FEATURE

Contractors' Capital Challenges

Satisfying surety bonding requirements, inflation, labor shortfalls, slow technology uptake, workplace safety, and rising interest rates are among the issues.

BY MARY JEANNE ANDERSON

A CONTRACTOR'S CHARACTER, capacity, and capital are the surety's areas of focus when determining whether to provide a performance and payment bond guarantee for a project. These three topics are known in the industry as the "3 Cs of surety underwriting." Of these three, the one that changes on a daily basis is the contractor's financial resources, capital. Managing the capital needed to finance work underway presents significant challenges for contractors. Furthermore, it presents the surety with a complex underwriting scenario that involves looking in a rear-view mirror at the contractor's past financial performance to make projections about future financial needs. If the contractor needs surety bonds on a regular basis, satisfying the surety's concerns regarding capital is just one more challenge in managing capital.

Why does a contractor need capital to run the business? How much capital is needed to run the business and why do sureties place so much emphasis on the liquidity of the capital? In the normal course of business, construction contractors need the ability to finance work based on cost estimates that are calculated before work even begins. Once work commences, contractors must finance the labor and materials for the first month of work before submitting an invoice to the owner for reimbursement of job costs, overhead expenses, and profit. It typically will take another 30 to 60 days for the owner to review the invoice and make payment. Effectively, contractors must have adequate liquid resources to finance several months of work on an ongoing basis until payment is made. Even then, the owner may withhold a percentage of the invoice amount as retainage until the job is substantially completed. Retainage percentages vary and are generally 5% to 10% of the total invoice amount.

The time gap between work performance and collection of payment expands even further for subcontractors who must submit invoices through the general contractor, which adds another layer of approval before the invoice is sent to the owner. Subcontractors often face a period of 60 to 90 days between performing the work and receiving payment. Significant financial changes can occur between the time contractors estimate the cost of the work initially and the time payment is received. Add in the fact that most contractors have numerous projects underway at the same time, and the financial challenges and potential risks are multiplied accordingly.

Funds to finance construction work are needed even when everything goes according to plan, but no job ever runs completely according to plan. This has always been true in the construction industry, but contractors today are facing more risk factors that can disrupt a plan than ever before. To weather these challenges, contractors need a financial buffer that allows them to finance the unexpected, unplanned events that inevitably occur while performing work on a job.

The challenges and risks that follow are universal to contractors today, and each has the potential to affect the contractor's capital negatively if not properly addressed.

Surety Bonding

One financial challenge faced by bonded contractors is satisfying the surety that there are sufficient funds not only to finance the work being undertaken but also to provide a financial buffer to handle the unexpected situations that arise. Contractors tend to be eternal optimists who concern themselves with the challenges of building and not managing finances. However, in addition to confirming that the contractor can build the project, the surety will want assurances that the contractor has considered the financial impact of potential challenges and that there is a liquid buffer to finance these challenges, referred to as "net quick" by most sureties.

Job Materials and Supplies

It is common for contractors to set the price of construction materials in an estimate before a contract is signed and work commences. Contractors have always faced the risk of price fluctuation when estimating material costs for a project because prices can escalate between the time a specific cost is used in the job estimate and the time the materials are purchased and installed. When a contract is a longer-term undertaking of a year or more, there is an even greater risk of price fluctuation due to the extended time frame between the estimate and the purchase of the materials.

Today this risk is elevated due to supply chain delays and global inflation, both of which have been covered extensively by the media. It is not only a question of whether the materials will be available at a specific price, but also whether the materials will be available at all when they are needed. Advanced planning places contractors in a better position to meet these challenges. So how do contractors plan for these challenges?

Contractors should do their research with their owners and suppliers before signing a contract. Contractors may be able to lock in both price and delivery dates with suppliers. Material price fluctuation and delays can be addressed through contract terms as well, creating a shared responsibility for cost differences and supply delays between contractors and owners. While most contractors do not have the funds to purchase all job materials in advance at a time when the prices are known, there may be an avenue that allows contractors to purchase specific supplies in advance, store them on the job site, and receive payment from the owner for the cost of the materials before they are used on the job. This will generally require negotiation with the owner and contract drafting by the attorneys so both parties are protected. Often this approach is taken when there is specialized equipment required for a job, as it assures that the equipment is available when needed for installation. It should be noted that stored materials and equipment may generate specific insurance issues to be investigated with the insurance agent.

Additionally, as suggested in the examples above, contractors should seek the advice of their advisors regarding financial, contractual, and other issues. Contractors’ advisors should include construction-oriented attorneys, insurance agents, bond producers, CPA firms, and sureties, among others. Their experience and advice could mean the difference between a profitable project or a losing one.

SIGNIFICANT FINANCIAL CHANGES CAN OCCUR BETWEEN THE TIME CONTRACTORS ESTIMATE THE COST OF THE WORK INITIALLY AND THE TIME PAYMENT IS RECEIVED. ADD IN THE FACT THAT MOST CONTRACTORS HAVE NUMEROUS PROJECTS UNDERWAY AT THE SAME TIME, AND THE FINANCIAL CHALLENGES AND POTENTIAL RISKS ARE MULTIPLIED ACCORDINGLY.

