

THE BOTTOM LINE



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Advantages to Having An Effective Cash Management System

We recently attended a seminar sponsored by the Construction Financial Management Association (CFMA) that was geared towards Cash Management. Cash Management is a topic that more than ever, everyone should be focused on. This article will touch on several key points that contractors should do to maintain a positive cash management system.

Cash is the lifeblood of the organization. Without cash no business can survive. Cash management involves billing and collecting cash on projects, projecting, controlling, negotiating and utilizing every tool available to bring the best return possible. Many companies have the billing down, however, they do not have a game plan for collecting cash on projects. By establishing a game plan for collecting your cash more efficiently, you can greatly improve your company's bottom line.

A simple question needs to be asked, "What is the benefit of having cash?" Here is a list of just a few of the major advantages that a firm has when it has a better cash management system:

1. Increase profitability through cash discounts
2. Minimize financing needs
3. Improve planned cash outlays for new equipment / tools
4. Reduce risk of financing customers
5. Improve relationships with banks and bonding companies

Many of us are offered discounts from suppliers. This is part of the normal course of business. But how many of us take these discounts? By doing a simple mathematic equation, you will see that taking the industry discount is more cost efficient in most cases. For example, let's say that a supplier offers you a payment plan of 2/10; Net 30. If you were able to pay your supplier within the first 10 days, the return on your investment would be approximately 37%, as opposed to the 2-3% you are currently receiving from your bank. The rate of return is measured as follows:

$$\begin{array}{l} 2\% / 100\% - 2\% \times (360 \text{ days} / 30 \text{ days} - 10 \text{ days}) \\ 2\% / 98\% \quad \times (360 \text{ days} / 20 \text{ days}) \\ .02041 \quad \times 18 \quad = 36.7 \text{ or } 37\% \end{array}$$

Again, most of us do not think about this important factor. But remember this return on investment was for only one order. Think of how many orders you have in a year and you will see that this will quickly help to improve your company's cash flow and Net Income.

Many contractors have large finance charges to worry about. Whether it is equipment loans or interest on the bank line, many contractors are paying more for finance charges that are not necessary. For example, on equipment loans many contractors feel that they are only as powerful as their latest equipment purchase. This is obviously not the case. By working on your cash management system, you can negotiate better deals with the finance company.

I don't know about you, but I believe that banks make enough money. You do not need to give them more by over using your company's bank line. While bonding companies request that every contractor have a bank line, this does not mean that you should be maxed out on it. Bank lines of credit are intended to be like a safety net, used when a requisition is late or when an emergency occurs. By paying down your bank line you will actually improve your firm's bottom line. Remember, the more cash you have means less borrowing, which in turn means less interest, which means an improved bottom line.

Every company looks to purchase major items every couple of years, whether it is new equipment and/or computers for the office. By working on your cash management system, you will be in a better position to put money aside for these big purchases. Similar to parents putting money away for a vacation or a child's education, you must discipline yourself to begin

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"Famous Quotes"

"I would say that the quality of each man's life is the full measure of that man's personal commitment to excellence and to victory—whether it be football, whether it be business, whether it be politics or government."

Vince Lombardi

"You'll always achieve more through movement than meditation."

Gary Halbert

"He who has something to sell and whispers down a well is not apt to make the shiny dollars as he who climbs the tree and hollers."

Robert Collier

"There is no shortcut. Victory lies in overcoming obstacles every day."

Anonymous

The Importance of a Project Cost Breakdown

"A gambler is someone who plays slot machines. I prefer to OWN the slot machines."

Donald Trump

"Leadership is action, not position."

Unknown

"The key to achievement lies in being a How thinker, not an If thinker."

Unknown

"A good scare is worth more than good advice."

Ed Howe

"If you want truly to understand something, try to change it."

Kurt Lewin

"Taxation has made more liars out of the American people than golf."

Will Rogers

"Security is mostly superstition. Life is either a daring adventure or nothing."

Helen Keller

"To know the pains of power, we must go to those who have it; to know its pleasures, we must go to those who seek it; the pains of power are real, its pleasures imaginary."

Charles Caleb Colton

Contractors are often asked to provide a detailed project cost breakdown when submitting a request for bonds. The information provided in a project cost breakdown enables the surety bond underwriter the opportunity to gain a better understanding of the scope of work being bonded as well as to determine if there are any parts of a project that present a greater degree of financial exposure than others. The project cost breakdown helps the surety bond underwriter develop a greater level of comfort, especially when requests for bonds are larger than those previously considered.

