2020 Construction Market Outlook

CSBA
COMMERCIAL SURETY BOND AGENCY

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OVERVIEW

2020 will forever be the tale of two stories – a booming construction market followed by a pandemic induced recession, the likes of which we have never experienced.

Coming into 2020, the strength of our contractors' profitability and backlogs exceeded the peaks reached in the boom of 2007 and 2008. Gross profit margins remained strong, revenues were up, and general & administrative overhead (as a percentage) was at an 11 year low for our customers, resulting in some of the strongest net profit margins we've seen in a decade.

There were some exceptions. In last year's report we noted that, "…some contractors are showing cracks in their organizations from growth, which has resulted in lower profit margins and in a few cases, net losses." This showed up in the 2019 numbers as the percentage of our contractors that were profitable declined from 94% in 2018 to 89% in 2019.

Evidence that some contractors were having trouble managing their growing backlogs also showed itself in increased surety losses. The surety industry's loss ratio (the percentage of losses paid on bonds for every dollar of premium) rose to 19.1% in 2019 - a number not seen since 2013 after the Great Recession. Through June 2020 it has risen even further to 21%. This is discussed in more detail in the surety update section.

Realizing a lot has changed since the beginning of the year and current data is important to help give contractors a perspective of the evolving marketplace, we updated our report to include results of our contractors through June of 2020. Due to timing, we weren't able to include all of our contractors' results, but we think the sample included gives a fair perspective of the first half of this year.

Another feature we added to this year's outlook is historical data going back to the 2008 Great Recession for perspective. While the cause of the recession this time around is certainly different, many of the affects for contractors are similar. Our hope is to shine a light for the construction marketplace on what happens during these cycles such that the lessons learned can be applied to help contractors navigate the current environment more successfully. We hope this is particularly helpful for those that may have started their business after the 2008 downturn and are riding the rollercoaster for the first time.

WHAT'S NEXT?

Forecasting what is to come has never been more challenging. Economists range widely in their predictions, and the news is full of conflicting messages.

***"The economy will continue to rebound at the sped that the virus goes away. It is as simple as that. When it does go away,we are going to be back to where we were at the start of this thing."* Chris Thornberg, Beacon Ecomonics**

***"The Next Global Depression Is Coming and Optimism Won't Slow It Down"* Time Magazine**

Never before has an economic recovery been compared to so many letters and shapes. Is it a "V", perhaps a "U", maybe a "W", or even a square root "√"? The truth is that nobody knows, certainly not us. While we do present some forecasting data with the help of Liberty Mutual and Dodge Data & Analytics, our main goal is to provide current data of what we are seeing in the marketplace, overlap some common sense, and give our readers a few important things to consider.