Labor

Contractors are struggling to fill the void being left behind by the baby boom generation exiting the marketplace and the industry experience and expertise that has been lost as a result. Five years ago, a 2018 study by the Associated General Contractors reported that 78% of U.S. construction firms were struggling to find qualified employees,[1] which was before the COVID pandemic shutdown or the threat of a looming recession. In AGC's 2022 survey, 93% of construction firms report they have open positions and 91% are having trouble filling at least some of those positions, particularly among the craft workforce that performs the bulk of onsite construction work.[2]

Contractors recognize this is a major problem and are taking steps to resolve this crisis primarily by increasing the appeal of working in the construction industry. Options used include increasing base pay, providing performance-based incentives or bonuses, and offering enhanced benefits; but these do not address the fact that available candidates lack the skills needed to work in construction. The AGC reports that one of the main reasons labor shortages are so severe is that most job candidates are not qualified to work in the industry or cannot pass a drug test.[3] To combat this in part, some contractors are developing training programs to train workers and to enhance their skills; but training is not a substitute for years of experience in the field. Of necessity, contractors are putting additional cost into their estimates to allow for workforce deficiencies that may affect job estimates, project scheduling, or both.

A secondary workforce challenge for general contractors is the subcontractor who may not be able to staff its portion of the work with enough skilled workers to complete the work on time. Subcontractor performance issues can quickly mushroom into time delays and cost escalations. One easy solution to this challenge is to ask for surety bonds from the subcontractors and to rely on the bonding company to prequalify the subcontractor's ability to perform and respond if there is a default under the bond. Bonded subcontracts can provide excellent protection to concerned contractors.

Technology

The construction industry has been historically slow to adopt and use new technology. There are few comprehensive construction systems available, and those that are available are seldom used to the fullest capacity. Many firms continue to stubbornly rely on old methods and technological systems. In that respect, the generational change underway in construction may help resolve this problem as younger, more technology-savvy workers are brought on board.

According to McKinsey & Co., investment in technology for architecture, engineering, and construction has experienced an explosion of investment and a wave of start-up launches with an estimated $50 billion being invested in AEC tech between 2020 to 2022. This amount is 85% higher than the previous three years.[4] Improved construction technology may alleviate the strain caused by workforce shortages or reduce overall costs.

Safety

Workplace safety is a continuing challenge facing the construction industry. Per the Bureau of Labor Statistics (BLS), construction is the second most dangerous industry in the United States for workplace deaths, second only to transportation occupations,[5] and construction laborers have one of the highest rates of injuries and illnesses of all occupations.[6] The inherent danger of the construction industry exacerbates the difficulty faced by contractors in finding and retaining qualified workers. A culture of safety can make a construction firm more attractive to workers.

CONTRACTORS' ADVISORS SHOULD INCLUDE CONSTRUCTION-ORIENTED ATTORNEYS, INSURANCE AGENTS, BOND PRODUCERS, CPA FIRMS, AND SURETIES, AMONG OTHERS.

Cost of Borrowing Money

The Federal Reserve raised interest rates 10 times between March 2020 and June 2023 in response to high inflation concerns. This means that, while contractors are dealing with the higher cost of materials and labor driven by inflationary forces, the cost of borrowing money to finance those items and to acquire fixed assets is now much higher than it was prior to 2022. While it will be more expensive for contractors to borrow money, banks may be reluctant to loan money to contractors, resulting in less favorable terms and conditions on loans. A strong, positive bank relationship is more important for contractors today than it has been in many years.

The higher cost of borrowing money will also affect project owners, particularly private owners who borrow funds to finance their projects. The increased cost of borrowing money may prevent new projects from proceeding, thereby limiting the amount of available projects for contractors. Owners may be less likely to make schedule concessions requested by contractors if the extension requires them to pay more for their financing to grant the additional time. Additionally, an owner may choose to hold on to money longer, delaying payments to the contractor. Slow pay by the owner can mean delays in contractor payment to subcontractors and suppliers, creating a financial ripple effect across the entire project.

Summary

Each decision contractors make has the potential to affect capital. Without adequate capital to finance work, contractors cannot successfully perform contracts. Having a financial buffer to address the myriad challenges facing contractors will help weather the unexpected, and ultimately it can be the difference between success and failure.

Find Out More

Keep in the know about the current challenges faced by contractors by signing up for the free *NASBP SmartBrief* weekly e-newsletter: **www.smartbrief.com/nasbp**. Access NASBP Virtual Seminars on similar topics here: **https://learn.nasbp.org/**.

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End Notes

1 *Seventy-five Percent of Construction Firms Plan to Expand Headcount in 2018, Contractors Are Optimistic About Strong Economy, Tax & Regulatory Cuts, AGC*, **https://www.agc.org/news/2018/01/03/seventy-five-percentconstruction-firms-plan-expand-headcount-2018-contractors-are-0** (last visited Aug. 9, 2019).

2 *Construction Workforce Shortages Risk Undermining Infrastructure Projects As Most Contractors Struggle to Fill Open Positions, AGC*, **https://www.agc.org/news/2022/08/31/construction-workforce-shortages-risk-undermining-infrastructure-projects-most-contractors-struggle-0**.

3 *Id*.

4 Jose Luis Bianco, et al., *From Start-up to Scale-up: Accelerating Growth in Construction Technology*, McKinsey & Co. (May 3, 2023), **https://www.mckinsey.com/industries/privateequity-and-principal-investors/our-insights/from-start-up-to-scale-up-acceleratinggrowth-in-construction-technology**.

5 U.S. Bureau of Labor Statistics, Table 3: Fatal Occupational Injuries For Selected Occupations, 2017-21 (updated December 16, 2022), **https://www.bls.gov/news.release/cfoi.t03.htm**.

6 U.S. Bureau of Labor Statistics, *Occupational Outlook Handbook, Construction Laborers and Helpers*, **https://www.bls.gov/ooh/constructionand-extraction/construction-laborers-and-helpers.htm?**