



DAN FAUCHIER

“Hidden Equity” threatened by CARB regulation

Fasten your seat belts: this issue we talk to the “money men.” Here are two financial experts, in the prime of their careers, who have studied CARB’s proposed off-road diesel emissions regulations and come to similar—startling—conclusions regarding the likely economic impact on the engineering construction industry (Note: this conversation took place during mid-March 2007, based on the most current regulatory language available at press time).

EGCA member CIT Construction (an affiliate of The CIT Group, one of the nation’s largest independent finance companies) specializes in financing for the construction industry. The CIT Group will celebrate its 100th anniversary in 2008. Its Southern California vice president is Ralph Potter, who has been with CIT for nearly 32 years. The opinions expressed by Ralph in this article are his and do not necessarily reflect the views of The CIT Group, or its affiliates (Ralph’s lawyers made me say that).

EGCA Member Allenbrooke Insurance Services is the largest surety operation on the West Coast. President Glenn Dethloff (pronounced “DETlof”) has been in this business over 30 years. After starting, building and selling his very successful surety company, he retired briefly, then rejoined the working world to build yet another successful family enterprise.

FAUCHIER: *Gentlemen, with how many contractors’ balance sheets are you familiar?*

POTTER: Over the years, I have seen and analyzed several thousand financial statements submitted by different contractors.

DETHLOFF: We evaluate over 50 annual year-end financial statements, and many of those are engineering contractors with a lot of equipment. I’ve seen thousands over the years.

FAUCHIER: *Ralph, on what finan-*

cial factors does CIT base its lending decisions?

POTTER: Along with other factors such as quality of management, the top four financial factors are working capital, cash flow, leverage and the quality of the company’s equity account or net worth.

FAUCHIER: *Glenn, how about bonding limits, what you call “surety credit”? How do you establish those?*

DETHLOFF: Surety credit is primarily determined by two criteria: working

tors who have a substantial amount of equipment also have a hidden asset taken in to account by sureties. This asset is the sales value of depreciated equipment which is no longer shown on the financial statement of the contractor. This hidden asset often allows a surety underwriter to provide maximum aggregate surety credit over and above the

I see a state-by-state cascade effect on pre-1996 equipment values, starting in California...It will likely wipe out 25%-50% of “hidden equity.”

capital and net worth. A surety normally extends aggregate surety credit using a working capital to uncompleted work ratio of 10 to 15. For example, if working capital is \$1 million, then aggregate surety credit available would be \$10 million to \$15 million of uncompleted work. A surety also evaluates net worth in determining surety. Normally, a surety likes to see a net worth ratio of at least 10. For example, if net worth is \$1 million, then a surety is comfortable with a \$10-million to \$15-million work program.

FAUCHIER: *What is “hidden equity”?*

POTTER: Hidden equity relates to the quality and amount of the equity. Well established companies have developed hard assets in which they have taken large amounts of depreciation over the years. In some cases the assets are totally written down to zero. Many of these assets still have value and can easily be sold for cash. Since these assets are carried at zero or their book value is considerably below market value when taken as a group, you then have hidden equity. This increases the financial strength of the company.

DETHLOFF: Engineering contrac-

working capital and net worth ratios.

FAUCHIER: *How do you assure a company can weather market fluctuations?*

POTTER: I like to see management that has been around for a while. In my view, there is no substitution for experience or what I call “trial by fire.” Most contractors that have been around for a while have learned from the disasters and are better prepared and quicker to respond when they see a disaster on the horizon. From a financial perspective, having a solid net worth is the first line of defense, assuming the company has not added too much leverage or debt.

Every company is different, but we generally become concerned when leverage pushes past 5 to 1. Higher levels of leverage can be tolerated if the company has a solid net worth. By that, I mean that the assets of the company are not distorted by continuing to carry doubtful receivables and large stockholder receivables. On the plus side, we look at the equipment fleet which should reflect heavy depreciation and therefore a high degree of probability of hidden equity. All of this contributes to creating a picture of financial stability to weather adversity.

FAUCHIER: *What happens to your lending if the value of machinery shrinks, for example, when you see Tier 0 values fall?*

From 2007-2010, sureties see a 30%-40% decrease in work... but due to CARB-induced equipment costs, CalTrans will only be able to complete 56% of planned projects for the same costs.

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DETHLOFF: With the new engines required in the proposed CARB rule, the off book depreciated equipment value would be severely reduced. There would be no market for this equipment in California. As a result, the surety would re-evaluate the depreciated equipment value, and would probably not use it when determining surety credit lines.

POTTER: Since these machines likely have been in the fleet for some time, this could represent a deterioration of the hidden equity we talked about earlier. In a worst case scenario, since some Tier 0 units really are not that old, the company could have debt on the equipment. In this situation, depending upon how much downside there is in the market, the contractor could be upside down on the value versus what is owed in debt. This harms the financials in two ways: 1) a loss on sale and 2) the need to generate outside cash just to get rid of the debt.

FAUCHIER: *What do profit margins have to do with a contractor's ability to pay?*

POTTER: You want the highest profit margin you can get. Margin is supposed to compensate you for the risk in

inspectors, owners, etc. An additional wild card today is the new set of CARB regulations.

DETHLOFF: If you make a profit, your surety backing goes up, if you lose profit your surety goes down and you can do less work.

FAUCHIER: *Ralph, does CIT have similar evaluations as bonding companies?*

POTTER: From my experience, Bonding companies tend to focus more heavily on the working capital and the ability of the company to create cash. We look at the same financial data, but we focus more on the long-term strength of the financial statement. The bonding company has a lien on the job receivables and we have claim on the iron. CIT Construction knows that each year's financial results are unique to the work that the contractor had that year and that the next year can have very different results.

