Surety Market Update and Forecast: 2015
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Introduction / Executive Summary

The surety market is stable and the construction economy is improving. We do not foresee a dramatic change in market behavior in 2015. However, there are a number of subtleties in market dynamics and emerging trends that are important to consider in formulating strategy and staying ahead of the field. Surety issues that dominate discussions with clients and underwriters include economic opportunities, joint ventures, alternative project delivery methods, subcontractor default risk management, talent acquisition, margin enhancement, surety capacity, surety rates, and global competition. We will explore each of those topics here in our 2015 Surety Outlook and Commentary.

Construction Industry Review: Improving Economic Results Leads to Demand for Talent

Economic activity in the construction segment has improved over the past 12 to 18 months. The US Census “Put in Place” construction factors are up 3.3% over last year and 11.3% over the last two years. Private spending is up 3.4% with office, healthcare, commercial, and manufacturing seeing double digit growth. Public spending is up only 1.7%, driven by education facilities up 9%, while street and road construction is down 1.7%.

U.S. construction spending from 1993 to 2014, by sector (in billion U.S. dollars)

Residential construction activity has been an important component of overall construction spending. It peaked in 2005 at $668 billion, when it was 59% of the overall construction economy. It bottomed out in 2010 at $229 billion, when it represented less than 30% of the construction spend. In 2014 it had rebounded to $359 billion, up 20% over two years and is now 37% of the construction annual spend. This includes both single family homes construction as well as multi-unit residential projects such as apartments and condominiums.
As construction economic activity has improved, we often hear challenges to find good people at all levels in the construction and surety business. Organizations were forced to reduce overhead during the slowdown, and now need to rebuild their teams as activity picks up. Construction unemployment peaked in 2010 at 20.6%. In October 2014 construction unemployment had fallen to 6.4%, as outlined in the graph above.

Recruiting experienced field labor and project management resources is a primary challenge in the fastest growing markets, such as general building in New York City, Boston, South Florida, California, and Texas. The large I-4 project in Orlando has increased costs for project labor in that market, as we have heard of salary increases at more than 25% compared to the time before the project was awarded. This dynamic also presents itself in several cities in Texas and Southern California due to major road projects. We are also seeing gaps in the executive management level at firms of all sizes. Some of these openings are driven by continuity, but others result from growth and investment from global companies in the American market.

**Margin Enhancement and Risk Management**

Despite pressure from increased competition, margins are modestly up in the private general building market from 1%-2% to 3%-4%. Risk management products such as contractor controlled insurance programs (CCIP) and subcontractor default insurance (SDI) are an important margin enhancement tool that can be employed while mitigating risk for larger contractors.

In the subcontractor market, margins are again moving into the low double digits in the more active geographic markets. The large road and heavy civil market margins remain under pressure. Contractors have capacity and public owners remain budget constrained. As a result, most of these firms are finding it difficult to raise margins. On jobs under $100 million, margins are in the mid-to-upper single digits. Finally, for the largest projects, particularly those with alternative financial models (e.g. P3 and Design Build Finance (DBF)), margins improve slightly to the low double-digit range.

Specialty trade contractors are seeing a return to double-digit margins, particular in the “hot” private general building markets.

Recently, no fewer than 10 firms bid on a complex, $300 million heavy civil infrastructure project in New York City.
Surety Industry Review: Ample Capacity, while Talent Demand Mirrors Contractor Issues

The surety industry continues to report highly profitable results and modest top line growth, based on an increase in construction activity. The Surety and Fidelity Association of America (SFAA) results through the third quarter of 2014 reflect the continued favorable loss trends seen in recent years, with an overall loss ratio of 15%. Market share is concentrated with the leading 10 carriers, which control close to 65% of all premium placements. For contractors with revenue in excess of $100 million, the market for contract surety is even more concentrated in the five largest carriers.

