

Surety Outlook 2019: The Peak of the Cycle...

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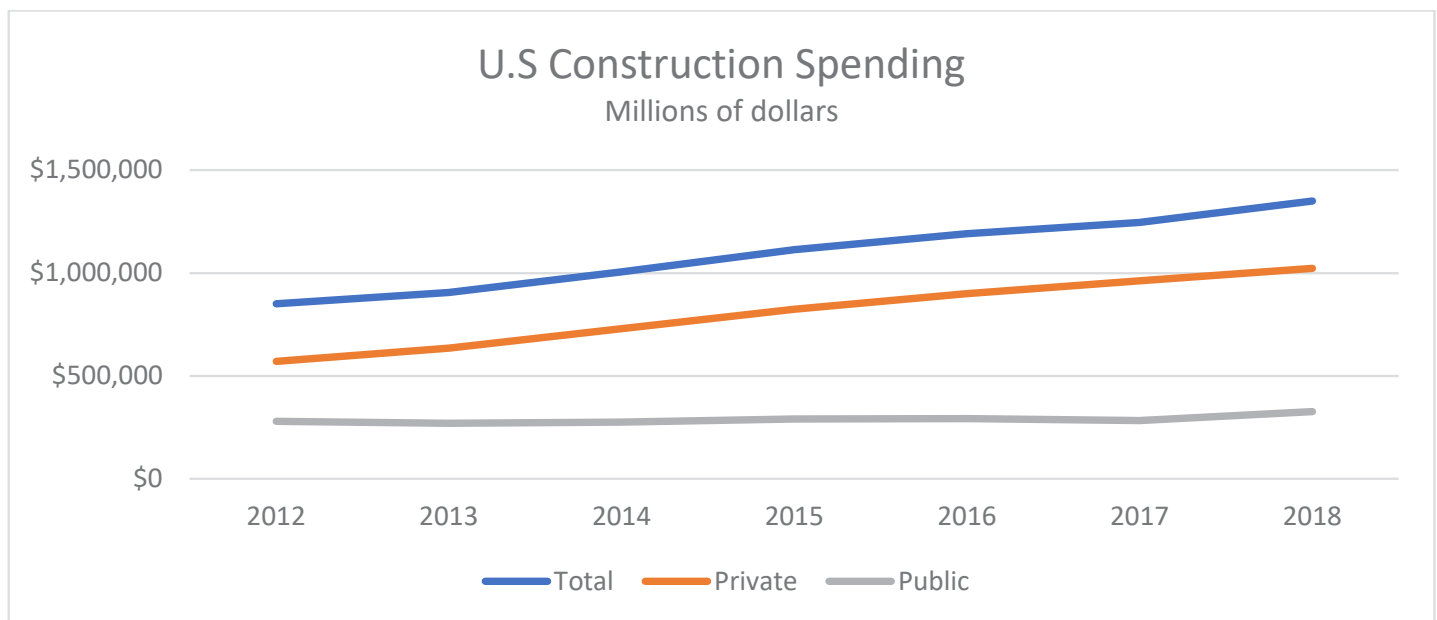
As we close on 2018, the construction and surety industries remain robust and resilient. For most contractors, backlogs are as strong as they have been in over a decade, margins have returned to pre-recession highs, and work is abundant. For Surety companies, profits are at an all-time high, loss margins remain low and demand for bonding, along with total spending in the building industry, continues to grow across the nation.

According to the U.S. Census Bureau, total construction spending in 2017 was \$1.24 trillion and is expected to grow to over \$1.35 trillion by the end of 2018 (**Table 1 below**).

Along with construction spending, the Surety industry's historic results have continued to improve. Since 2012, the direct written premium for the industry has grown from \$5 billion to over \$6.2 billion at the end of 2017, an increase of over 23%. And the industry does not appear to be slowing down any time soon, with projected direct written premiums of over \$6.5 billion in 2018.

