Surety Market Update 2019

Anticipating a stronger push for more disclosure from global firms on major projects outside of the US

Empower Results®

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Contract Surety Industry Results

The contract surety industry remained profitable in 2018, continuing a multiyear trend of solid performance. Premiums continue to increase with low loss activity consistent with prior years and the overall norm.

One notable emerging trend was contract surety loss related to high-end capacity users in the international sector. Specifically, 2018 saw several high profile European losses that spilled over into loss for North American companies with foreign parent ownership. These surety losses were driven by too much debt and poor operational performance, which was masked by financial reporting rules which allowed for a lack of transparency. New IFRS and GAAP accounting rules and stricter underwriting standards by the surety and credit industries will likely set a more conservative tone for 2019 and beyond.

Underwriters are pushing for greater transparency from global companies on non-bonded, non-US projects, requiring granular reporting of project revenue, cost and profit. Historically, US surety underwriters have tended to focus on bonded US work and its performance. However, with poor operational performance in other areas of the world having an adverse material impact on the balance sheet of global firms, these financial challenges will impact US bonded work and underwriting standards will tighten. A stronger push for more disclosure is anticipated for global firms on major projects outside of the US bonded backlog. Overall, global firms continue to have a higher risk appetite than their American competitors, particularly in project size and complexity, and discernment of political risk.

The surety market will be closely watching the enterprise risk management of these global firms as they pick where they are comfortable with providing surety credit. High capacity surety credit is of particular concern, and you can expect to see surety companies taking a more conservative approach to picking winners and losers.

Some credit tightening in the overall marketplace is anticipated in 2019, as a variety of factors may lead the economy to the edges of mild recessionary pressures. These factors include a flattening yield curve, inflationary pressure caused by the Fed's interest rate hikes and associated liquidity exiting the market, and ever increasing corporate debt. Trump's tariff strategy and sovereign debt issues in the EU, especially Italy, may place further downward pressure on the global economy. The result may be reduced or limited lending for infrastructure improvements. Global corporate clients with less than investment grade ratings may face debt refinance risk. Pending bankruptcies in the large global contractor industry and struggling retail space are additional concerns that may impact future surety results.

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$ In Millions	FY-2017	FY-2018**	Q1 - 2019
Direct Premium Written	6,227	6,552	1,664
Direct Premium Earned	6,017	6,303	1,599
Direct Losses Incurred*	938	818	267
Direct Loss Ratio	15.6%	13.0%	16.7%

*Losses include IBNR.
**The 2018 results are preliminary numbers
***These results are published by The Surety & Fidelity Association of America

Innovative Performance Security Products

Carriers continue to look to demonstrate value and differentiate themselves. This has fueled further evolution in the development of innovative performance security products, including the development of a performance security array of products for privately financed and public private partnership (PPP) procurements. These include traditional performance bonds with added "pay on demand" liquidity features.

The contract surety market is competitive and healthy, with sufficient capacity. Carriers continue to look to demonstrate value and differentiate themselves. This has fueled further evolution in the development of innovative performance security products, including the development of a performance security array of products for privately financed and public private partnership (PPP) procurements.

These include traditional performance bonds with added "pay on demand" liquidity features. Other creative performance security solutions involve expedited dispute resolution features, which force parties to quickly arbitrate any disputed default termination and bind the surety to the decision of the arbiter. These protect owners from the risk of a surety failing to act as a result of a bona fide dispute.

While the number of transactions involving innovative surety performance security remain relatively few, they have been used on some very sizeable procurements, such as I-66 in VA, the 1-64 Hampton Roads Bridge-Tunnel Expansion Project, the Brightline/All Aboard Florida project, and the recent I-75 DBFOM (design build finance operate and maintain) in Michigan.

As parties look for ways to decrease the cost of capital and ensure adequate performance security for projects, these products are useful tools.

Mega Projects

To avoid catastrophic loss, contractors need to carefully select JV partners, better align estimating costs, add sufficient contingency, and establish a margin strategy consistent with long-term profitability objectives, rather than simply driving revenue.

