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The Wrong Kind of Impact: When Buyouts Bust Bondability

By Stephen Ducharme of Old Republic Surety

Successful construction companies often begin with a dream, a truck, and a job. A contractor builds a small firm into a large, multi-million-dollar company. At some point, the contractor passes on the hard-earned business to the next generation or sells to a partner or investor. What the contractor may not realize, though, is that a buyout can adversely affect a company's bond program.

Poorly drafted terms and conditions of a sale may impact the construction company's bondability, leading a surety to reduce or cut off the company's bond credit. That, in turn, may threaten the company's pipeline of business.

Given that many small-to-midsized contractors are privately owned, it's important for bond producers to stay informed regarding their clients' buyout plans. The key to protecting a contractor's bondability is to have conversations with the surety and contractor before such a sale takes place.

The Consequences of a Buyout

Contractors are sometimes reluctant to discuss a potential sale and may also have signed nondisclosure agreements. However, sellers need to understand the consequences of a buyout. Here are four key questions to ask about a potential sale:

1. **How does the buyout impact the company's capitalization and debt levels?** Sureties are always concerned about a company's working capital and net worth when it takes on debt. If the buyout is crafted in a way that increases the amount of debt or depletes the cash position, it could put significant stress on the balance sheet. Underwriters are unlikely to extend credit if they feel there isn't sufficient capital in the company to work through its project backlog, pay its suppliers and subcontractors, and carry its debt load. A cash buyout, on the other hand, shouldn't affect the company's working capital.
2. **Is personal indemnity still an option?** The personal indemnity requirement in a surety contract gives the surety recourse if the contractor doesn't complete the job. The contractor is personally liable for making the surety whole if there is a default. That's a powerful incentive for a contractor to work things out with the obligee. When a contractor sells to a publicly traded company or private equity firm, personal indemnity usually isn't an option. This can imperil the company's bondability.
3. **What is the buyer's motivation?** The buyer may be seeking rapid growth or want to take cash out of the company. Sureties look for steady, predictable growth and become concerned when companies grow too fast. Sureties also like to see contractors keep some of their profit in the company. An owner who cares about his or her legacy will want to be sure the buyer's goals align with his or her own and that the new owner's business plan is sustainable.
4. **Will top employees remain at the company?** Many contractor customers have personal relationships with a company's owner and project managers. The same holds true for subcontractors and suppliers. These relationships are part of the value and viability of the company. If key people in a company are headed out the door with the change in ownership, it's a red flag for the surety underwriter. Losing the skill sets of key people and the relationships they have cultivated can result in lower work quality, increased costs, and mismanagement. Consider having a transition period for the owner and key employees.

Steer Clients Away from Pitfalls

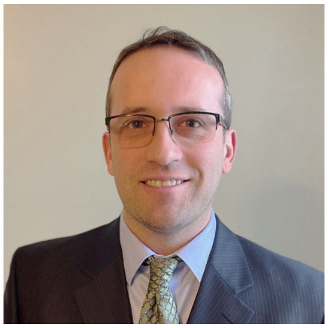
All parties to a buyout need to understand the essential role of bond credit in the construction business. By communicating up front the importance of surety, bond producers can help steer their clients away from potential pitfalls.

Regardless of whom the buyer may be, if the terms of the sale cause an overnight drop in working capital and equity, it will have a negative impact on the surety program. Terms that allow reasonable time for payment without dramatically depleting the balance sheet are more likely to retain uninterrupted surety credit.

If the selling owner finances the sale personally through a note payable, he or she may be asked to subordinate the debt to the surety. If the selling owner has a sense of legacy and is invested in the success of the company in the hands of the new owner, this is not an onerous course to take to continue the surety program for the company.

If the company is being sold to a key person, it may be preferable to sell ownership interest in the company in stages to allow the operating income of the company to fund part or all of the buyout so that the amount of debt associated with the final sale can be minimized or eliminated.

Talking about these challenges prior to a sale can ensure the buyout has a happy ending from a bonding perspective.



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