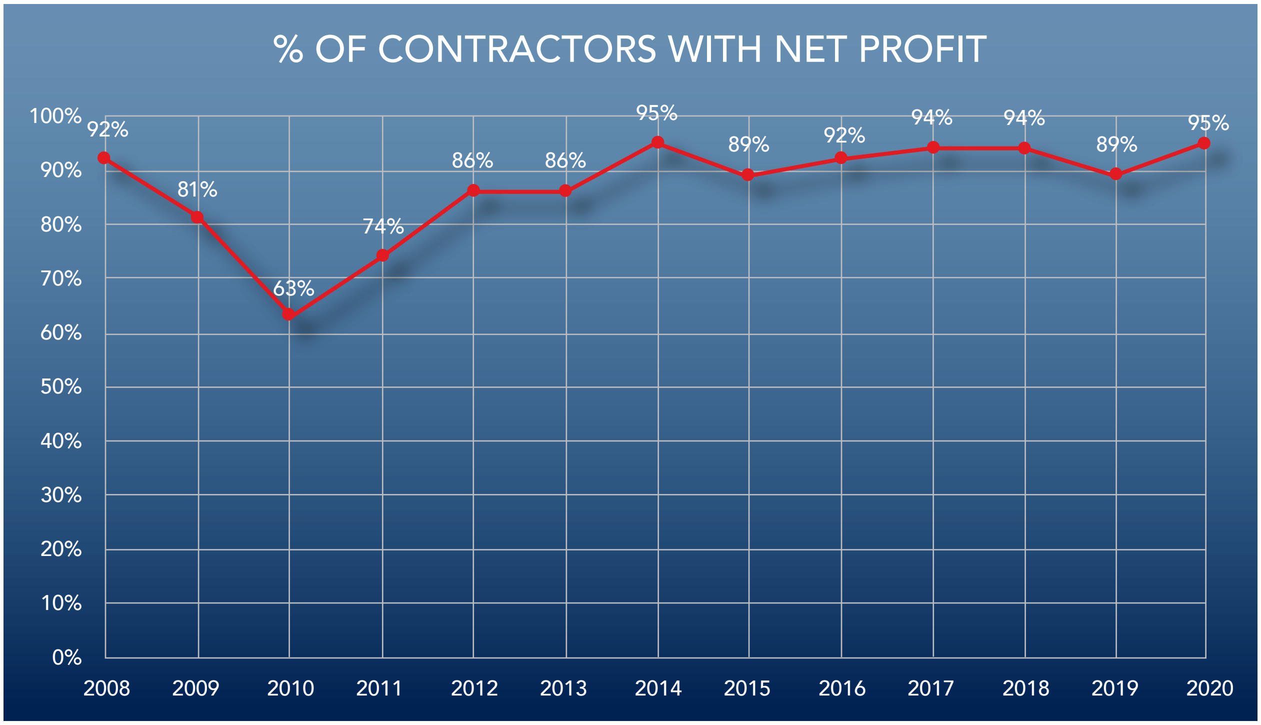
Our overriding sense is this - there has been a shock to the economy, which reduces the amount of money being spent. This reduces state and local tax revenues – the direct source of funding for most public construction projects. Just picture the City of Anaheim's budget right now with Disneyland, Angels Stadium, and The Honda Center closed since the Pandemic began. Private construction is also having challenges. Hotel and office building have dropped off dramatically.

Therefore, we feel like it is safe to say that the construction market will pull back and contractors should be prepared for that. We will discuss the various experts' projections as to the extent of the pullback in the forecast section.

We hope that this report will help provide context to the many difficult decisions you will have to make in the coming year, and we wish you, your loved ones and your employees the best during this challenging time.

