HOW GENERAL CONTRACTORS CAN INCREASE THEIR BOND CREDIT:
Key Metrics and Practices

For general contractors, enhancing bond credit is crucial for taking on larger projects and expanding business. Bond underwriters review various key financial metrics and operational practices to determine contractor bond worthiness. Understanding these important factors can help general contractors improve their bond credit:

1 CRITICAL FINANCIAL METRICS

Building a strong credit history and keeping solid financial footing helps a general contractor manage relationships with their banks and it demonstrates to bond underwriters the business is a good investment.

+ **Working Capital to Program Ratio** – One of the most important financial metrics for bond underwriters is the contractor's working capital in relation to their overall bonding program. Typically, bond companies like working capital to be 5% compared to the total backlog, subject to other criteria being met.

+ **Debt-to-Net-Worth Ratio** – A general contractors debt-to-net-worth ratio is another key measure. Bond underwriters prefer to see a ratio of 3:1. Some contractors, especially construction managers/general contractors, can stretch that ratio to 4:1, depending on their debt structure.
    - It's also important to keep interest-bearing debt-to-worth under 1:1, ensuring financial obligations that accrue interest don't overburden the company. This can also include revolving bank lines of credit.

+ **Bank Line of Credit** – Bond companies favor general contractors who have established lines of credit with their banks. A strong recommendation is to secure a line of credit that amounts to 10% of the contractor's backlog. This is critical for cash-flowing retainage, which helps the general contractor manage working capital during the project's lifespan.
    - Review bank covenants to check they are reasonable. If a borrowing base applies, check "bonded receivables" are not excluded in the bank's underwriting formula. If excluded, a company with a large credit line may only be able to access a small part of the agreed-upon credit.

2 CONTRACTUAL TERMS

Bond companies closely examine a general contractors' contracts with project owners. Certain provisions in these contracts can significantly reduce the risk for the general contractor and their surety:

+ **Price escalation clauses** protect against rising material costs.
+ **Time extension provisions** cover delays due to external factors like weather or supply chain issues.
+ **Pass-through provisions for subcontractor performance** allow the general contractor to hold subcontractors accountable for poor performance, minimizing the general contractor's liability for delays or defects.
+ **Cost-plus contracts** can also be advantageous for maintaining profitability. These contracts, which reimburse actual project costs plus an agreed-upon fee, help general contractors avoid financial loss due to unforeseen expenses.
    - While cost-plus contracts help cover costs, they often come at the expense of higher potential profit margins compared to lump-sum contracts.
+ Negotiating damages can be critical for the success of a job, and in turn how a bond company underwrites on a job-by-job basis. A dollar figure instead of an open-ended damages provision can help ensure that damages are reasonable.
    - If consequential damages apply, try to put a cap on the damages. It is suggested to be no more than 20% of the contract value.
+ Checking for no subtle "long-term warranty" provisions.

These advantageous terms present in contracts can make a general contractor more attractive to bond underwriters.

3 SUBCONTRACTOR MANAGEMENT AND PREQUALIFICATION

General contractors must demonstrate that they are mitigating risks associated with subcontractor performance. Bond companies want to know whether the contractor is:

+ **Prequalifying subcontractors** by obtaining references and verifying their bondability. This can include asking subcontractors for financial statements.
+ **Requesting subcontractor bonds** in cases where a subcontractor poses a higher risk. This ensures the subcontractor's poor performance won't threaten the project's success or the general contractor's bond capacity.

Strong subcontractor agreements clearly outlining responsibilities and potential liabilities help general contractors manage risks effectively.

4 PROJECT SELECTION AND FOCUS

General contractors can show discipline in pursuing projects that align with their preferred size, scope, and geographic territory. Bond underwriters view projects outside a business' core focus with caution. When this occurs, a general contractor steps outside of this zone must justify why the opportunity makes sense strategically and financially. Risk increases significantly when a contractor stretches into projects beyond their scope.

5 INTERNAL CONTROLS AND SYSTEMS

Bond companies want to see general contractors with robust internal controls in place. This includes:

+ Systems for checks and balances between project managers and estimators.
+ Regular job status meetings are essential to ensure that projects are running smoothly.
+ Production of accurate financial statements on a percentage-of-completion basis each month.

Bond underwriters also look for the general contractors ability to forecast future revenue and adjust overhead accordingly.

These financial metrics and operational best practices can improve a general contractor's bond credit, making them eligible for larger projects and expanding their business capabilities. Meeting the expectations of bond underwriters in these areas improves the contractor being viewed as a lower risk and more bondable.

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