The continued results and positive forecast for both underwriters and contractors have many wondering, "When is the market going to reach its boiling point and how do I prepare for the inevitable decline?" Many subcontractors, overextended with work opportunities and thin on resources, have started to show signs of struggling and an increase in defaults. This growing frequency of subcontractor defaults has resulted in some of the industry's largest sureties experiencing significant general contractor failures domestically and internationally.

Table 1



Source: U.S. Census Bureau.

Rather than speculate, surety reinsurers are beginning to institute firmer underwriting compliance standards for front-line sureties. In response, surety underwriters are depending even more on their clients and agents to proactively manage their operation and risks associated with growth in an expanding economy. “Best-in-class” contractors are using the market’s positive growth and outlook to focus on what they do best and intelligently grow their backlogs, rather than over extending themselves by taking on work far outside their abilities and capacity. As growth continues, three main questions continue to be at the top of all contractors’ and underwriters’ minds: Labor shortages, material costs, and governmental policies.

Continuing Labor Shortages

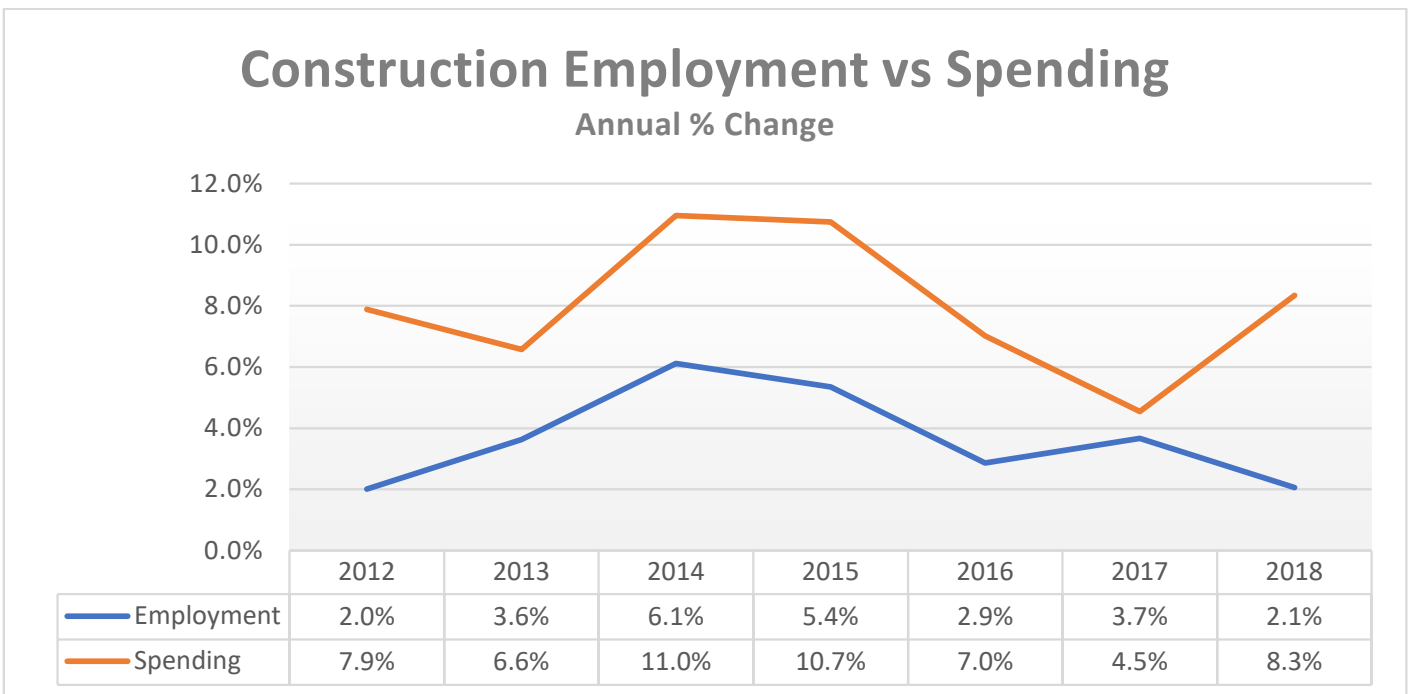
The ability to attract and retain skilled labor is the number one concern of general contractors, sub-contractors, suppliers, and vendors, whether union or non-union. Although the quantity of skilled labor has increased in recent years, it has not kept up with the increase in construction spending. As a result, the industry is experiencing one of the largest

labor shortages in history.

