Surety and Construction
Market Outlook for 2016

The year of margin recovery
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Higher levels of construction spending in the residential, commercial, public and private markets, along with a dropping unemployment rate, signal a distinct improvement in the construction economy. At the same time, this growth stretches the industry talent pool and stresses balance sheets while margins slowly climb to a comeback.

Introduction

Market optimism and confidence finally made its mark on the still-recovering construction industry in 2015. In September 2015, unemployment in the industry dropped to 5.5 percent, a level not seen since the boom of 2005-2007, and a significant rebound from the March 2010 low of 24.9 percent. Employment is even tighter in growth markets and major cities in the south and west.

Residential spending is at a seasonally adjusted $394 billion, up 17 percent from last year. This was a strong jump from the $240 billion we saw in 2010, though still short of the $650 billion in 2005. However, total construction spending reached $1.1 trillion, up 14 percent over last year and matching 2005-2007 record levels.

But this has been a recovery of jobs and volume, not margins and profits. Even with the apparent rebound of jobs and spending, though, Surety companies consistently report that work in process schedules are full of profit fade, red ink, and low margin results despite record levels of revenues and backlogs. Even high quality firms and industry leaders, regardless of size, are disappointed with margins and bottom line profits. Yet, improvement is on the horizon.

As backlogs increase, General Contractors (GCs) are more confident raising margins into the three to four percent range, up from one to two percent. Self-performing sub-contractors and civil firms now consistently see eight to ten percent. Though not the five percent for GCs or 15 percent for self-performing sub- and civil contractors of the mid 2000s, this is a marked improvement after, particularly in public/ heavy/civil, margins languished around cost to a few points for many years.

To add momentum, President Obama signed a new five year, $305 billion Highway Bill in December 2015—the first long term investment in the United States transportation system in many years. This signals rising confidence and opportunities in a part of the market that already sees gaining competition.
Challenges in the talent pool

According to United States Department of Labor (DOL) statistics, monthly construction job openings in 2015 increased 300-400 percent to ~135,000-170,000, up from ~38,000-65,000 in 2009. As project opportunities expand, however, the talent pool struggles to catch up. Finding and keeping qualified people to manage larger and more complex projects is a challenge.

GCs face headwinds with stepped-up immigration laws, higher college enrollment, competing career opportunities in industries considered to provide safer and less strenuous work, heightened diversity mandates, and a tight employment market in which skilled laborers, project superintendents, and others see 20-25 percent wage increases by switching employers.

The talent pipeline presents a significant problem. During the economic downturn, fewer young people entered apprenticeship programs—only 259,000 from 2009 to 2011 according to the DOL. This is down from the 531,000 we saw from 2005 to 2007, many of whom could not find reliable employment in their trades and left the construction industry altogether.

Meanwhile, increasing diversity requirements challenge GCs to engage DBE/SBE/WBE firms while increasing enforcement and penalties. As a result, a number of well-qualified DBE/SBE/WBEs experience operational strain because there are simply not enough of them to meet demand.

Simply put, the workforce is ten years older than it was in 2006, and workers who were in their late 40s are now thinking about retirement. The pipeline of new people has a hiring gap of roughly six to seven years and now, when talent is needed to staff growth, there is a formidable hole.

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Source: United States Department of Labor (DOL) statistics

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The Surety market, meanwhile, faces a similar talent gap. Underwriters and brokers must have significant experience to tackle P3 (Public Private Partnerships), DBF (Design Build Finance), and a regular flow of project opportunities over $100 million. However, the severe contraction of training programs and college campus recruiting in the recession years means that there are just fewer experts right now to manage complex placements and financial analysis of international companies. That said, many firms initiated “grow your own” programs over the last two years, but these are still too nascent to yield results.
Surety loss trends

Many predicted a spike in Surety losses as the downturn prolonged. However, stress was low due to lack of growth, and so provided a soft landing. Although losses picked up in 2013 and 2014 for some of the major companies, the industry did not experience them on a level that caused an insurer retrenchment in underwriting or reinsurer exit from the business (as we saw in 1999 and 2000).