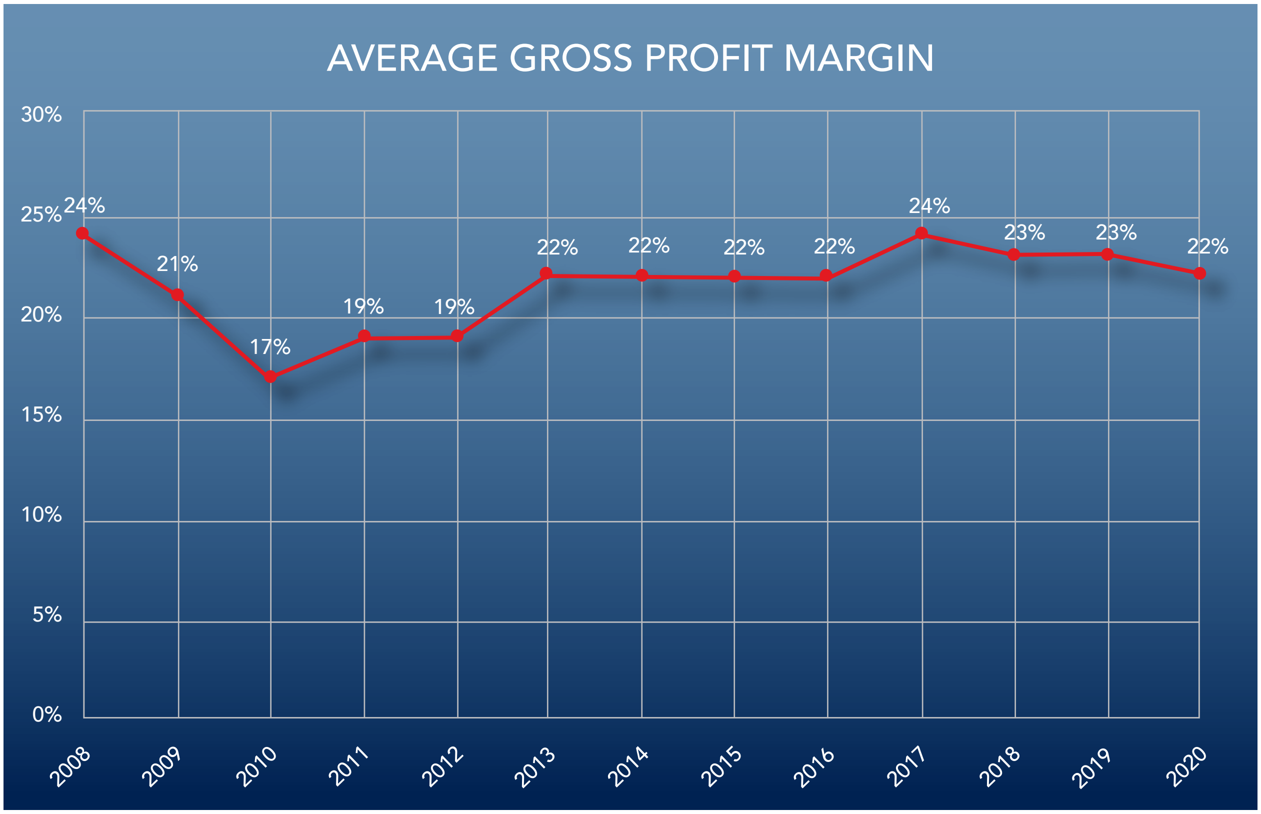
CUSTOMER PROFITABILITY

2019 was another solid year for profitability with 89% of our contractors showing profitable results. That was down from the year before as some contractors had difficulty managing their backlogs. As of June 2020, 95% of our customers are showing a profit, and we expect the rest of 2020 to hold steady with the downward trend starting in 2021.