The information provided in a project cost breakdown typically consists of labor costs, material costs, subcontract items, and the estimated gross profit percentage. The surety bond underwriter will review the labor cost item to determine if the project is labor intensive. Labor-intensive projects may present a concern particularly if the time allowed for completion is of short duration. Costs associated with labor-intensive projects may be more difficult to control if the project is delayed due to weather, design problems, or disputes between the Owner and other trades.

The material costs that comprise a construction project will reveal whether the bid includes any large material or equipment purchases or whether there are any expensive specialty items in the project. Bond underwriters usually acknowledge that large material and equipment items can be billed for upon delivery, thereby reducing the bonding company and contractor's exposure. The material cost breakdown will also provide an indication as to whether any significant equipment suppliers will be required to provide bonds back to the contractor. Obtaining bonds back from large or specialty equipment suppliers will also reduce the bonding company and contractor's exposure. A detailed project

cost breakdown should also include a list of subcontractor trades and the costs associated with their respective work. The ability to obtain bonds back from subcontractors whose work constitutes a significant portion of the project will increase the bonding company's level of comfort, especially when considering larger requests for bonds. When subcontractors assume a greater portion of the actual work involved in the construction project, the working capital demands for the general contractor are significantly reduced. Subcontractors are required to finance the start-up of their portion of work, thereby freeing up the cash flow of the general contractor requiring the bonds.

The estimated gross profit percentage is also important when providing a detailed cost breakdown on a project. When the project includes estimated gross profit margins in excess of a firm's historical levels or a predetermined number such as 20%, the surety bond underwriter will give additional consideration to the bond request. A significant estimated gross profit percentage tends to serve as a psychological safety net to the bonding company. The large gross profit allowance will not only cover the company's normal overhead and profit margins, but also acts as a funding method to offset potential escalations to costs that were not originally expected prior to the bid.

The detailed cost breakdown will always play a significant role when bond requests are underwritten. The breakdown will allow surety underwriters the opportunity to gain a better understanding of the actual work involved in the project as well as to determine where the financial exposure rests. Although not a guarantee, the cost breakdown will often times prevent a surety from declining a bond request based solely on the dollar size of the project submitted.

Contractor Failures & Bonding Companies' Support

No contractor says before they bid on a project, "This is the job that is going to put me out of business!" All projects begin with optimism and hopes for success. No one plans to fail; yet 10,000 construction firms fail each and every year. So, thousands of companies fail even though the owners of the firms were optimistic about the firms' future results. It is not just the new businesses that fail. More than half of the failures are contractors who had been in business for more than five years! According to the

Associated General Contractors of America, one-half of all construction firms in business today will be out of business six years from now. Bonding Companies are very sensitive to those things that in the past have been characteristic of contractor failures. They include:

- insufficient liquid financial resources,
- large project size increases,
- unfamiliar project owners,
- performing projects that are different in scope,

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Contractor Failures & Bonding Companies' Support

- bad management,
- geographic unfamiliarity,
- no continuity or business succession plan,
- constant litigation.

Some of the above are self-explanatory. We will, however, go into a couple of these in greater detail in this issue.

Insufficient working capital to handle the backlog undertaken. Many of the contractor failures and claims activity that a bonding company experiences are either a direct or an indirect result of insufficient working capital. Let's face it - cash is king. The bonding companies look at the firm's financial management:

- What is the firm's debt to worth ratio? Does the firm have too much debt?
- Analyze the operating expenses. What is the firm's break-even revenue level?
- How is the company's cash flow? Are accounts receivable turning too slow?
- How is the firm, and in many cases, its principals' individual credit reports?
- Are the lines of credit sufficient to handle the backlog undertaken? Is the line of credit available or is it consistently tapped out? Is the firm dependent on the line of credit to survive?

Project size increase. One of the most common elements among contractors that fail is a significant increase in the size of their projects. While contract price is not the sole indicator of project complexity, there is a correlation between the complexity and financial demands of a project and its contract price.

There appears to be a common misconception that if a firm is profitable at certain levels, that same firm can maintain profitability on

larger projects. Larger projects require additional resources, both monetary and human, as well as careful planning, administration and project management. Larger projects have different environments, different labor issues, different complexities, different subcontractor relations, and different cash flow requirements.

Often times with large project requests, we see that this one project takes up most of a Contractor's aggregate bonding program. We, then, have a lack of diversification issue - "all the eggs in one basket". A frequent comment, which is no doubt true, is that it is just as easy to administer a \$10,000,000 project as it is a \$1,000,000 project. While this may be true, there is something to be said for diversification. Depending on the contractor's financial position, handling a number of smaller projects would decrease the chances of one project taking the firm under. A number of different projects usually means that projects will be in different stages, and the firm will not be totally dependent on that one check coming in each month.

