Contractor Financing

How to improve your chances of obtaining a loan in today's tight credit environment

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A White Paper exploring the unique challenges contractors face in obtaining financing, and offering tips for improving the chances of obtaining a contractor loan in today's tight credit environment.

Obtaining financing is difficult for contractors even in good economic times. In uncertain times like these, the most important thing to focus on as you prepare your financing request is the preparation and presentation of current and accurate financial statements.

The credit crunch has made it more difficult for businesses in practically every industry to borrow money, but contractors are finding the going especially rough. In many parts of the country, single- and multi-family homebuilding have virtually ground to a halt, and commercial, institutional and industrial aren't faring much (if any) better.

Even in the best of times, lending to contractors is challenging for banks. This is due to a number of different factors, including the sensitivity of contractors to business cycles, wide revenue swings, low barriers to entry, high levels of competition among contractors, relatively low contractor gross profit margins, and the overall volatility of the industry.

According to Dev Strischek, author of *Analyzing Construction Contractors* and instructor of a course for bankers of the same name,[1] contractors fail more often than businesses in other industries, and the failure rates rise faster during a recession. "The statistical record of contractor failure has led to its classification as a high-risk industry," he says. As senior vice president and senior credit policy officer in Atlanta's SunTrust Banks, he works in one of the nation's toughest construction lending markets.

In this environment, contractors in search of financing must do everything they can to position their companies in the best possible light to bankers and potential lenders. This starts with the preparation and presentation of current and accurate financial statements.

Determining a Contractor's Creditworthiness

While the details of commercial loan underwriting can get complex, the concept is relatively simple: Banks want to lend money to contractors — or any type of business, for that matter — that they deem creditworthy; or in other words, contractors that will be able to repay their loans.

To determine the creditworthiness of a contractor, the banker will need to analyze current financial statements. The statements that are most important to include in a contractor loan request are:

- Balance Sheet
- Income Statement
- Accounts Receivable and Inventory Agings
- Job Status Reports
- Cash Flow Projections

In analyzing a contractor's financial statements, a banker is primarily trying to determine if cash flow generated from the operations of the business will be sufficient to repay the loan *and* all of the business' other existing and proposed obligations.

"The contractor is a manufacturer of a unique, one-of-a-kind product that takes a long time to build," notes Strischek. "Much of a contractor's working capital is tied up in large, slow-turning, construction-in-progress inventory." Operating cash flow is heavily dependent on the contractor's ability to assemble and present to the owner proof of the percentage of work accomplished. These monthly progress billings are the contractor's source of cash for labor, materials, taxes, principal and interest.

To demonstrate cash flow, banks want to see — you guessed it — contracts. "We need to be able to determine that as a contractor performs work, it will derive enough cash flow from its operations to repay existing creditors as well as new debt," says Strischek. "Don't just tell me you have work — show me the contracts and your cash flow projections." For example, if you want to borrow money for one year, show your banker monthly or quarterly cash flow projections that will demonstrate your ability to repay the loan in this timeframe.

Aside from cash flow, banks will also consider two other potential sources of repayment: collateral and personal guarantees from the owner. Bankers often ask contractors to pledge personal assets in support of a loan, usually their primary residence.

As for collateral, it tends to be more problematic with contractors than with most other types of businesses, such as those with inventory. Most contractor collateral consists of equipment or billings for work-in-progress. "If we repossess a contractor's equipment, we effectively put them out of business because they no longer have the equipment they need to do their work," Strischek explains. "And it's difficult to liquidate progress billings and turn them into cash because the work isn't finished."

When a contractor fails to finish work on a bonded contract, the bonding company usually obtains job rights from the contractor, which gives them payment priority over a bank's right of assignment. "When push comes to shove, the bonding company moves ahead of everybody else," says Strischek. Therefore, most contractor loans are underwritten as unsecured even if the bank has taken collateral.

Lender Red Flags

If you're a contractor in search of financing, you should be aware of certain red flags that bankers tend to associate with troubled contractors. Dev Strischek, senior vice president and senior credit policy officer of corporate risk management with SunTrust Banks, identifies the following red flags:

- A ratio of accounts receivable to accounts payable of less than 1:1. Ideally, this ratio should be 2:1 or 2.5:1.
- Poor payment records, judgments, liens, bankruptcy, etc. for the firm and/or principals on credit agency reports.
- Delinquent taxes (payroll, income, sales, etc.).
- Contractors that are unlicensed or whose licenses have expired.
- Contractors who can't get bonded or whose bonding capacity has been cut, and/or those unable to renew insurance coverage with their current bonding company.
- A lack of current financial statements, including contract status reports.
- Contract status reports that show major jobs behind schedule.
- Contractors working on jobs outside of their traditional geographic area and/or their traditional types of projects.
- Poor estimating and job-cost reporting, as evidenced by cost overruns, late reports and/or declining backlog.
- Poor financial management, as evidenced primarily by consistent problems with cash flow.