The 2008 recession saw backlogs shrink, and contractors were focused on managing overhead and ensuring sustainability. To survive, many had to make difficult decisions to lay off key employees, opting to keep only the most vital roles filled. Many of the employees who were laid off were unable to find work and forced to retire or seek employment in other industries. At that time, training and developing the construction industry’s future work force and leaders were non-existent. In addition, high schoolers became more focused on four-year college placement as opposed to joining the workforce immediately upon graduation or learning a trade.

Today’s contractors are feeling the long-term effects of this mass exodus in the construction labor market and, now with demand at an all-time high, contractors simply don’t have the supply of skilled labor to match the need. The year 2018 marked that largest gap in growth between new construction employment and construction spending since post-recession. (**Table 2 below**)

Table 2



Source: U.S. Census Bureau & Bureau of Labor Statistics

To meet demand, many companies are hiring new employees who might not have the experience needed, or simply don't meet the company's culture and standards for employment. Regardless, these new employees are needed to ensure that companies can take advantage of the current market and meet their growth plans. This is a principle issue, and continues to emphasize the importance of partnering with or employing a high-level human resources professional who not only can ensure you are hiring the right employees, but also ensure these employees are retained and developed into future leaders in their respective fields.

To sustain the construction marketplace and ensure growth as an industry, it's up to business owners to hire and develop the right talent. If companies fail to do this, the industry could experience a wave of subpar construction that could have significant and potential long-term consequences.

Rising Material Costs

The cost of materials has always been a key concern for contractors, but in today's market it seems to carry even more weight. Even without rising tariffs, material costs have increased significantly over the past 12-24 months. (**Table 3, below**)

Securing material and trade buy-outs, post project award, has become vitally critical to the economic

success of contractors. In a rising material cost environment, contractors that have not properly guaranteed project costs, from bidding through execution of work, have not only experienced a slippage of profits, but often a net loss of overall operations. Once a contract is in place and the project has begun, contractors have little to no ability to bill material cost escalations to a job. Proactively managing material costs and anticipating changes can have a significant impact on the success and profitability of a contractor.

Proactively managing cost means being able to anticipate increases in the price indexes and having a comprehensive understanding of specific contract terms and conditions. For example, "Buy American" provisions continue to become more common in construction contracts. These provisions usually require that a minimum amount of materials on a contract be purchased in the United States, which in some cases can increase the cost of a project dramatically. The purpose of these provisions is to help stimulate domestic material supply. In most cases, however, the provision actually increases costs and puts additional stress on domestic vendors and suppliers.

To manage these risks, "best-in-class" contractors lock in fixed prices with their vendors and suppliers before starting projects, thereby avoiding the uncertainty of the future costs of materials. Maintaining good relationships with your vendors, suppliers and

Table 3
Key Construction Material Costs

	PPI 12 months % Change (Sept. 2016-2017)	PPI 12 months % Change (Sept. 2017-2018)	PPI 24 months Total % Change
Diesel Fuel	25%	29%	54%
Steel Mill Products	8%	18%	26%
Aluminum Mill Shapes	12%	11%	23%
Copper & Brass Mill Shapes	29%	-9%	20%
Paving Mixtures	0%	11%	11%
Gypsum Products	8%	8%	16%
Lumber & Plywood	7%	6%	13%
Ready-Mixed Concrete	3%	4%	7%

Source: Bureau of Labor Statistics

trades continues to be critical to success. In addition, as contracts become more and more onerous, it remains important to negotiate ideal payment terms with both owners and general contractors. For example, billing for materials upon purchase and storing them onsite or in a secured location allows the contractor to be paid upfront for the purchase as opposed to upon install. This allows the contractor to manage cashflow more effectively and sustain its profit margin throughout the job.

