project managers. When staff demonstrate they have completed (and successful) projects under their belts, bonding companies can trust that the companies have the ability to consistently build their projects in a profitable manner.

## **Systems and Processes**

Contractors should provide their surety bonding agents a transparent look into the companies so they can see firsthand the processes involved in estimating, project management, and accounting. Agents don't want to see that these areas operate in silos. Instead, they want to make sure that the moving parts of a project work together smoothly. For example, agents can be invited to a company's weekly or monthly project meeting to see the team in action. It's also advisable to give surety agents tours of some worksites so they can observe operations and meet the team.

## **Awards**

Contractors should not be shy about their achievements. Awards for safety, craftsmanship, green building, and similar areas show surety agents that a contractor is both serious about its work and recognized within the industry. Awards help build a good reputation, and a good reputation is what an agent wants to see.

## **People Skills**

The charisma of the person dealing with the surety agent should not be underestimated. Bonding is largely built on relationships, so a contractor must have the right person talking to the agent. This person should be able to "sell" the company.

## 2. Capital

Capital is another critical consideration for bonding companies when assessing capacity. They will examine several factors.

### **Debt-to-Equity Ratio**

Bonding companies want to see a debt-to-equity ratio no higher than 2 to 1. In other words, the debt on a contractor's balance sheet should not represent more than twice the equity.

### **Retained Earnings**

High retained earnings demonstrate that the owners do not just take all of the cash out of the business every year but that they are committed to the sustainability of the company through, in part, reinvestment.

### **Backlog**

Backlog is a great thing, but a significant contract backlog could also prove troublesome if deemed too high for the company's size and thus a drain on capital – generally, a backlog equal to 10 to 15 times the equity. Another general rule of thumb is to make sure 10 percent of the largest contract does not exceed 25 percent of retained earnings. Lastly, make sure backlog gross profit covers at least 50 percent of administrative expenses heading into a new fiscal year.

### **Working Capital**

Bonding companies also want to know that they can access liquid assets quickly in the event they must step in and take over a project. Remember that, when assessing working capital, surety agents generally will not consider prepaid or soft assets, such as insurance, sporting event tickets purchased for marketing purposes, and deposits. Hard assets such as cash and accounts receivable are key. Ten percent of the cost to complete open jobs is generally considered sufficient for working capital. At the end of the day, cash is king.

### **Underbillings**

Bonding companies carefully scrutinize underbillings. Underbillings can represent a myriad of problems on a job and can ultimately lead to profit fade. Profit fade can suggest poor estimating skills or unforeseen problems on a project. Habitual profit fade is cause for alarm among bonding companies.

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## Credit

A contractor should have access to credit through a reputable lender. A credit line should be available but not consistently maxed out. Large bank debt can be worrisome, especially for general contractors without the need for large equipment. Such debt is less of a negative for equipment-dependent companies such as heavy highway contractors.

## Financial Decisions

Savvy contractors include their sureties in major financial decisions in order to have everyone on the same page and to avoid unwelcome surprises. Contractors that make serious financial decisions without consulting with their sureties, only to learn their surety company is not happy about it, are likely to see their capacities reduced and their opportunities to bid on new projects diminished. Generally, contractors should inform their sureties in advance about ownership transitions (including owner buyouts and employee stock ownership plan transactions), investment opportunities, and acquisitions, to name a few significant financial decisions.



### 3. Completion

A solid history of successful completion goes a long way toward boosting capacity. Bonding companies obviously prefer firms that boast proven track records of finishing projects on a timely basis. In order to consistently demonstrate such a record, companies must have the consistent resources and expertise on hand. Again, contractors should not be shy or self-deprecating. Instead, they need to highlight their victories such as employee growth numbers and personnel retention rates. When prudent, companies should let the public know about ongoing project size.





## Consider the Big Picture

A solid relationship between contractors and their sureties is a necessity for growth. While no concrete formula to enhance bonding capacity exists, many ingredients, when put together, can provide for significant capacity. Contractors would be wise to fully appreciate the multiple factors that determine bonding decisions. Ultimately, sureties and agents want to help companies achieve their strategic goals – but they have to consider the big picture. Contractors that want to maximize their bonding capacity should do the same.



## Learn More

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