Contractor Financial Analysis

Banks consider both financial and non-financial factors when analyzing contractor loan requests. In its financial analysis, a bank will look at four main factors.

1. ***Profitability*****:** As we noted earlier, the relative ease of entry for competitors and high volatility in the construction business usually lead to low gross profit margins for most contractors. Also, with most jobs, there is a higher cost-per-unit-installed during the first half of the job due to the learning curve involved. Revenue usually catches up to cost during the second half, but contractors can be vulnerable early on.

2. ***Liquidity*****:** The contractor should be able to demonstrate enough cash to cover at least four weeks of wages and payroll taxes and one month of trade payables and utilities. According to RMA contractor statistics[2], the average contractor has 12 percent to 13 percent of total assets, or 5 percent to 7 percent of sales, on hand at any given time, which is usually enough for this.

3. ***Solvency*****:** There's a subtle difference between liquidity and solvency: Liquidity is the ability to meet short-term obligations and solvency is the ability to meet long-term obligations, including those to both debt and equity holders. It also includes the ability to maintain assets, like replacing worn-out capital equipment, and to pay the construction company's owners enough in the way of dividends.

   In gauging a contractor's solvency, bankers want to see more than just a positive tangible net worth. There should be enough funds to cover principal and interest payments, capital expenditures, rent and lease payments, and owner draws or dividends.

4. ***Leverage*****:** Bankers are wary of lending more money to contractors that are already highly leveraged, especially those with heavy short-term debt. "If a contractor has a 3:1 debt-to-worth ratio but 90 percent of it is long term, at least we know that not all of the debt is coming due at once," says Strischek.

Non-Financial Analysis
In addition to detailed financial analysis, banks will also consider a number of non-financial factors as they gauge a contractor's loan request. Here are some of the most important ones, along with guidance on what banks are (and aren't) looking for:

- **What type of contractor is it?** Most bankers view general contractors as lower risks than subcontractors, because they generally have stronger financial statements than subs and are one step closer to the source of payment for work performed. Contractors should also be legally licensed, and the license holder should be an active employee.

- **How experienced is the management team?** Management ability is critical to a contractor's success; therefore, an accurate gauge of management's capabilities will be fundamental to the banker's assessment of its creditworthiness. "High turnover is an occupational hazard in construction, so bankers aren't necessarily alarmed when they see numerous job changes," says Strischek. "But the changes should come at natural breaks, like the completion of projects or the wind-down of a business cycle."

- **What is the construction company owner's level of involvement in the company?** Most bankers like to see owners who are actively involved in their contracting business — reviewing most bids (and all large bids) themselves and personally visiting job sites. Construction management texts encourage contractors to try to visit their job sites weekly and spend about 25 percent of their time in the field. "Close supervision tends to keep projects on time and on budget," Strischek says.

- **What are the contractor's billing terms and policies?** Bankers will look very carefully at a contractor's billing practices, including how frequently jobs are billed and which jobs are under-billed and over-billed. They're especially interested in any front-end loaded billings, since these can leave the contractor short of revenue to pay remaining costs at the end of a job.

- **What is the contractor's size?** Default probability statistics[3] show that small contractors are more likely to default on their loan obligations than large ones. For example, a contractor with $1 million or less in annual sales is more than twice as likely to fail after one year as one with $5 million to $10 million in sales, and the small contractor is *nearly four times* as likely to fail after one year as one with more than $25 million in sales.

- **Are the contractor's customers primarily public or private?** Since most public jobs are awarded on a bid basis, their gross profit margins tend to be lower and there are usually more administrative requirements. Total gross profit dollars are often higher on public jobs, though, since the jobs are usually bigger.

- **Is the contractor's business heavily seasonal and/or cyclical?** The less exposed a contractor's business is to seasonality and business cycles, the less risk it poses to a bank. Contractors in the north, for example, are usually impacted much more by the weather than those in the south. As for business cyclicality, residential housing is a good example of an industry that goes through tremendous boom and bust cycles — and is therefore considered higher-risk by most banks.

