Mitigating the Risk of Subcontractor and Supplier Default

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Agenda

- Introduction
- Default Risk in 2013
- Protecting Yourself from Default
  - Qualification
  - Bid Leveling and Buyout Process
  - Performance Security
  - Managing Payments and Lien Risk
  - Risk Management Plans
- Wrap up and Questions
Factors Driving Increased Default Activity

Economic Cycle is different and multifaceted in construction
- Lower lows and higher highs
- Cycle trails general industry by 6-18 months
- Residential vs. Non-Residential (Building vs. Civil)

Downturn of 2008 - 2011 was a time of LOWER default risk
- Most GCs and subs carried large, high margin backlogs out of the boom
- Took on new work on low margins but had strong cash positions
- Bid prices dropped rapidly – replacing a defaulted contractor sometimes involved a profit!!!

“Recovery” of 2011 - Today
- “The Marginless Recovery”
- Culling of the heard
  - Strong → Stable
  - Stable → Weak
  - Weak → Bankrupt
  - “Fade Away”
Why and How to Qualify Subcontractors

Qualification can lead to better decisions

- Avoid buying out subcontractors likely to default
- Understand who you are doing business with
- More transparency into purchasing decisions
- Build risk management plans around weaker subcontractors
- Manage aggregate risk to subcontractors and suppliers

Things to consider in a qualification program

- Pre-Award, Pre-Bid, Ongoing
- Centralized/Decentralized
- Subcontractor’s perspective
- 80/20 Rule
- Technology and outsourcing
- Gathering information or reviewing it?
Qualification in Construction Today

General Contractors

Subcontractors
Challenges with Qualifying Subcontractors

- Qualification is not yet accepted in construction
- Getting subcontractors on board
- Keeping the database current
- Resources are limited
Building a Qualification Program

Some of the main aspects of a successful qualification program:

- Program **mission statement** and goal development
- High level program design (pre-award, pre-bid or ongoing; centralized/decentralized review, etc.)
- **Communication planning** and execution (internal and external)
- Detailed program and **form design**
- Subcontractor **onboarding**
- Monitoring & Evaluation
- Periodic **redesign** and redevelopment
Performance Security

Owner Options
- Bid bonds
- Performance and payment bond
- Parent company guarantee
- Letter of credit

GC Options
- Subcontractor bonds
- Subguard®/SDI
- Letter of Credit
- Personal Guarantee/Indemnity
- Owner indemnity
- Lien rights (upstream)

Subcontractor Options
- Material supply bonds
- Lower tier sub bonds
- Lien rights (upstream)
Bid Solicitation, Leveling and Analysis

- Getting enough bidders but not too many
- Bidder de-scoping best practices
  - When
  - How

Selection and Awarding Work

- Lowest vs. best value
- “Just in time” qualification
- Letters of Intent

Contracting

- Standard Terms
- Scope of Work
- Before you start…
Managing Payment Risk

Risk exists on all sides of the construction invoicing and payment process
- Over and underpayment risk at all levels
- General lack of transparency
- (Archaic) exchange of paper documents for paper checks

Getting it wrong can be catastrophic
- Overpayment to a subcontractor who defaults
- Owner or GC bankruptcy leave unsecured creditors
- Fraud is (unfortunately) common
- Costs of monitoring and compliance are substantial on all sides

The Importance of the Schedule of Values
- Getting enough detail
- Look for front end loading and overloading specific items
- Agreeing to an SOV and signing it off

SOV and Payment Applications
- PMs role vs. Superintendent
- Communication
- Reviewing the monthly pay application
- The pencil copy and revisions
Technology Can Help Manage Payments and Reduce Risk

What services are available?
- Business process consulting
- Software service provider sales or implementation services

What Technology is out there?
- Document imaging
- Electronic invoicing
- Electronic payment systems
- E-signatures
- Multisystem integration

How do you chose technology?
- Your needs and your attitudes
- Point solution vs. industry solution
- Installed software vs. SaaS

Calculating your return on investment

Managing your IT implementation
- Including key stakeholders
- Understanding implementation costs vs. maintenance costs
- Don’t buy just because they are selling
- Buying technology AND support
Risk Management Plans

What is a Risk Management Plan?

Downstream RM Plan
- Security (Bond, LC, PCG, PI, OI)
- Payment Management
  - Additional Retention
  - Joint Checks
  - STLW
  - Early Pay/Reduced Retention
- Project Management
  - Additional Supervision
  - Weekly Meetings
  - Weekly/Monthly Schedule Review/Sign of
- Safety Management

Upstream RM Plan
- Actively manage lien rights
- Direct payment from owner/GC
- Reduced retention
If it All Breaks Down...

What happens in 2013 when a sub fails to perform:

And that was the easy part...

DEFAULT and TERMINATE

NOTICE to CURE
... Then Options are Limited

Turning a Default from Gray to Black and White
- Always start with the contract
- Getting commitments in writing
- Notice to cure

Post Default Options
- Default and terminate
- Default and reduce scope
- Default and supplement
- Default and hire workforce/management

Managing Replacement Work
- Time and material vs. lump sum
- Keeping track of costs
- Keeping the project on schedule

Other Considerations
- Performance security and default
- Default and the owner
Summary

- Default risk will be elevated for next 24 months
- All parties are at risk
- Known risk can be better managed than unknown
- Some key steps to reducing risk
  - Qualification program
  - Bid leveling and contracting
  - Performance security
  - Managing payments and cash flow
  - Risk management plans
- Risk is there – Manage it!
Jonathan Halloran
EVP, Client Services

1405 Lake Cook Road
Deerfield IL  60015
(T) 847-235-8415
(C) 773-372-4657
jonathan.halloran@texturacorp.com