Governmental Policies

Like most businesses, the construction industry is significantly affected by monetary and regulatory policies. Today's rising interest rates will have a major monetary impact on contractors. The Federal Reserve has strategically kept interest rates at historic lows, stimulating investment in our economy, which has resulted in a significant increase in residential and non-residential construction. However, as the Federal Reserve has been systemically increasing the interest rate, we can expect to see a tightening in construction lending from banks and a decrease in overall investment. This will have a direct negative impact initially on residential projects then on commercial construction and overall spending in the building industry.

Although we might see a decrease in the private construction spending as interest rates increase in 2019, there should be a flow of infrastructure spending under the Trump administration's infrastructure plan to help support growth in the public sector.

To prepare for the rising interest rates, companies should continue to be aggressive with their lenders by locking in low rates now, aggressively paying down interest-bearing debt and avoiding the use of operating lines of credit. As always, "cash is king" in the construction industry. The ability to finance costs and retain liquid paying power will continue to be one of the most important factors in the success and growth of a contractor.

2019 Risk Management Seminar Series



Conducting a Thorough Accident Investigation

Wednesday, January 9th - Downtown
Wednesday, January 16th - North County
7:30am Registration
8:00am - 10:00am Program

Performance Management for Supervisors

Wednesday, February 6th - Downtown
Wednesday, February 13th - North County
7:30am Registration
8:00am - 10:00am Program

This year we are offering certain seminars in our North County office (5857 Owens Ave., Suite 300, Carlsbad, 92008).

To register, click on the 'register now' button in the announcement email, or contact Bethany Mongold at Mongold@cavignac.com or call 619-234-6848.

In 2019, most contractors will start to experience a wave of impacts on the regularity influence of the new revenue recognition requirements of the American Institute of Certified Public Accountants (AICPA). On May 28, 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. According to the AICPA, the standard will eliminate the transaction and industry-specific revenue recognition guidance under current U.S. GAAP and replace it with a global principle-based approach to determining revenue recognition. This standard has the potential to affect every entity's day-to-day accounting and, possibly, the way business is executed through contracts.

While public firms must already be compliant, private firms are required to start reporting their revenue compliant with ASC 606 starting 1Q 2019. The challenges are many, particularly for construction businesses -- from setting up the right performance obligation contracts, handling one-time set up costs to factoring in costs of acquiring and tracking contracts. Not only the direct and indirect costs associated with complying with the new standards will be a challenge, but credit relationships with both sureties and lenders will be tested. Producing CPA financial statements in 2019 will not be as easy as in the past. As a result, it is anticipated that contractors will experience both longer times needed to produce conforming and reliable statements and that contractors will need to be prepared to positively explain the changes to their credit partners.

Conclusion

The construction market is cyclical in nature, and the current upswing will not last forever. Yet, in spite of the fact that the market has been experiencing the longest expansion in history, there is little to suggest that the end is near. This past year has seen strong growth in construction despite a weakening labor pool, increasing material costs, and uncertainty surrounding governmental policies.

Many factors will continue to obstruct the construction industry in 2019 and beyond. However, wise contractors will continue to capture acceptable profit margins by proactively growing, developing and managing an appropriate level of highly skilled work force while driving the continuous improvement of "best-in-class" operating, accounting and cash management performance standards. ■



Spotlight On



Cavnac & Associates is proud to support local and non-profit civic organizations, including Ride Above Disability



Ride Above Disability Therapeutic Riding Center is a place that teaches recreational riding to children and adults of all ages with special needs. The idea was to create a place where the entire family unit could come and feel welcome, relax and enjoy their time at the ranch. While special needs riders are our focus, we also teach siblings and parents who are interested, which gives our families an activity they can share together.