- **Is the contractor's business capital-intensive with a heavy reliance on fixed assets?** Heavy construction is typically more capital-intensive than other trades, and may also be more hazardous. In these instances, insurance coverage will be more difficult and expensive to obtain — factors a banker may take into consideration when analyzing a loan request.

- A banker may also want to personally examine a contractor's equipment for upkeep and orderliness and inquire about trends in downtime, repairs and maintenance. "Sloppiness, deferred maintenance and poor recordkeeping may divert the contractor's cash away from loan repayment," notes Strischek.

- **How are the contractor's workmen's compensation and unemployment ratings?** Poor ratings and a poor OSHA record will result in higher insurance premiums, and may also reflect poor recordkeeping, unsafe field practices or fraud — all serious deterrents to bank lenders.

- **How accurate are the contractor's estimations?** A banker will scrutinize cash flow projections to try to determine a contractor's track record in estimating accuracy, as well as how much net worth and profits are derived from jobs in progress. "Declining gross margins on jobs-in-progress usually indicates productivity problems caused by ineffective management in the field," says Strischek.

- **How do the contractor's financial ratios compare with those of its peers?** Bankers will compare a contractor's financial ratios with those of other contractors with similar assets or sales using RMA's *Annual Statement Studies*. To qualify for financing, a contractor's ratios should meet or exceed the median figures, says Strischek.

- **Are the contractor's financial statements audited?** Most bankers prefer audited statements to unaudited ones for the assurances that a knowledgeable third party brings to the reliability of the numbers. In fact, sureties typically expect the contractors they bond to submit annually audited financials. Bankers may still extend credit to contractors who provide company prepared statements or tax returns, but as the size of the request grows, expect bankers to ask for third-party prepared financial statements.

- **How many years has the contractor been in business?** Most bankers like to see that a contractor has been in business for at least two and preferably three years. "When a contractor has only been in business for a year or two, it's hard to get a feel for whether they're going to be able to go the distance," says Strischek.

- **How many competitors does the contractor have — and who are they?** Trades with relatively low barriers to entry (like carpentry, plumbing and heating) usually have high levels of competition, which results in more price competition among contractors and more risk for banks. HVAC in south Florida is a good example.

"You'll find more than a thousand HVAC contractors in the Yellow Pages down there, so even a good one will have to cut prices to get business," Strischek says. "On the other hand, there aren't as many contractors doing road building or bridge construction because you need heavy equipment and more financial resources to finance it."

The Final Analysis
While quantitative number-crunching is obviously important, Strischek notes that a lack of strong leadership is the leading cause of contractor failure. In a comprehensive study conducted by FMI Corporation, a construction management consulting firm, it was determined that "poor strategic leadership" was a factor in 76 percent of contractor failures. This was higher than "inadequate capitalization" (58 percent) and "loss of contractor discipline" (45 percent).

In the end, a banker's credit analysis will identify *all* of the financial and non-financial factors (including these top three) that positively or negatively affect the contractor's ability to repay the loan. Doing so gives contractors the best chance of obtaining a loan, while enabling banks to mitigate the risks involved in lending to them.

Loan Covenants

To help reduce their risk of loss and enhance their ability to monitor the financial performance of contractors they lend to, bankers may include financial covenants in the loan agreement. These are minimum financial benchmarks the contractor must achieve and maintain in order for the loan to be considered in good standing. Typical covenants likely to be encountered in contractor loan agreements include:

- Minimum current ratio
- Minimum net working capital
- Maximum debt-to-worth ratio
- Minimum tangible net worth

In addition, in term loan agreements or at renewal, the bank may require annual step-ups in net working capital and tangible net worth minimums by adding some percentage of income to the amounts for both of them. The intent is to make sure the borrower is building up enough equity in the business to balance debt and support future growth.

[1] Dev Strischek, *Analyzing Construction Contractors, Third Edition,* Risk Management Association: Philadelphia, 2005. For more information, contact RMA at www.rma.org or at 214-446-4000.

[2] *Annual Statement Studies: Financial Ratio Benchmarks,* RMA: Philadelphia. For more information, contact RMA at www.rma.org or at 214-446-4000.

[3] *Annual Statement Studies: Industry Default Probabilities and Cash Flow Measures,* RMA: Philadelphia. For more information, contact RMA at www.rma.org or at 214-446-4000.