In the “olden days” of the mid-2000s, single bond capacity was restricted around $250 million. Today the surety companies do not have issues with writing bonds in excess of $2 billion. As an example, a recent project with an estimated $2 billion value required a 100% payment bond and a 50% performance bond. Despite the project’s valuation, the surety industry responded without issue or concerns as to the value of this endeavor.

One key consideration for large bonds is a strong joint venture (JV) team. Sole ventures typically top out somewhere around $500 million, depending on project type: general construction (higher threshold – less self-performance), or heavy civil (lower threshold, more self-performance). Heavy civil projects tend towards JVs driven more by construction industry risk management practices (check estimate, share people and equipment resources, shared cash flow) than surety requirements. Fully integrated JVs are the norm, as opposed to line item JVs. As JVs have increased in size and have longer durations, there is a growing need and trend to allow for monthly or quarterly distributions to cover some portion (perhaps 50%) of the overhead costs of respective partners. We are seeing this being negotiated more often into JV agreements.

Surety risk is materially lower in a JV, based on the joint and several obligations within the partners, yet the industry does not discount rates for JVs. Aon is advocating change in 2015, with stronger consideration given to the enhanced risk structure of JVs that should be reflected in pricing discounts.

Reinsurance for the surety line is readily available on favorable terms, in part fueled by alternative capital flowing into reinsurance in search of a better return, and profitable surety results. We are seeing new participants (e.g. Berkshire Hathaway), and increased risk appetites from current carriers. Contract surety loss ratios are about 10 points higher than non-contract surety (commercial bond products). Our team is aware of contractor difficulties currently being managed by surety claim departments which may ultimately result in a single significant loss. However, even with this looming issue, which has the potential to generate a loss in excess of $100 million, we do not foresee a dramatic change in market conditions. Contractor bond rates are not increasing – in fact, we see pressure to lower rates and expect that trend to continue, simply based on supply and demand factors along with profitable results.

The surety industry is also seeing competition for experienced talent at the underwriter and broker level. Many of the larger surety companies have reinvigorated their training programs in an effort to have the people resources to support their business opportunity. We have seen the entrance of new market participants to contract surety and their staff is coming from the top five surety carriers. We have also seen new surety agencies created by staff departing larger surety brokers. This makes it more challenging to have the experienced talent needed to manage more complex contractual risks, financial procurement models, and larger projects by the surety industry.

Surety companies that benchmark client financial conditions continue to see strong balance sheets and significant cash positions, so there are a number of very healthy construction firms with plans for growth. This will keep pressure on retaining and attracting top talent.
Subcontractor Default Insurance (SDI) Market Performance

The Subcontractor Default Insurance (SDI) market traditionally provides a risk transfer mechanism for larger ($750 million and more in annual revenue) general contractors to protect against the peril of subcontractor default. In recent years, new providers have entered the market creating some competition. One area that has changed is that middle market contractors, (e.g. $200 - $500 million in annual revenue) have been able to find SDI product offerings available. The SDI market is geared towards building trade subcontractors with contracts generally under $3 million, although the product can handle larger subcontractors. It is not designed to meet the needs of the heavy civil contractor business.

General contractors and underwriters of the product line are seeing an increase in loss frequency, particularly relative to contracts signed in 2010, one of the worst times in the recent construction economic cycle. The frequency of claims is related to performance, e.g. being behind schedule, poor quality, etc., rather than financial default. Contractors have been investing over the years in better pre-qualification practices and underwriters have intensified their requirements. However, terms and conditions for this product line remain stable, despite relatively high-profile defaults in the third quarter of 2014.

Critical Marketplace Dynamic: Public-Private Partnerships

The public-private partnership (P3) procurement model resulted in five closed deals in the United States in 2014, with a combined value of $4 billion. The pipeline for 2015 P3 deals is robust with 15 deals in the procurement process, totaling $15 billion in construction and representing 6.4% of infrastructure project spending in the U.S. About half of the domestic P3 deals include long term Operations and Maintenance (O&M) contracts, reflecting the American trend towards the public entity retaining long term O&M responsibility. In other countries that have made use of the P3 model, the percent of O&M is much higher. Several states, including Virginia, Texas, Florida and Indiana led the initial P3 charge. Given their positive results, more states seeking public infrastructure financing solutions, e.g. Pennsylvania, Massachusetts, and North Carolina are getting into the game.

