

Incorporating the
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Are You Proactively Managing Your Subcontractors to Avoid Defaults?

The number of construction cranes dotting skylines across the country continues to increase as commercial construction is projected to experience double-digit growth in 2015.¹ Despite this rosy forecast, general contractors continue to grapple with the issue of subcontractor default that is primarily caused by having insufficient capital to handle today's market realities.

Many subcontractors do not have the cash or credit lines to handle extended payment terms from owners, fluctuations in material costs or an uninsured loss because of poor-quality work.

As a result, general contractors should actively manage subcontractor default risk by using a disciplined and rigorous subcontractor prequalification process as well as subcontractor payment best practices, so they can help keep their projects on budget and on time.

Foreseeing Default

When a general contractor senses subcontractor default may be a possibility on a project, every attempt should be made to assist the subcontractor in completing its work.

Providing supplemental staffing and assisting with payroll or material procurement are important steps — even though doing so can put a strain on

a general contractor. The strain of missing project deadlines and associated fines or compromised quality could have a much bigger impact on a general contractor's business.

That's why general contractors need to be vigilant about their subcontractors' financials. Among the early warning signs that a subcontractor is at risk for default include difficulty processing a contract document, a fluctuating workforce size and poor morale, frequent and unanticipated supplier turnover, and strained ability to manage payables and receivables.

When a general contractor discovers a subcontractor's financial condition has deteriorated, it is important to communicate this to both pre-construction services for future bids and also to operations in the event the subcontractor is working on existing projects.

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Checking Financial Health Through Prequalification

The goal of the subcontractor prequalification process is to determine the company's financial resiliency and management capabilities. That information can then be used to decide which subcontractors should be asked to bid on the project and which ones should ultimately be selected. A prequalification process should, at a minimum, include:

Subcontractor Data Collection — Create a formal Subcontractor Prequalification Package that includes requests for detailed information on management, project history, operations, references and financials. Document requests should include three years of audited financial statements and a surety capacity letter from the surety — not the broker. It is important that every potential subcontractor receives and submits a completed prequalification package. The data should be collected and updated yearly or prior to bid and/or award. Make an effort to verify the information received is valid, true and correct. Calling references will help confirm the validity of the information provided.

Risk Criteria & Quality Analysis: Determine the specific criteria necessary to develop high- and low-risk levels based on the data collected

from the Subcontractor Prequalification Package. Evaluate subcontractors for their financial strength and “high-risk” potential. Sample criteria include aggregate workload, percentage of work subcontracted to second-tier contractors, working capital versus cash flow, accounting methods used, and quality and safety records. Also, consider factors like their capacity to successfully execute business plans, the continuity and stability of their management and ownership, and their experience completing contracts of similar scope, size and complexity in a timely, safe and qualified manner.

Risk Scoring & Subcontractor Action Plan: Develop a scoring system that incorporates management characteristics, financial position and post-project evaluations. Combine these scores and assign an overall risk score that will provide clear direction on which subcontractors are given a green light both for current and future bidding processes, including single-project and aggregate-program amounts. In cases where a clear green light is not present, use a risk mitigation plan to address any deficiencies.

Create a database that allows for comparative analysis during a bidding process and make it available to all staff responsible for choosing and working with a subcontractor.

Incorporating the subcontractor prequalification program into project life cycles and the corporate culture is critical to the successful management of subcontractors.

Vetting Vendors to Prequalify Subcontractors

Not all general contractors have an internal team available to spend time developing and executing a Subcontractor Prequalification Process, which is why a number of third-party vendors provide specialized services in this area. Typically, the vendors perform a prequalification for specific subcontractors at least annually.

Subcontractor prequalification vendors can provide a varying range of products and services. Having a vendor that can help with the following can be of great value:

- **Data Collection Platforms** — Many vendors use a Web-based platform to collect and store subcontractor prequalification information. Data entry is performed by the general contractor, subcontractor or vendor. In some

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cases, the platform can automatically calculate financial ratios.

- **Document Collection and Verification** — The vendor should collect and verify the necessary subcontractor documents like insurance certificates, bonds and financial statements.
- **Proprietary Financial Analysis** — A vendor should deliver a proprietary financial analysis and rating for each subcontractor using appropriate ratios and calculations.
- **Project Calculations** — The vendor should calculate single-project limit and aggregate-program limit.
- **Robust Reporting** — A vendor should provide detailed prequalification reports that include, at minimum, data collection platforms, document collection and verification, proprietary financial analysis, project calculations and robust reporting.

Knowing how to integrate subcontractor payment management best practices into a project is critical.

After receiving the vendor data, the general contractor still needs to implement any subcontractor action plans, including rejecting nonconforming subcontractors or implementing required risk mitigation plans.

Managing Payments

Once subcontractors are chosen for a project using the prequalification process, a general contractor can also help reduce the risk of default by managing payments appropriately during the project.

Zurich claims data has shown that general contractors with top-tier payment management practices have generally achieved exceptional results with regard to limiting or avoiding such losses.

Knowing how to integrate subcontractor payment management best practices into a project is critical. Some of the issues to address as you assess whether your organization is using best practices include:

- Are your subcontractors overbilling and are you overpaying them, risking higher losses if a default occurs?
- Do you have an accurate schedule of values prior to start of work?
- Are you using project-specific quality control plans to mitigate the risk of nonconforming work?
- Are you monitoring and verifying downstream payments to lower-tier subcontractors and vendors/suppliers to ensure payment receipt?

- Are you verifying that union payment obligations are current?
- Are you using joint check agreements for higher-risk and nonperforming subcontractors?
- Are you maintaining 10% or higher retention on higher-risk or nonperforming subcontractors?

Confidence In Numbers

The construction industry is recovering at a good pace, and industry confidence is at its highest in seven years. General contractors need to build that confidence into their projects by selecting subcontractors with the financial strength to perform work on time and at the highest quality and ensuring that their subcontractors are working within proven payment practices.

Developing structured and robust prequalification and payment management processes can help create a win-win for both general contractors and subcontractors, while ensuring a history of projects delivered at the highest level of professionalism. **Q**

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¹ <http://www.aia.org/press/aia105448>

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