



# Stable Surety Programs for Private Equity-Owned Construction Companies

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Despite rising interest rates and growing recessionary fears, private equity remains a popular class of investment for acquisition and ownership of closely held businesses.

Recently, construction has become an attractive industry for capital investment as aging business owners look to retire. Access to stable and predictable surety capacity remains an essential requirement for many successful construction companies, but it is often overlooked when negotiating a sale to a private equity firm. Lack of surety support can be incredibly disruptive and cut contractors off from pursuing high-quality projects.

The priorities and objectives for private equity firms often vary considerably from those of traditional family ownership of construction firms and often don't align with the traditional approach to surety underwriting. This different approach frequently leads to conflict and ultimately a reduction in available capacity and/or substantial collateral demands which leave the contractor and their new ownership in a difficult position. But with better communication, transparency and understanding, access to predictable surety capacity is possible.

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## Bridging the Balance Sheet Gap

Historically, private equity deals have relied on leverage and borrowing against intangible assets and goodwill with the end goal of delivering returns to investors. This approach is diametrically opposed to traditional surety underwriting which prioritizes debt-free balance sheets, liquidity and capital retention. The surety focuses on tangible and highly liquid reserves that can be deployed in the event of a claim or to remedy a losing job. Investment fund modeling often focuses on metrics like adjusted EBITDA, amortization and depreciation, and financing terms. The goal for private equity-owned companies is to distribute excess capital for use in future investments, whereas closely held construction companies often retain capital on the balance sheet as a way to bolster the operation for future generations.

Private equity-owned contractors should highlight positive cash flow, availability under lines of credit, and long debt maturity windows to assure surety carriers that they have the capital on hand to endure underperforming projects and cyclical economic trends. By taking a genuine interest in the surety's concerns, a private equity-owned contractor can begin to develop a rapport with their surety and build a level of trust that moves beyond viewing the surety as just another vendor.

## Limited Indemnity Is a Stumbling Block for Sureties

To establish a surety program, customers, known as principals, are required to sign a document known as an indemnity agreement. The indemnity agreement requires the principal to act to hold a surety company harmless in the event of a loss. In most cases, the surety company also requires the owners of the company to sign the indemnity agreement personally as well to ensure cooperation in the event of a claim and reduce the risk of upstreaming of funds. Because of the structure of most private equity funds, personal/parental guarantees are not available, and the surety

is limited to the indemnity of the principal only. Without the parental guarantees, a contractor could conceivably distribute all tangible liquid assets out of the company in advance of an impending claim, thereby leaving the surety exposed and without recourse.

There are a number of tools available to address these concerns:

- Additional or limited-dollar indemnity from funds or other related companies.
- Use of a capital retention agreement to ensure that a certain amount of tangible equity will remain in the company to support ongoing bond obligations.
- Use of partial or full collateral provided via letter of credit or cash.

That said, retention of tangible liquid assets on the balance sheet remains the surety industry's preferred form of security. Over time, showing a willingness to retain capital will build trust with the surety company and help support growth of the aggregate program.

## Understanding Bond Obligations

While some bonds have a definite term or are cancellable in nature, most performance and payment bonds that contractors are required to post are noncancellable and in force until completion of the underlying obligation. And while sureties try to estimate the duration of their liability, issues such as project delays, critical path failures by other contractors, and a host of other disturbances can all considerably extend the surety's liability. For larger projects, these obligations can often extend beyond five years and, in some cases, even longer. This has proven to be one of the key differences between commercial (non-construction) surety, where one-year bond forms are common and surety capacity is easier to secure, and contract (construction) surety, where open-ended exposure has made securing capacity more difficult.

Often sureties are reluctant to take on obligations with long durations because it becomes increasingly more difficult to predict what a company's financial condition will look like at project completion the farther away that date is. Private equity-backed contractors must also address how the expected duration of current bond exposure fits within the overall debt maturity. If debt is coming due in the next year, but the contractor's ability to refinance seems uncertain, sureties will be reluctant to add exposure that runs beyond that maturity date for fear that new terms may radically increase debt financing costs or that an inability to refinance may lead to a default or bankruptcy.



## Conclusion

Private equity firms should make sure they fully understand how important surety is to a contractor before investing. For some, a strategic shift away from bonded work may be a viable solution. For others, a bond program is an absolute necessity and access to capacity must be protected at all costs. Ultimately, the earlier private equity engages the sureties, the fewer surprises they can expect as it relates to the surety program. When dealing with surety carriers, transparency and good communication will always increase the likelihood of a positive outcome. But private equity firms must also acknowledge that sureties will have capitalization and retention requirements that could impair returns to shareholders. These requirements should be fully understood and taken into consideration when looking at new investments.

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## Sources and Further Reading

**McKinsey Global Private Markets Review 2023 | McKinsey**

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