The inability to find a bipartisan consensus on a long-term solution to the Highway Trust Fund increases the momentum of P3 procurement solutions. The gas tax has not been increased since 1993, so the Infrastructure Trust Fund requires emergency funding from the General Fund every two years. This prevents a longer term view of financing public infrastructure. We expect the trend towards P3 to continue in the United States, forming a meaningful market share of larger projects.

While the largest 2014 domestic P3, the $2.3 billion I-4 Ultimate Interchange project in Orlando, required a $750 million performance and payment (P&P) bond, not all P3 projects require traditional bonds. These projects are financed by private sources of capital. Lenders are more concerned about delay risk than default risk. It is often critical for projects to have a timely completion to initiate the flow of cash to re-pay debt. Examples include toll revenues and government availability payments. As a result, lenders insist on the performance security providing immediate liquidity to potentially meet debt payments during a delayed construction completion.

The surety industry is engaged through their trade organization to promote the requirement for P&P bonds on P3 projects in the U.S. They emphasize the payment bond protection for labor and material, the total backlog perspective of the surety, and their experience of managing a contractor default. In addition,
they are engaged in product development to adjust their standard product to also address the delay risk concerns of lenders and the bond rating agencies. Bond forms that include an accelerated dispute resolution process for bond claims and liquidity sub-limits are being considered. The Canadian market has seen more activity on these new P3 products. In fact, a small number are being used on closed deals to meet the needs of the owner, lender, and contractor with increasing frequency. We expect this product evolution to continue in both the Canadian and US markets as alternative financing grows.

Legal Implications of Industry Evolution

The owner’s legal community and contractor and surety legal departments have been engaged in longer negotiations around contract terms, such as damages, delays, warranty, and maintenance obligations. Bond forms are also being negotiated. We often see requests to modify the standard AIA bond forms. During the worst parts of the slowdown, owners and specialty law firms became more aggressive in expanding contractor risk via warranties, delay clauses, and financial risk in contracts. With some market improvement comes the contractor effort to swing back the legal pendulum. P3 contracts have created some of the bigger challenges as the basic premise is for the developer special purpose vehicle (SPV) to push as much risk as possible to the design build construction joint venture (DBCJV), in order for the SPV to have an optimal risk profile. This facilitates borrowing construction funds at the lowest debt cost. This dynamic is distinctly different than in the past, when particularly public contracts were fairly standard. The US P3 and DBF market is slowly working itself to more standards after several years of working towards the optimal contractual and performance security solutions.

Summary: 2015 Construction and Contract Surety Market Outlook

Our outlook for 2015 for the construction and contract surety marketplace calls for a continued uptick in construction activity. We see the surety market remaining competitive and capacity and options for contractors to be favorable. Contract surety loss frequency and severity will develop negatively, but not suddenly or dramatically affecting availability. Attracting and retaining executive and field skill personnel will be a high priority challenge for contractors, surety companies, and specialty surety brokers and agencies. Alternatively financed projects (P3, DBF) will also grow as a share of the construction market.

Global companies will continue to invest in the US market, and acquire US construction companies, particularly in “continuity” situations where there is a generational leadership transition. Construction related insurance products such as SDI and CCIPs will be an important component of particularly the general contractor market. The heavy, civil, transportation segment will see modest margin improvement and backlog opportunities, primarily as a function of public infrastructure funding challenges. General contractors and specialty trades will experience better margin and backlog market conditions.
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.

For more information, contact your Aon account executive, visit us at aon.com/construction, or follow us on Twitter (@AonConstruction).