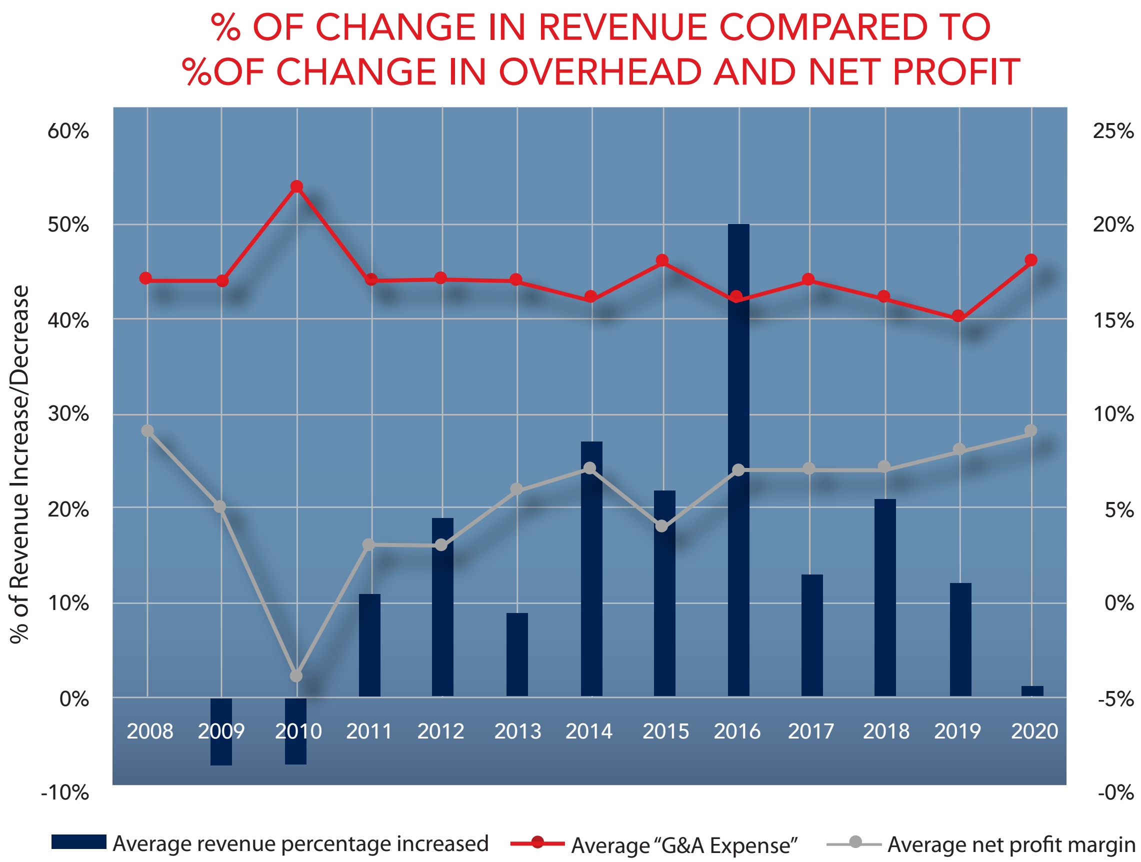
Gross Profit Margins

The average gross profit margin for our customers was 23% in 2019, and it slipped to 22% this year. We expect that our contractors gross profit margins will either hold at 22% or slip slightly for the remainder of 2020 as they deal with the disruptions of Covid. While the degree of the challenges is different for every contractor, all have dealt with some loss of productivity in the field and office, delays in schedule, or cancelled jobs. A study from the, "…New Horizons Foundation, the research arm of the Sheet Metal & Air Conditioning Contractors' National Association (SMACNA), found that its members have taken a 17.9% hit to productivity since the outbreak began, resulting in a 7% financial loss."



As we embark on what looks to be a downward trend in the construction industry, we think it is worth noting the decline in gross profit margin from the previous 2008 peak at 24% to the trough of 17% in 2010. While these numbers represent an average among many different types of contractors, we believe the thing any contractor can take away is margins declined by roughly 7% (a drop of almost a third). There is no way to tell if the same will hold true this time around, but perhaps it gives some basis for contingency planning to see how your company would hold up if margins did in fact decline by that same amount.