While the size, complexity and duration of large "mega" projects continue to increase, the profit on a majority of these same projects continues to deteriorate. The landscape is littered with firms that have taken on mega projects and experienced significant loss.

Some underestimated the transfer of risk while others did not adequately consider the impact of late and protracted ROW and permitting work. Acurately capturing risk and its associated cost during the estimating process has been a significant challenge given the size and complexity of these projects. Hard lessons have been learned. To avoid catastrophic loss, contractors need to carefully select JV partners, better align estimating costs, add sufficient contingency, and establish a margin strategy consistent with long-term profitability objectives, rather than simply driving revenue.

Despite this loss landscape, mega projects continue their forward march. Larger surety companies, which write about 60% of all surety business, are regularly seeing projects in excess of $500 million. Even single projects in excess of $2 billion are becoming more frequent. These projects tie up billions of dollars in surety capacity for years.

Given the ferocious use of capacity, a relentless focus on profit margins is critical.

To ensure success, prudent contractors are drawing on key risk mitigation tools, including:

- **Joint Venture (JV) partnerships:**

  The right JV partner adds both synergy and simple balance sheet protection. It can provide a check on the bid estimate, risk sharing on cash flow, and all-important sharing of the most precious of resources, talent. Contractors should carefully select partners based on the skill set the project requires, and how the partnership complements respective skill sets and matches the needs of the project. Corporate cultures are critical and should not be overlooked in the formation of a partnership. In addition, partners should conduct full financial due diligence of any prospective partner.

- **Robust Risk Committee process:**

  Best practices harness multidisciplinary risk committees which bring various disciplines together to examine legal/contractual risk, financial risk, estimating risk, engineering risk, political risk, and the risk of sufficient labor and subcontractor availability.

- **Rigorous subcontractor qualification and risk mitigation strategies:**

  Firms with the strongest qualification process produce the strongest financial results. Further risk protection comes with the use of subcontractor default insurance and bonding of key subcontractors.

- **Solid project scheduling techniques and protocols:**

  Completing a project on time and on budget is always the number one goal. Widely available project scheduling technology can help to avoid delays.

- **Leveraging advancing technology:**

  Technological innovation is revolutionizing the construction industry. Firms that avail themselves of this advancing technology will reap tremendous rewards in efficiency, safety and long-term operation and maintenance.

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Category	2018 Direction	Commentary	2019 Outlook	Commentary
Pricing / Rates	↑	Surety industry remains profitable in 2018.	↑	Premiums continue to increase.
Limits	N/A	N/A	N/A	N/A
Deductible / Retentions	N/A	N/A	N/A	N/A
Coverage	N/A	N/A	N/A	N/A
Capacity / Appetite	↔	The surety market is competitive, healthy, with sufficient capacity.	↔	Global firms have a higher risk appetite than US firms
Losses	↔	Surety losses in the US remain relatively benign while globally surety losses are growing in Canada and Europe.	↔ ↑	Lower loss activity remaining the overall norm in the US with growing loss activity on a global basis.

Large Commercial Surety

Commercial surety capacity is at an all-time high, with many new market entrants and several current surety carriers increasing their capacity and appetite.

Positive economic and industry drivers have created sustained softness in the large commercial surety market. Commercial surety capacity is at an all-time high, with many new market entrants and several current surety carriers increasing their capacity and appetite.

Investment grade issuers averaged less than 1% of all defaults (27 in total) since 2007. As insurance companies seek to improve underwriting results to counter-balance lower investment returns, commercial surety is a natural area of interest with results experiencing combined ratios well below 70%. Excess capacity and increased competition have provided those with better credit improved pricing and offered those with lower credit access to capacity not previously available.

