REDUCING CONSTRUCTION FAILURES

by Steve Brown

Banks with high levels of contractor or developer concentrations should note the results of recent studies. Analysis done on contractor failures from 2002 to 2004 found 29% of contractors will fail and of those, 39% were companies that had been in business for more than 10Y. The million dollar question is why contractors fail and whether there is a way for banks to predict such events in advance. Post-default analysis indicates fast growth is one contributing factor common in many contractor failures. Smaller companies brimming with business will often cut corners to meet demand. It makes common sense, as managers are spread around more and more, infrastructure isn't built out fast enough to support the growth and inexperienced employees are oftentimes promoted too quickly. Such companies simply don't have the time to post jobs and interview candidates, as the work keeps flowing in faster and faster. Without adequate controls, inaccurate billing risk increases, project estimates can be wide the mark and cash flow problems can surface. As a general rule of thumb, banks should ramp up monitoring on construction clients that are expanding revenue at a rate of more than 15% per year, or growing faster than their regional market. Another contributing factor in many contractor failures can be attributed to job size. Contractors that routinely build $1mm sized projects can quickly be overwhelmed when jumping to $10mm projects. Banks should calculate as part of their due diligence the average project size over the past 2Y and compare it to upcoming projects. An increase of 25% or more in average project size could be a precursor to potential problems. Another key area bankers should monitor relates to the quality of the contractor's systems and reporting. Those that utilize quality estimating software and have a strong accounting system are proven to have a superior handle on cash flow, thereby reducing lending risk to the bank. Another point of due diligence for bankers is to make sure customers have a post-bidding review process in order to identify and refine overall accuracy. Banks should also analyze vendor and supplier relationships. A count should be made of the number and depth of suppliers, to ensure project timelines have a good chance of being met. The faster a contractor can analyze and refine their bidding process or go to their bench to get out of trouble (and avoid delays), the less chance the loan may get into trouble. Research also finds that contractors can get into trouble when they move into a new geographic region. Many contractors see the rebuilding around Hurricane Katrina as the next gold rush, but many are likely also over their heads. Delays associated with labor, weather, soil conditions, suppliers, permits, codes and many other factors can lead to disaster. Banks should ensure contractors have well documented financial statements, references, insurance and bonding information for any subcontractors that they may use. In addition, developers moving into new areas should be closely monitored. Nuances among and between each construction subsector requires specialization and knowledge that only comes with experience. Bankers should also be wary of contractors with expertise building highways who think they can build housing subdivisions. Finally, as with most things, follow the cash. The longer the credit cycle takes to turn and the greater the number of projects a contractor or developer have underway, the more they may need to supplement any slowdown with cash. Contractors with weak or concentrated banking relationships may increase risk exposures. Given the shift in the credit cycle, taking action now to help your contractor or developer clients is worth the extra effort. Protect the risk exposure in the bank by protecting the customer.

BANK NEWS

Small Loans

FDIC Chair Shelia Bair continues to beat the drum that banks should get into small-dollar loan program in order to compete with payday lenders (and drive down spreads). While Bair made the case that $1k loans for 1Y can be profitable if you have the right processing structure, regulators also appear ready to add extra incentives in the next several months (by expanding loan guidelines to include these types loans for CRA attribution).

Kids Savings Marketing

We remind banks that the National Teach Children to Save Day is coming up April 24th. This is an excellent time to promote savings accounts for the 16 year old and under set. Many banks are getting their local Congresspersons or mayors to join in-branch events.