Bigger is not necessarily better; richer is better. Remember, it is not the top line (Revenues) that counts; it is the bottom line (Net Income). Listen to your bonding company. They have a view of the "big picture". They want to write bonds; they need to write bonds to stay in business. They are not the enemy; they want you to succeed, to reach your financial goals. You only know one construction firm really well - yours. They know thousands. During these stressful and uncertain times, a contractor would be wise to carefully listen to his/her bonding company.

Advantages to Having An Effective Cash Management System

putting money aside for investments to help your company grow. By working on a cash management system you will be able to prevent financial problems due to financing your subcontractors and/or suppliers. Many times, a requisition is held up for some reason, which might have an adverse effect on your subcontractors. What will happen if your subcontractor approaches you for payment for work performed before you get paid? Can you pay them? Unfortunately for many of us, the answer is no. This leads to delays on projects or subcontractors walking off the project.

Your bonding company and bank are in the business of extending credit. On a yearly and semi-annual basis, your bank and bonding company are looking to assess your receivable collection and if your payables are being paid in a timely manner. By having a positive cash management system, you will see that no matter what kind of market you are in, your bonding limits and bank credit will not be affected.

Like so many contractors have stated in the past, banks are never there when you need them, so be prepared and have your financial strength work to your advantage.

"Force is all-conquering, but its victories are short-lived."

Abraham Lincoln

"Experience shows that success is due less to ability than to zeal. The winner is he who gives himself to his work body and soul."

Charles Buxton

"There are three categories of people in industry—the few who make things happen, the many who watch things happen, and the over-whelming majority who have no idea what happened."

O.A. Battista

"There's no traffic jams on the extra mile."

Unknown

"There's a fine line between eccentrics and geniuses. If you're a little ahead of your time, you're an eccentric, and if you're a little too late, you're a failure, but if you hit it right on the head, they call you a genius."

Thomas J. Watson, Jr.

Top Writers of Surety Bonds In 2001 from The Surety Association of America

Group / Company Name	Direct Premium Written	Direct Losses Incurred	Top 25 from 1995
1) Travelers Property Casualty Corp.	\$446,066,804	\$250,935,139	18
2) The St. Paul Companies	\$375,647,882	\$224,105,697	5
3) Zurich Group	\$268,816,668	\$ 99,324,794	3
4) CNA Surety Corp.	\$259,387,009	\$124,784,562	2
5) *American International Group	\$183,679,675	\$384,455,446	7
6) Safeco Insurance Companies	\$153,684,018	\$ 82,302,298	8
7) Liberty Mutual Group	\$142,983,444	\$234,553,923	15
8) Chubb Group of Insurance Companies	\$136,293,956	\$365,886,872	11
9) ** Fireman's Fund Insurance Companies	\$117,854,491	\$296,078,540	9
10) The Hartford Insurance Group	\$115,471,629	\$ 62,848,809	10
11) Kemper Insurance Companies	\$110,756,123	\$ 85,216,347	21
12) Seneca Insurance Company, Inc.	\$ 70,945,408	\$ 42,587,245	
13) Great American Insurance Companies	\$ 61,447,830	\$ 31,483,129	19
14) NAS Surety Group	\$ 51,649,221	\$ 17,360,832	
15) RLI Insurance Group	\$ 50,245,015	\$ 18,646,892	
Grand Total for All Writers	\$3,397,037,788	\$2,567,733,391	

* In 2001, announced plans to exit surety market for those accounts with less than \$50,000,000 in Corporate Net Worth.

** Exited the surety marketplace. St. Paul acquired the renewal rights to this book of business.

Best Wishes to A Friend and Colleague

Theresa Burke retired on May 31st, 2002. Theresa has been in the surety industry for over 20 years and has closely "bonded" with her clients. As most of you know, Theresa was always there to lend a helping hand to her clients and co-workers. All of us at ACC would like to wish Theresa Burke a very happy retirement. She will be sorely missed.

Letter from the Editorial Staff

This newsletter is designed with our readers in mind. All inquires and ideas regarding this or future newsletters are appreciated. Please send all inquires to me at anthony@esuretybond.com. If you know anyone who you feel would like a copy of our newsletter, please let us know so that we can include them in our mailing list. Please let us know if you would like to receive this newsletter via e-mail.

Disclosure

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