RIDE ABOVE DISABILITY
Therapeutic Riding Center

For more information, go to www.radtrc.org

Health and wellness tips for your work and life—
presented by Cavnac & Associates



This One Thing You Use All the Time May be Covered with Flu Bacteria

With peak flu season approaching quickly, you know how important it is to constantly wash your hands and disinfect shared spaces, but there's probably one thing you've been neglecting to disinfect: your cellphone.

Researchers from the University of Arizona found that cellphones carried 10 times more bacteria than most toilet seats. And, what's even more alarming is the fact that cellphones are the perfect vehicle for spreading germs to other people.

That's why it's so important to take the proper steps, like disinfecting your phone daily, using hand sanitizer and practicing good hygiene habits, to keep your phone germ-free this flu season.

Don't Let Cooler Temperatures Derail Your Workout Plan

If you find it harder to keep up with your workout program as the temperatures drop, you're not alone. Every year, many Americans find it increasingly difficult to remain committed to their plan as the holidays, shorter days and less-than-ideal weather create obstacles.

Whether you're a gym-goer or outdoor exerciser, there are simple ways you can overcome the winter obstacles and stay on track with your workout plan.

- **Acclimate to colder weather by warming up inside.** If you're an outdoor exerciser, try doing your warmup inside. By doing so, you'll raise your body temperature and already be warm before you step outside.
- **Prep for your next day the night before.** If you're an early morning gym-goer, try getting everything you need for the next day together the night before. This way, all you need to do when your alarm goes off is get up, get dressed and go to the gym.
- **Have a backup plan.** Even the most dedicated exercisers will lose their motivation. That's why it's essential to have a backup workout plan that you can do at home. It doesn't have to be lengthy, doing something is better than doing nothing at all. Aim to have three or four full-body workouts ready for when you need them.

Crunchy Potato Casserole

2 cups corn flakes (crushed)
2 pounds potatoes (peeled, grated)
¼ cup butter (melted)
¼ tsp. black pepper
1 onion (chopped)
1 10-ounce can cream of chicken soup
¾ cup fat-free sour cream
1 cup low-fat cheddar cheese (shredded)

PREPARATIONS

1. Heat oven to 350 F.
2. Combine potatoes, butter and black pepper in a large bowl.
3. Add onion, soup, sour cream and cheese. Mix well.
4. Pour mixture into a 13-by-9-inch baking dish and sprinkle with corn flake crumbs.
5. Bake for 45 minutes.

Makes: 8 servings

Nutritional Information (per serving)

Total Calories	240
Total Fat	7 g
Protein	8 g
Carbohydrates	35 g
Dietary Fiber	3 g
Saturated Fat	3 g
Sodium	340 mg
Total Sugars	4 g

Source: USDA

3 Ways to Fight Holiday Stress

Holiday stress plagues many Americans every year. Top holiday stressors include staying on a budget, managing multiple commitments and finding the perfect gift. Use these three tips to help keep holiday stress at bay this year.

1. **Create your budget now.** If you're stressed about how your holiday spending will impact you after the holidays are over, you're not alone. Remember, the sentiment of a gift is much more important than the cost. Set a realistic budget and do not go over it.
2. **Shop early.** Sometimes, you can get great deals on presents even before the holiday season hits. Moreover, you can avoid the scenario of not being able to get the gift you want because it's sold out.
3. **Don't overcommit yourself.** Are you planning on hosting a holiday dinner? Are there any holiday parties you have to attend? Do you have to pick up loved ones from the airport? Making a list of your commitments will help you plan your time and help you avoid double-booking yourself.

Don't let stress get in the way of you enjoying your holiday season.

Holiday Budgeting 101

Money is the No. 1 holiday stressor. Budget wisely by following these simple tips:

- Review your shopping list carefully. Does everyone listed truly need a gift?
- Set a maximum dollar limit for each person and stay within that limit.
- Leave the credit cards at home when you go shopping.