More and more companies are using surety bonds to create financial flexibility in lieu of traditional financial instruments, such as letters of credit and bank guarantees. Surety guarantees are increasingly available on an international basis; bond acceptance from international obligees and the surety market's appetite to write them are becoming more closely aligned. Growing capacity from existing carriers and new entrants continues to push use of surety product supporting various financial guarantee structures, such as collateral for insurance programs, bonds in lieu of funded escrow requirements, and other creative financial solutions.

Commercial Surety Market Conditions

The market conditions for large commercial surety remain extremely positive, and we expect this trend to continue through 2019.

While excess capacity is available at competitive terms and conditions, it is important for the Indemnitor and surety company to maintain discipline during positive credit cycles. Indemnitors need to be vigilant in managing outstanding exposures.

Project performance liability should be tracked and properly closed upon project completion. Indemnitors should understand the requirements for properly releasing liability across all global jurisdictions where surety guarantees are being issued. Compliance obligations should be reviewed annually to determine if the bonded obligation is still required based on the operations of the business. It is critical for an Indemnitor to understand and closely manage the aggregate liability supported by surety credit. The time to manage aggregate exposure to the surety is not when there is a sudden change to the Indemnitor's credit profile, or an adverse change in the commercial surety market conditions.

Surety credit terms remain very competitive and Indemnitors should review all costs of credit to determine the most efficient instrument to satisfy performance security requirements. Where previously only a bank instrument was considered, Indemnitors should consider surety credit for various financial guarantees and international obligations. The market conditions for large commercial surety remain extremely positive, and we expect this trend to continue through 2019.

Change on the Horizon: Ownership

Change and disruptors are impacting all businesses in all sectors, and having a greater effect, at a faster pace, than at any time in the past.

Companies realize that these changes and the expectations of clients require companies to adapt and invest in technology and innovation to remain relevant in the future. As business owners get closer to retirement age, investing to achieve future returns in a changing environment is not always attractive. This is a valid concern: the abundant risk in the construction industry is well understood by executive owners. In fact, construction contractors made up the largest number of respondents to [Aon's most recent Global Risk Management Survey](#).

While the rapid pace of change is a valid concern, it is also an opportunity for strategic or financial buyers seeking to make new investments, and is likely to accelerate changes of ownership in many sectors.

These issues are certainly relevant to construction company owners. Many leading construction firms have ownership teams within ten years of planned retirement. At the same time, the industry may experience tremendous changes in building with Infratech investments expanding rapidly.

This is a material issue for the surety industry. A majority of global surety premium and assumed liability was derived from construction firms. Change of ownership will typically result in large adjustments to the capital structure of the contractor. As ownership transition plans are created, advisors usually focus first on equity and debt structure. This is certainly important, but if the company relies on surety bonds to obtain new work, balancing surety company needs is essential as capital structure is developed.

A surety broker with extensive experience with ownership changes can help companies successfully navigate this environment. Merger and acquisition advisors understand that expertise in this field is paramount as transactions race to the finish line. Unexpected issues are common and the ability to rapidly put forth creative solutions that satisfy all constituents to a transaction is pivotal. A strong surety advisor/broker can also help ensure transaction value is properly realized, and help to establish an optimal and sustainable post-closing surety program.

Items to consider when working with a surety broker during an ownership transition:

- How many transactions have been supported?
- Scale of the surety program capacity created for acquired companies
- Relationships with strategic and financial buyers
- Skill and experience working with buyers and sellers
- Track record of establishing indicative — and achievable — program terms
- Proven ability to work with other capital providers to achieve bankable deals
- Experience working with board members and company officers
- Shared insight and foresight around changes that may develop
- Capabilities to assist human resource matters
- Ability to deliver other transaction liability insurance products to assist in closing

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About Aon Surety

Every year, Aon Surety provides more clients with more solutions to difficult problems than anyone else in the construction space. In fact, we place bonds for 25 percent of the Fortune 500 companies as well as the largest global companies outside the U.S. In 2019, our clients can expect the same unwavering commitment: Our Surety team stands ready to help contractors navigate the challenges of the marketplace and move from project inception to completion, maximizing profitability and prudently managing risk.

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.

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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