Revenue, Overhead and Net Profit Margins

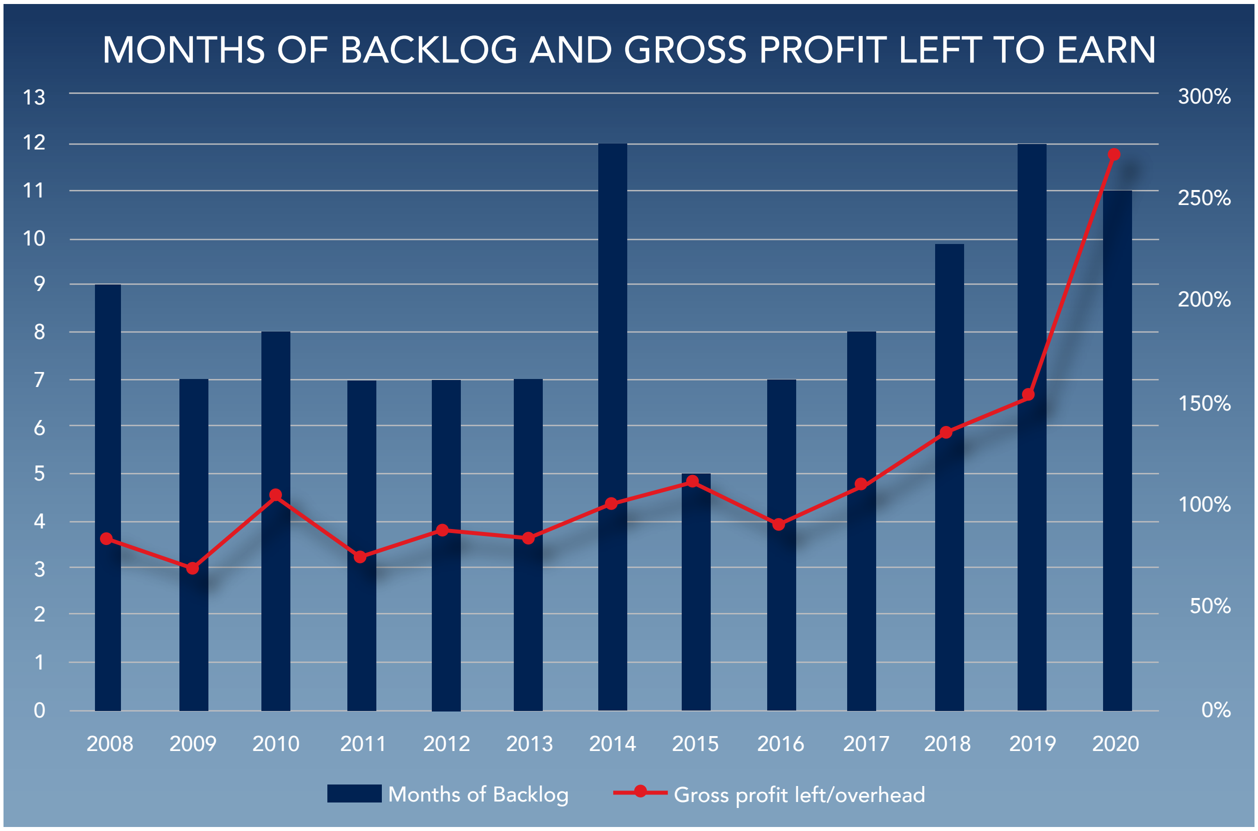


In 2019, our contractors increased their revenues 11% on average over the prior year. Based on the chart above you will see it appears that most managed to do so with proportionally less general and administrative overhead, which brought the overhead expense down to 15%. The combination of increased revenue, high gross profit margins and lower overhead as a percentage, resulted in an uptick in net profit margins to an average of 8% in 2019 and a slight increase in 2020 to 9%.You'll note that the percentage increases in revenue has gone down for the third time in a row – a sign that we've likely hit peak revenues this cycle.

This graph also shows one other important thing – a lesson from the 2008 Great Recession. In 2009 and 2010, revenue declined while overhead as a percentage increased. That increase in the overhead percentage was due to contractors delaying overhead reductions, which ultimately caused many contractors to lose money.

BACKLOGS

Another bright spot coming into 2020 were our contractors' backlogs. At the end of 2019, our contactors had 12 months of backlog holding fairly steady at 11 months of backlog through June 2020.



Our contractors didn't just have big backlogs coming in this year though. They had very profitable backlogs. So much so that, they could cover almost 1.5 times their overhead coming into 2020. This certainly helped many contractors when the pandemic hit and construction work was deemed essential, as it allowed most to continue plowing ahead.

The problem for contractors is replacement work. Already we have seen many bid lists increase to more than 10 bidders in many cases. On average our customers are having to bid more work than previous years and their hit ratio has declined to an average of 26% compared to between 27%-30% in the prior four years. As work available to bid continues to dry up and our contractors' backlogs decline going into the first quarter of 2021, we expect competition to intensify, hit ratios on bids to go down further, margins to erode and eventually revenues to drop.

SURETY MARKET UPDATE

The surety industry's results largely mirrored that of contractors coming into 2020. Most sureties were doing very well with several years of growing premium and relatively few losses paid on bonds. Just like contractors, there were exceptions. Some sureties have found it difficult to maintain their disciplined underwriting. Part of this is likely due to the increased competition that we've written about over the last 10 years where the number of surety companies has doubled or tripled in some markets. This has led many sureties to stray away from best practices in underwriting and to take on greater risks.

All of this showed up in the 2019 loss ratio results (the dollar amount of losses paid on bonds divided by the premiums). You can see by the chart below that the loss ratio for the US surety industry ticked up to 19% - a level not seen since 2013 after the 2008 Great Recession. The rising loss ratio continued into 2020 with the year-to-date results through June coming in at 21%. For the 2nd quarter of 2020, 5 of the top 20 sureties had loss ratios above 40% - an unprofitable and unsustainable level.

