Understanding General Contractors' Perspective on Default Risk and Subcontractor Qualification

As the construction economy recovers from the downturn, optimism has begun to spring up among General Contractors all around the country. The AIA Architectural Billings Index (ABI), a strong predictor for construction activity, was 53.8 in August, 2013, up from a mark of 52.7 in July and part of an increasing trend in recent months[1]. Developers, while still cautious, are breaking ground on long-delayed projects. The sense of optimism in the air is somewhat dampened by the continued wariness of lenders, some of whom are demanding 30% or more equity to fund projects. This demand makes only the best deals feasible and pressures Contractors to provide increasingly competitive bids. Still, there is a foundation of hope that conditions will continue to improve throughout 2014.

History has taught us, however, that recovery periods are the riskiest time for default among all of the boom and bust phases of the construction economic cycle. The Surety & Fidelity Association of America reported a 22 percent loss ratio for the top 100 sureties in 2013, up from 12 percent five quarters ago. While the rates are still historically low, the nearly doubled loss ratios in a little over a year have drawn everyone's attention.

Fear of Non-Performance and Default

At first glance it might seem counterintuitive, but the highest default risk occurs during economic recoveries rather than during downturns. During the recession of 2008 to 2011, many Contractors had large, high-margined backlogs carrying over from the prior boom period. As Contractors took on new work with lower margins, their strong cash positions began to wane, which led to a decrease in the number of defaults. Even when defaults did occur, it was often possible to re-procure the work with a new Subcontractor for less than the balance left with the defaulting Subcontractor. This created a favorable situation for the General Contractor or Owner.

As the economy recovered, bid prices have stabilized, but it is still largely a "margin-less recovery," where profits are not strong enough to help companies return to healthy balance sheets. General Contractors used up cash reserves to stay afloat during the downturn and the high margined backlog has dried up. The current low-margin work means diminished cash flow and reserves, leading to a much higher risk of defaults. Strong Contractors are now stable; weak Contractors may have to resort to bankruptcy. It is more important than ever for General Contractors to safeguard projects and Owners against default risk.

This situation is further exacerbated by the current trend of General Contractors being pushed to finance work for owners and by Subcontractors being pushed to finance work for General Contractors, with suppliers financing everyone. One small disruption in this supply chain can have ripple effects throughout the project.

[1] AIA Architect, September 18, 2013, "Strong Conditions Revealed in Architecture Billings Index," by Kermit Baker, Hon. AIA.

Fear of non-performance and default is driving more and more General Contractors and owners to require Subcontractors and suppliers to undergo rigorous qualification processes before awarding work, sometimes applying the process before allowing a Subcontractor to even bid on work. For Subcontractors, this means completing more paper work just to get qualified to work with a client. General Contractors feel justified in placing this burden on the Subcontractors as they are under pressure to manage their risk portfolio.

The Size and Shape of Qualification Programs

A relatively new practice in the construction industry, Subcontractor qualification traces its roots to the invention of Subguard®, Zurich North America's Subcontractor default insurance (SDI) program that was launched in 1996. Subguard and other SDI programs require General Contractors to qualify their Subcontractors to reduce default risk. Subcontractor due diligence also generally leads to better project outcomes. Over the last 10 years even Contractors not using SDI programs have begun to see the value of qualifying Subcontractors.

Qualification programs come in many different shapes and sizes today. Large companies run sophisticated programs, while other builders still rely on a more traditional qualification program, namely, acquiring a performance and payment bond on all Subcontractors. Some may have no qualification program at all. In between the extremes are a variety of qualification programs. Some attempt to qualify all bidders or at least those to which the General Contractor wishes to award work. Some programs are run by a centralized team, with those buying subcontracts simply required to check qualification lists prior to awarding work. Others programs rely on project teams to collect and analyze qualification data themselves. No matter the type of program, there are a number of options and considerations to building a successful qualification program.

Factoring In Success for a Qualification Program

The first factor that a General Contractor should consider when building a qualification program is whether it can be consistently executed. From an operational standpoint, a program that is workable and used consistently is much more valuable than a program that on paper identifies all weak Subcontractors but is not used. Qualification is an area where the "great" is frequently the enemy of the "good."

Too many qualification programs involve long forms that are 15 pages or more. Subcontractors frequently balk at completing them, while General Contractors struggle to find the resources necessary to review and monitor these long forms. A set of key questions and information requests will generally separate Subcontractors with potential problems from stronger Subcontractors. Long questionnaires can be reserved for those who fail an initial screening or those who are strategically more important, such as critical path trades or hard to replace scopes of work.

Second, maintaining an up-to-date database of qualified Subcontractors and distributing it to those making bidding and purchasing decisions is critical. A perfectly executed qualification process that is not communicated to buyers is of little value. In order to make an informed decision, a purchasing manager or project manager estimating or buying out a job needs easy access to the latest qualification information. This should include data on how much work is currently contracted with the Subcontractor being considered. An otherwise well-qualified Subcontractor may be the wrong one to award a job if the General Contractor judges his aggregate ability to do work is $1 million and the General Contractor has already awarded him $3 million.

Third, focusing on the wrong items will not only bog down a qualification process but will also lead to poor decision-making. When building a qualification program, a General Contractor must decide which factors are most important in qualifying for bids or awards. Financial strength is at the top of nearly everyone's list of qualifiers. What else is important to General Contractors? Safety, quality, project experience, management capabilities, litigation history, surety relationships? All of these categories, and many more, can be important. General Contractors need to decide which are the most important, based on experience, priorities and strategy. Focusing on the right indicators is often the difference between success and failure.

Finally, there are several other important considerations in building and executing a qualification program. Internal organizational buy-in, Subcontractor communication and onboarding, and ongoing program monitoring and evaluation are just as important to the success of a program as the first three considerations are to the establishment of a program.

A number of technologies can aid in developing and maintaining a program. However, by itself, no technology can ensure a successful program. Qualification is not entrenched or understood enough in the industry to simply drop in a technology solution to replace process. Good qualification technology will supplement and support a process. However, technology cannot **be** the qualification process. When General Contractors explore qualification technology, they need to consider the support that accompanies it for both the General Contractor and the Subcontractor users.

The Road Ahead for Qualification

Default risk will continue to be elevated in 2014 as the construction recovery continues. Default on a project can happen at any organizational level and affects all parties involved in the project. Understanding where default risk lies is the first step to mitigating it. General Contractors will continue to use qualification programs to help them manage default risk. Setting up good processes and following through diligently can help mitigate – but not eliminate – the risk and cost of Subcontractor default while minimizing the burden of implementation. For Subcontractors, the process is here to stay. Subcontractors need to continue to find new ways to manage the qualification process so they can continue to work with their long-term and new General Contractor clients.

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