

Price Escalations May Lead Aggressive Bidders To Default

Materials costs are outpacing prices for finished buildings in a number of sectors

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By *Bruce Buckley*

Rising materials prices coupled with aggressive bidding in a down economy have raised concerns that a new wave of contractor defaults may be on the horizon. While the contracting community proved more resilient during the downturn than some had predicted, many firms that bid aggressively in recent months and slashed profit margins face considerable hardships as prices for materials and consumables continue to rise.

"The trends we're seeing show that the vise is tightening on contractors," says Ken Simonson, chief economist for the Associated General Contractors. Construction prices rose 6.1% between February 2010 and February 2011, according to the U.S. Labor Dept.'s Producer Price Index. During that same period, prices for finished buildings remained nearly flat, with new office, industrial and warehouse structures up less than 1% and those in education sectors up just 1.4%, according to the data.

"Contractors were reportedly already bidding jobs at costs," Simonson says. "This means that a further 6% rise in their input costs, unmatched with any pass-through to owners, is certainly going to push some firms out of business."

Escalating Concerns

Five years ago, when the construction market was rapidly expanding, trade contractors and general contractors had more leverage to put escalation provisions in their contracts with owners, says Scott Trethewey, executive vice president for risk management and finance at Moss & Associates, Fort Lauderdale, Fla. With the market now at the bottom, more contractors are willing to retain that risk if it helps win work, he points out.

"There are people making bets that they will be able to procure materials within the context of their budgets," Trethewey adds. "As prices go up, only time will tell if those were good decisions or bad decisions."

Don Nabor, vice president and director of risk management at Gilbane Building Co., Providence, R.I., says while the contractor works to build escalation provisions into its contract, in many cases it gets "a great deal of pushback" from owners. "We're trying to work closely with owners to make sure they understand that there is escalation exposure out there, and they can't leave that exposure with the contractor and subcontractor in this environment," Nabor says.

Defaults Deferred

Concerns over contractor defaults percolated when the recession began, yet losses have been limited, says Fred Schwait, chief underwriting officer for construction services, bond and financial products at Travelers Insurance. "There was an expectation of losses by the industry, but so far they have been limited," he says.

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In the first nine months of 2009, the surety industry incurred \$957 million in losses on \$3.9 billion in written premiums, up from a ratio of \$706 million to \$4.3 billion during that period in 2008, says the Surety & Fidelity Association of America. In the first nine months of 2010, however, the surety industry incurred \$654.5 million in losses on \$3.9 billion in premiums, bringing loss ratios back in line with pre-recession figures.

Ed Littleton, vice president of risk management at Balfour Beatty Construction, Dallas, says that many subcontractors stayed solvent by feeding off of working capital built during the boom years. “A lot of contractors put on fat for the winter,” he says. “Working capital was at a good level going into this recession, and that has paid off for them.”

Littleton notes that contractors with significant fixed costs—such as fleets of heavy equipment or in-house production facilities—suffered the most, while most of those companies that could lay off labor survived. But in today’s economy, many subcontractors are bidding aggressively and could pay the price for those decisions in the near future, Nabor says.

“Everyone’s concern going into 2012 is that the backlogs of contractors are much more thinly priced than they were in 2008 and 2009,” Nabor points out. “So now, all of a sudden, we’re seeing escalations kick in. If defaults do happen, the ability to manage those defaults within the original contract value will be very challenging. The feeling is that you’re going to see a larger financial impact from potential defaults.”

While February’s Producer Price Index statistics for materials prices are troubling, Littleton expects that the worst is yet to come. “Oil prices are already back above \$100 per barrel, and now with the tragedy in Japan, what impact will that have on demand as they rebuild? Everything points to big increases in commodity prices,” he says.