

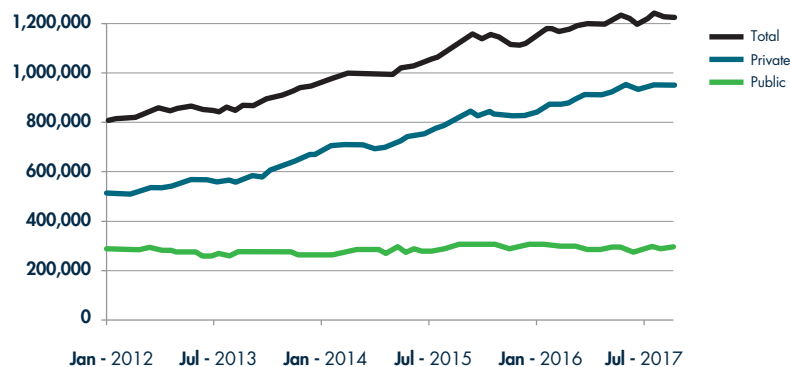
Using Subcontractor Prequalification to Help Mitigate Risk and Increase Success

By Gabriel Valls

The rebounding construction market demands even greater discipline and diligence when considering subcontractors.

Nearly a decade ago, the construction industry suffered an unprecedented loss during the Great Recession. Fast-forward to today: Government figures show that construction spending in 2016 was almost \$1.2 trillion with year-to-date figures projected to be even higher in 2017 (Exhibit 1).¹ Construction employment increased by 16,000 in June 2017,² according to the Bureau of Labor Statistics (BLS). The BLS also calculated that the industry added an average of 20,000 jobs per month between January and May 2017—a 54% increase when compared to gains averaging 13,000 per month in 2016 (see Exhibit 2).³

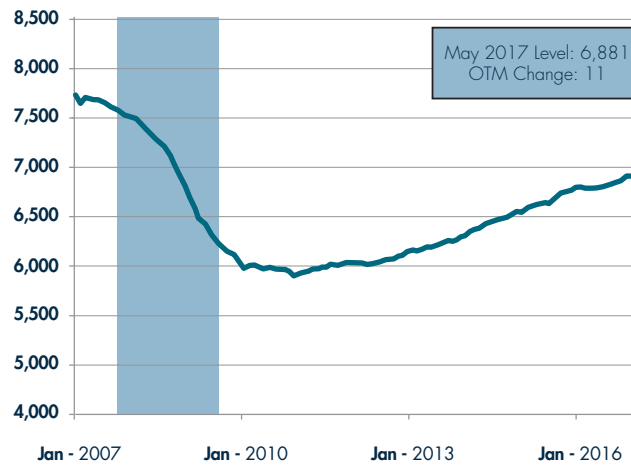
Exhibit 1. Construction Spending
(Seasonally Adjusted Annual Rate) Millions of dollars



Source: U.S. Census Bureau, July 3, 2017

Exhibit 2. Employment in Construction

January 2007 - May 2017 | Seasonally adjusted, in thousands



Source: Bureau of Labor Statistics, Current Employment Statistics survey, June 02, 2017.
 Shaded area represents recession as denoted by the National Bureau of Economic Research.
 Most recent two months of data are preliminary.

On the surface, the forecast looks extremely favorable. Scratch that surface, though, and you'll find an industry pitted by the effects of the Great Recession, with subcontractor default being one of the most visible of the consequences.

In fact, subcontractor default is an even greater risk in robust 2017 than it was during the downturn of 2008. Subcontractor default increases as markets rebound, due in large part to the cash requirements of funding a growing backlog while still grappling with the human capital and financial strains suffered in the down times.⁴

Considering that a single subcontractor's contract can reach well over \$100 million, general contractors that fail to award contracts wisely are putting their companies, their projects and their reputations in jeopardy.

Subcontractor Default Insurance losses today can and have surpassed \$65 million on major projects. For those companies that want to position themselves against default, prequalification can be one of the best leading indicators for success—provided it is done properly and continues to evolve with the changing market.

Growing Pressures in an Evolving Marketplace

Because the pressures to perform and meet budgets are substantial, pursuing due diligence as it pertains to pre-qualification remains a hurdle for many general contractors. The economic rebound has created a lot of work—possibly more work than the industry can comfortably handle on a per head count basis. But right now there's a limited labor pool to match this influx of work. Many construction workers left the industry during the Great Recession, not to return. The Associated General Contractors of America (AGC) analysis of government data reports that although jobs have increased, unfilled job openings continue to affect the industry.⁵ At a time when much of the current, skilled workforce is aging, unskilled or insufficiently trained workers are likely filling many positions.

What's more, owners are pursuing unique, one-of-a-kind projects and may be setting unrealistic design and schedule expectations. The projects are bigger than ever, easily reaching beyond \$1 billion. This puts even more pressure on general contractors, which in turn contractually pushes such pressures onto their subcontractors. What is interesting about this approach is that the organizations least capable of shouldering such financial pressures—the subcontractors—are forced to carry most of the burden.