FAUCHIER: *How can regulations,*



RALPH POTTER



GLENN DETHLOFF

accelerate as other states clone the California model with the potential for a cascade effect on Tier 0 equipment values. In my opinion, this will likely wipe out somewhere between 25-50% of hidden equity over time.

DETHLOFF: If an engineering contractor cannot acquire enough work to provide the additional profit needed to pay for the new engine costs, then the financial statement would be severely impacted in a negative manner.

Here's an example: In 2007 say a contractor has: \$1 Million in working capital, \$2.5 Million in net worth and \$5 Million in depreciated equipment value. His probable surety credit is \$18 Million. Now say in 2008 that same contractor had a profit of \$500,000 and spent \$1 million on new engines. This contractor now has \$500,000 in working capital (not \$1 million), \$2 million in net worth, and zero dollars in depreciated equipment value. Now his probable surety credit is \$5 million, not \$18 million.

The engineering contractor who INCREASED his profit by \$500,000 now has bonding capacity which is 60% less than the year before!!

FAUCHIER: *Wow! This regulation could really destroy the economics of this industry! What is the role of the contractor's balance sheet in weathering market downturns?*

POTTER: The quality of the balance

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Contractors will be faced with a decision to downsize, fail, retire or relocate outside of California.

the job. Highly complex, risky jobs should have a premium in margin to compensate for the down side potential. This is not always the case due to the bidding process. The net margin of profit usually falls between 2-10% depending on the type of contractor, their market focus and the overall amount of work available. As the pool of available work shrinks, backlogs thin out and margins can drop. Contractors must watch this carefully since thin margin jobs have zero tolerance for error. As margins shrink, an imbalance is created between risk and reward and the likelihood of losing money increases.

FAUCHIER: *What affects contractor profitability?*

POTTER: The construction market is volatile and subject to a number of variables: weather, job site conditions,

like the CARB reg, affect hidden equity and profit margins?

POTTER: This regulation could have a significant impact on all contractors that own a fleet of equipment. Margins could decline due to early retirement of productive equipment. This is compounded by the need to spend considerable money to modernize, or rather, modify the fleet structure. Construction is on a competitive bid basis and only a portion of cost can be passed through. The full impact of this cost cannot be pushed through until many years down the road as the field gradually levels out. Hidden equity will decline by an unknown amount as values decline for all Tier 0 equipment. This decline could

Sureties have a lien on job receivables, and equipment lenders have claim on the iron.

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sheet is of paramount importance. Contractors rely heavily on the ability to convert equipment to cash to adjust their fleet, reduce expenses and reduce debt. The hidden equity in the balance sheet is also for borrowing capacity to finance your way through a tough job with heavy retention and change orders. An erosion of the balance sheet reduces a contractor's options and puts stress on the ability to obtain future work and weakens bonding and borrowing. Keeping a clean and solid balance sheet is extremely important.

FAUCHIER: *How does a shrinking bottom line, balance sheet and hidden equity affect ability to finance equipment?*

DETHLOFF: If working capital, net worth, and hidden assets are reduced there would be a significant effect on the availability of surety credit.

POTTER: Quite simply, the ability to borrow and raise needed cash will

FAUCHIER: *What are your predictions for industry shrinkage due to the proposed CARB reg?*

POTTER: It will take some time for the full impact to be felt. This is due to the compounding effect of year over year expenditures and debt needed to change out virtually all equipment in the state over the coming 15 years. As leverage increases and profits are squeezed, companies will be faced with a decision to down size, fail, retire or relocate. This could be accelerated by the decreased bonding capacity of California contractors due to added debt and decreased working capital and an influx of out-of-state contractors obtaining profitable work while their balance sheets and bonding are intact.

FAUCHIER: *Can rental companies fill the void?*

POTTER: They will to a limited extent. Rental companies generally operate at a higher level of leverage than

to allow more time to replace/retool them. They need to get a waiver from the Federal Government to obtain a longer time frame to implement the fleet change out. Instead of the 10-year plan, it should be 15 years due to the size and complexity of the California economy. The fleet size classification should be higher. The small and middle size fleet categories should be larger.

DETHLOFF: Well, picking up on the construction cost issue, if an engineering contractor needs to increase profits by \$1 million to cover the expense of new replacement engines this can only come from increasing the costs of bids to the state and public entities. For the next three years, surety projections indicate that available work will decrease by 30% to 40%. This means that to be able to increase the profits needed for the engine replacement, the cost of construction will increase by at least 46%!

State entities, such as CalTrans, will be able to complete only 56% of the work it thinks it is going to complete in their present budget. Surety credit will tighten and there will be fewer contractors who can bid on public work, probably raising bid numbers even higher.

FAUCHIER: Each new piece of information you and others reveal further confirms what a disaster this could be for everyone, unless we can partner with CARB to make this regulation work. Let's hope everyone stays in touch at www.cleanairconstruction.org!

— Dan Fauchier
Public Works Advocate

Profit margins could decline, compounded by the need to spend considerable money every year to modernize the fleet.

decline. The end result could be the need to shrink the company as a whole until a level of equilibrium is reached.

DETHLOFF: If an engineering contractor was required to spend \$1 million during a fiscal year to update diesel engines to meet the new emission standards, the contractor would have to procure an additional \$10,000,000 of work or increase revenues by 40% or more. Otherwise, the contractor could not keep the same working capital and net worth values in the financial statement.

contractors already. There is only so much debt that they can add before their resources are strained as well.

FAUCHIER: *What do you hope CARB will do instead? And if this goes forward as proposed, what is the impact on construction costs and the taxpaying public?*

POTTER: CARB needs to include a safety valve in the regulations for adverse economic circumstances. CARB needs to take a look at low utilization machines



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