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# Protecting against Main Contractor Failure

Carillon is obviously the first thing that people think about when supply chain failure is mentioned, but they are not unique and there have been many others in the last ten years not least Connaught and ROK, to name but a few.

The next question is 'who will be next' and there will be – to announce that in an article like this would potentially contribute to the risk of their potential failure. But currently there are a small range of significant construction companies that are facing some challenging times.

In so many ways the real consequences of the failure or large construction companies are often met by the supply chain. Frequently SME's which collapse under the strain of a large unpaid bill. As public sector procurers we have a duty to protect our organisations from supply chain failure but also have a moral duty to the supply chain to take a measured view of contractors before they are engaged.

Having a good supply chain failure 'Avoidance Strategy' strategy is the key to this and there are a basket of techniques that should be considered to test the financial covenant strength of companies. But trusting one measure alone is risky.

## Financial Accounts Review

This is an obvious starting point but has the limitation of the data only being as good as the latest set of published/available accounts. If these are up to date then great then, but often they are not. In fact if accounts are overdue at Companies House this may be an indicator that trouble in brewing as most companies will not want to hold back on publishing a good set of accounts.

## Credit Reference Agencies (CRA)

This is a simple way of analysing financial strength. Most of the CRA's provide a score out of 100 for the companies they assess. The strength of these assessments is often limited to the publish/available accounts as well. The algorithms the CRA's use take into consideration a wide range of factors, but they all work differently and place different weightings on pieces of information. As a result for a single company you might have a credit scores varying from 37/100 to 55/100 - for the same company from different CRA's.

A word of caution with use of CRA's is that using their data alone is unacceptable to deselecting contractors as advised by Procurement Policy Note 02/13. CRA's often can offer a multiplicity of information and it would be recommended you examine as a minimum the list set out below:-

- ✔ Period last accounts submitted for
- ✔ Credit Score
- ✔ Recommended Contract Limit
- ✔ Recommended Credit Limit
- ✔ Profit
- ✔ Net worth

## Creditor Payment Days

Can be a useful measure of whether a company is facing challenging times. Under the Construction Act there is a legal requirement to settle undisputed payments within 30 days. A lot of construction companies are still being highly creative however to avoid meeting the spirit of this obligation. Where companies significantly fail to pay the supply chain by their stated periods or credit periods are extended this should place you on alert. Discrete conversations with the supply chain can be a good source of information in this area.

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## Bond Capacity

Is also an very interesting measure of the financial strength of a company. A financial performance bond would typically be set up to provide a payment of say 10% of the contract value if a company failed to deliver a contract so say if a contract of say £2million was being carried out a bond would provide £200K of compensation. The costs of supplying a bond can vary greatly and Bondsmen will do a great deal of due diligence before setting the premium. In other works they are really thoroughly investigating their investment risk. Where premia to supply a bond are coming back at a significant proportion of the bond amount alarm bells should ring loudly.

Others – the list can go on but the above list focusses on the most widely used practical measures.

Once part or all of the above 'due diligence' has been carried out - a conclusion should have been reached about the financial covenant strength of a company and whether it is – acceptable or unacceptable or acceptable with security measures in place. The most used forms of security are Parent Company Guarantees, Financial Performance Bonds, arguably Project Bank Accounts and sometimes Director Guarantees.

## Parent Company Guarantee (PCG)

Can only be used where there is a parent but more importantly the parent needs to have value & worth that make it beneficial to have a PCG from. So the parent(s) need to be carefully scrutinised too. There is an increasing trend from some construction companies to resist providing PCG's – do not be abashed if your request for a bond is resisted. If you take out a PCG make sure it covers you to at least the end of defects and does not exclude part of the project by value, area or type.

## Financial Performance Bonds (FPB)

Are covered above and can be useful to potentially acquire if you cannot get a PCG. A bond has a financial cost to secure that is paid to the bondsman, the cost of this is likely to either paid directly or indirectly by the client and this needs to be factored into any decision about requiring a bond. If you do require a bond then it is recommended you use the standard form of bond wording promoted by the Association of British Insurers (avoid other forms of wording offered by bondsmen as they will potentially reduce your level of protection).

## Project Bank Accounts (PBA)

While not a direct security measure to the client they certainly can help protect project delivery and afford a greater level of protection to the supply chain that they will receive prompt payment and the level of debt held reduced.

## Director Guarantees

Are not often used but are a form of security that is available and brings into sharp focus for directors the need to be more focussed in their risk taking.

The Procurement Approach we all adopt in the public sector is crucial. We need to ensure that the preserve scope to allow financial covenant strength to be carefully considered in the selection or deselection of contractors. It is also important that latitude is maintained to allow clients to obtain security measures when needed.

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## There are additional things that clients can strategically do to reduce supply chain failure:-

Carefully package work to avoid creating projects which are aggregated to such a great extent that the delivery failure poses significant impacts for the client. Equally disaggregation is not always possible, but care is needed that you do not wrap up too much into a project;

Where possible supply chain diversity should be created and avoid exposure or over exposure to single contractor;

Work with main contractors to look at how work is packaged and the packages that pose the biggest risk to project delivery. Also ask they identify the packages with the greatest risk of supply chain failure (which has most prevalently been ground works in recent years). But more importantly to look at ways of mitigating these risks by for example holding open reserve contractors if concerns exist.

In conclusion it is possible to contend that public sector procurers can play a significant role in guarding projects against supply chain failure. Clearly if companies set out to deceive auditors and recklessly fail to manage business with suitable propriety there is ‘maverick’ risk. But even this can be guarded against to some extent by using the above strategies.

## As SCF we play our part in supporting the above strategies via the following measures:-

- ✔ **All contractor were screened at the framework selection stage as having adequate financial strength to be admitted to the framework**
- ✔ **All contractors are continuously screened via Experian to ensure they have a satisfactory credit score**
- ✔ **All contractors have agreed to the SCF Fair Payment Charter requiring their supply chain is paid within 30 days**
- ✔ **SCF have a standard Parent Company Guarantee pre agreed with all contractors available to all framework users**
- ✔ **Project Bank Accounts can be called on if desired for all projects over £4million;**
- ✔ **Supply chain engagement is carefully analysed to ensure over reliance in not placed on particular members of the supply chain**
- ✔ **Package procurement plans are carefully assembled at an early stage to ensure inherent supply chain risks are identified and mitigated where possible.**

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If you wish to discuss any of the above themes in more detail with the SCF team please contact us today:

Website - **scfsolutions.org.uk**
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