This is why prequalification must be undertaken with diligence and seamlessly integrated with the general contractor's corporate culture. The old adage of "we have done business with them for years" no longer holds. As the breadth of a general contractor's reach expands into new market sectors and territories, it requires discipline—not a "see what sticks" attitude. Subcontractor red flags and weaknesses are visible to those who take the time to look for them.

Most ENR Top 400 general contractors should be, and probably are, conducting some type of preliminary prequalification work.

In this new, post-Great Recession landscape, the risk of making a poor award decision can result in general contractor bankruptcy. Here are some key questions to consider:

1. Is prequalification part of your organization's culture?
2. Are you a learning organization—one that evolves with the changing market and embraces change?
3. Does senior management embrace the results of prequalification, or will economic and competitive pressures overcome the obvious results of your prequalification?
4. Are you doing what you say you do?

Implementing a rigorous system will not only help streamline the process, but will also make it easier to find subcontractors with whom to create strong working relationships with in the future.

Changing With the Times

Aligning prequalification with due diligence requires an evolving mindset and self-discipline.

Break bad hiring habits. The rebounding construction market is not simply a return to pre-2008 construction levels. It's a new environment with significant and different challenges. A general contractor's behavior must follow suit. "I trust that guy" is not a reason to award a contract. Nor is making "one exception" when the data and due diligence point in a different direction. I have yet to meet a general contractor whose staff does not know when it's taking a gamble on a subcontractor. Going forward, a differentiator will be a general contractor's ability to pause and reconsider making such a decision.

Embrace prequalification as an ongoing initiative. An effective prequalification process should become part of an organization's culture, and it should be pursued consistently. For example, you should continually visit prequalification in the course of an upcoming project, and it should be done for each and every award.

Own the process and evolve for future success. Without a doubt, surety and Subcontractor Default Insurance are significant assets, offering valuable protection in today's high-stakes environment. Subcontractor Default Insurance, for example, has become a product that many general contractors depend on. This insurance product relies on the general contractor to prequalify subcontractors, to help ensure optimal results, and make prudent award decisions based on the subcontractor's proven ability to perform.

Seven Keys for Future Success:

1. Embrace and own the process.
2. Embody a culture of risk management.
3. Become a learning organization.
4. Seek leading indicators for future success.
5. Improve your operations and look for ways to incorporate best practices.
6. Develop a well-defined prequalification program focused on established protocols and individual accountability.
7. Apply lessons learned from past claims experiences to ensure they are not repeated.

Building Upon the Basics

When it comes to prequalification, challenging and enhancing the lens to evaluate subcontractors are very important. Three areas continue to be the focus, each with its attendant issues:

Character:

- What is the reputation of the firm and its principals?
- Has it ever defaulted on a contract?
- Is it in litigation?
- Does it have a strong claims management program?

Capacity:

- Does the subcontractor have a history of successfully completing contracts similar to this one in terms of scope, size, complexity and geographical area?
- What is its current manpower, and is this sufficient for the project under consideration?
- Have the facilities' capacity and maintenance practices been fully evaluated?

Capital:

- What are the quality and accuracy of the subcontractor's financial statements?
- What is the strength of its balance sheet?
- Does it have sufficient equity and liquidity to support the work?
- Does it have a good credit/pay history?
- Does it have an established banking relationship and adequate line of credit?
- Has it been profitable over the past three years?
- Does it have a surety relationship?

In today's environment, expanding the lens is paramount for success. General contractors must view prequalification the same way they view properly descopeing a bid. The process must be methodical, repeatable, trackable and supported by the organization's top tier. Essentially, prequalification is an ingrained aspect of the organization's culture.

In today's business environment, consider expanding your process to include:

- Prequalification for each award
- Creation and maintenance of a database
- Aggregation tracking
- Risk mitigation plans
- Post-project evaluations

Focus on all the tools that you and your peers have on hand and fully embrace all of the risk management strategies available in the marketplace. There's no better time to begin optimizing robust prequalification practices and learning from others in order to strengthen your organization and help secure its future.

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CITATIONS

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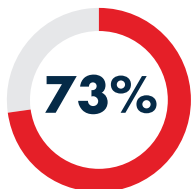
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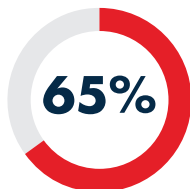
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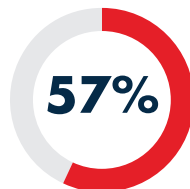
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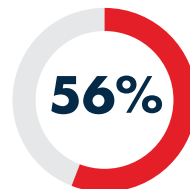
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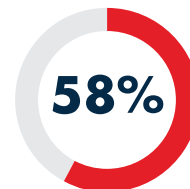
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