In fact, consistently high returns on Surety line equity attracted capital and encouraged new participants and higher levels of capacity in individual markets. Surety capacity commitments now exceed $1 billion, with some in excess of $2 billion. This is well over the $750 million the larger markets saw just a few years ago. The Surety and Fidelity Association of America (SFAA) loss ratio over the last ten years is depicted on the chart that follows.

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Surety History / Loss Results

With margin recovery showing life, the Surety market is poised for sufficient capacity and competitive conditions over the next 18 to 24 months.

The growth phase of the cycle, however, is often when cash flow demands put pressure on contractor balance sheets, so underwriters remain alert for signs of an increase in defaults. Subcontractor Default Insurance (SDI) carriers see a higher level of subcontractor loss activity, which is both a function of cash flow demands to fund rapid backlog growth, and the result of sub-par prequalification screening by GCs as new opportunities distract them from managing their risk.

Complex projects now require a more intensive Surety underwriting process that may include a legal review and financial analysis. In addition, Surety underwriters are challenged to understand global deals as they pertain not only to the contractor’s bonded backlog in the United States, but also their global footprint, un-bonded projects, and local country economies that impact global parent organizations.
The market today

Driven by underwriting profits, new entrants, and other competitive factors, bond rates, which were generalized as one percent of contract values, dropped closer to .6 percent. Traditional lines of insurance like Workers Compensation and General Liability maintain an expectation of loss due to the inherent risk in construction work. In Surety, however, the bonding company’s goal is to have no loss whatsoever, which drives the selection of contractor. As a result of this strategy, they maintain little to no rate to cover losses.

Several global construction companies emerged in the U.S. marketplace as major competitive forces with key acquisitions, and roles in “mega projects” and procurement models for Design Build Finance (DBF) and Public Private Partnerships (P3/PPP). These firms demonstrate that U.S.-based opportunities will be strong over the next decade as strategic assets to their overall platforms.

New bond forms seek to meet the demands of rating agencies and lenders on privately financed projects, DBF, and P3 projects. These forms include two basic differences from traditional performance and payment bonds; one is that some bonds include a liquidity payment in the five percent range similar to an LC while the surety more fully investigates the default claim. The other model of bond form innovation is an accelerated process for resolution of any default claim. The time for a surety decision and action is in the range of 60 days. These are used on a small number of projects, but the innovations are important steps to the surety industry adapting to changing procurements and demands of owners and lenders. It is also a function of a healthy and profitable surety market with capacity and a desire to innovate to maintain or grow market share.

These forms, though used on only a small number of projects, demonstrate the important innovation necessary to adapt to changing requirements of procurement, owners, and lenders.

Looking ahead

From a broad view, the next 12-18 months will see a continued, but slow shift in monetary policy, reflecting the increase in the Federal funds rate. Further, we expect the November 2016 U.S. Presidential election will stall long term thinking in the markets. In addition, global terrorism and its direct and indirect impacts on the domestic and global economies are a concern.

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In the construction markets, we expect sustained, moderate growth, along with persisting talent challenges. We also predict continued investment by international organizations in the U.S. construction market with an eye to gain a larger share of “mega projects”.

As it always does, Aon will invest in the construction business with market expertise, an experienced team, extensive data resources, emerging procurement models, exceptional performance security solutions, and risk management advisory.
About Aon Construction Services Group

Aon’s Construction Services Group is the preeminent provider of risk and human resources solutions to general and specialty contractors, project owners, and industry stakeholders. As the segment leader, Aon provides an unparalleled platform to serve the risk management needs of global contractors, an expansive network of offices to support service delivery for specialty firms and infrastructure projects, and the risk management industry’s leading global capabilities, delivered through colleagues who specialize in risk management for construction.

Our Surety team is the industry leader, with 145 North American colleagues developing solutions for contract and commercial bonding needs. Annually, we place in excess of $345 million in surety premium on behalf of our clients.

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*Specific insurance products and services are offered and sold
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