Top 100 Surety Companies in United States

Year	2015	2016	2017	2018	2019	2020 YTD June
Premium	$5.6 billion	$5.8 billion	$6.2 billion	$6.5 billion	$6.9 billion	$3.4 billion
Loss Ratio (Premium/Incurred Losses)	16.2%	15.5%	15.6%	13.0%	19.0%	21.0%
Based on results compiled by the Surety & Fidelity Association of America						

California saw an even greater rise in the surety industry loss ratio from 7% in 2018 to almost 17% in 2019. The California results are only published annually, so we will have to wait until next spring to see if the trend continued.

California Surety Results

Year	2015	2016	2017	2018	2019	2020 YTD June
Premium	$5.6 billion	$5.8 billion	$6.2 billion	$6.5 billion	$6.9 billion	$3.4 billion
Loss Ratio (Premium/Incurred Losses)	16.2%	15.5%	15.6%	13.0%	19.0%	21.0%
Based on results compiled by the Surety & Fidelity Association of America						

Surety companies are all bracing for an increase in claim activity on bonds as a result of challenges contractors are facing. There are certain areas of the country (states back east and the northwest including northern California, Oregon and Washington) where government shutdowns were more severe and are likely to have a negative impact on contractors' results.

The anticipation of problems has led surety companies to begin taking slight measures such as requiring timely financial reporting (typically 90 to 120 days past the year-end or quarter). They are also being more diligent in asking underwriting questions they may not have in the past. Some sureties have even begun to ask their contractor customers with inconsistent profitability or too much debt to find a new surety.

We expect losses for sureties to continue to rise over the coming years, and if that happens, underwriting will continue to get more stringent making it more difficult for some contractors to get the surety credit they need. We don't anticipate our contractor customers facing much of a challenge, because our proactive approach to managing their bond program enables more consistency. Those contractors that use general insurance agents to service their surety needs will likely find a much greater disruption in their bonding program.

CONCLUSION

For many contractors that started after 2008, this may be their first time going through a recession. Even fewer contractors have experienced a tight surety market, because the last one dates back to the early 2000's. Therefore, we have a few suggestions to consider.

Our first piece of advice is to ready your organization. What specifically does that look like? Continue dialing in your internal accounting and potentially increase your ability to report financials on a quarterly basis. This will help you make better decisions as times get tougher, and it can be a critical tool in communicating with your surety. Next, retain as much of the earnings in the company as possible, limit the new debt you take on, and keep your bank lines of credit available. Beyond those simple steps, frequent communication with both us and the surety will go a long way in navigating the uncertain waters ahead.

We are also encouraging our contractors to create contingency plans for their revenues and margins in 2021. As the charts on the earlier pages show, the 2008 Great Recession resulted in a cumulative revenue decline of 14% between 2008-2010 and declines in gross profit of one-third on average for the same period. So, one place contractors can start is to model your current financials based on revenue and gross profit margins declining to this same extent to determine what steps you would need to take in order to at least breakeven. You might come up with other various scenarios that are worse or better to have a playbook with a range of options.

Many contractors are taking the "wait and see approach" rather than doing this type of contingency planning. While this approach is understandable given the amount of uncertainty we face, it also puts a contractor in the position of being reactionary at a time when emotions are high, which may not lead to the best decisions. In addition, anyone who has been through an economic cycle knows that adjustments to overhead take time. When a contractor hasn't thought through the possibilities, it takes that much more time. In construction, this can have severe consequences, because overhead is often high and eats away quickly at a contractor's limited capital.

Dwight Eisenhower is famous for saying, "Plans are worthless, but planning is everything." The point being, the plan likely won't match the circumstances, but the knowledge you gain through the process will be invaluable in navigating through the landmines.

Lastly, if you depend on surety credit to operate your business, it is critical that you protect your hard- earned capital at all costs. Contractors that wait too long to make adjustments to overhead, will likely incur losses, those losses will reduce bonding capacity, which often sends companies on a death spiral. This means you may need to cut overhead before the declines actually happen.

We wish you and your loved ones the best during this challenging time, and you can count on us to be here to support you in any way we can as we navigate these uncharted waters.

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