SMALL CONTRACTORS INITIATIVE:
Bonding & Access to Capital

Opportunities to Increase Inclusion of Small Businesses in Government Contracting

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Introduction

If you talk to small business owners about their experiences working with Government contracts, they will tell you that it's not easy. This case study outlines how Government contracting requirements affect small businesses, and showcases three ways to increase inclusion of small businesses in Government contracting.

The Importance of Government Contracting

Federally funded construction projects represent substantial business opportunities for small construction contractors. According to the SBA Procurement Scorecard, in FY 2016, $100 billion (26 percent) of all Federal contracts was awarded to small businesses, and $39.1 billion (10 percent of total) was awarded to small disadvantaged businesses.

This report explores the challenges and opportunities facing small and emerging contractors in bidding for Federal contracts and how the public, nonprofit, and private sectors have responded to this issue creatively.

Over $100 billion in Federal contracts (26 percent of total contracts) were awarded to small businesses in FY 2016.

Why Does Increasing Inclusion Matter?

Having a diverse group of contractors ensures that Federal funds are distributed more equitably throughout communities, providing more opportunities to minority-owned, women-owned, and disadvantaged business enterprises (M/W/DBEs). Other potential advantages to a diverse bidding pool are increased innovation, access to new markets, and decreased project costs. Opening the door to Federal funds can have a lasting impact, as M/W/DBEs offer employment opportunities and investment in their local communities and create real economic development in the country as a whole.

Although HUD projects have clearly stated community-development objectives, many small, new, and/or M/W/DBE businesses find it difficult to qualify to bid on these opportunities because of Federally funded project requirements.

While efforts have been made to diversify the pool of contractors and bring in smaller, minority-owned companies, many contractors still find it difficult to meet Government requirements, such as demonstrating strong financials and management expertise. Access to Government contracts for minority contractors would be significantly improved by addressing three key barriers: surety bonding, access to working capital, and management expertise. This report describes why some of those requirements are in place, what challenges they provide, and innovative ways to approach those challenges to increase inclusion of small businesses in Government contracting.

Challenges to Inclusion of Small Businesses

To qualify for Federal contracts, construction businesses must be bonded, have access to working capital, and demonstrate management capacity. Interviews with Governmental entities, nonprofit organizations, private businesses, and small contractors highlighted these three primary challenges that need to be addressed in order to increase inclusion of small businesses in government contracting.

Challenge 1: Surety Bonds

In the United States, Federal construction projects are required to have surety bonds by the Miller Act, a law passed in 1935. Surety bonds guarantee that there will be funds to complete a project in the event that the contractor defaults on the project, which limits risk to the Federal Government. Contractors obtain surety bonds from surety companies or agents representing surety companies.

The Miller Act requires that prime contractors bidding for the construction, alteration, or repair of Federal buildings furnish a payment bond for contracts in excess of $100,000. Other payment protections may be provided for contracts between $30,000 and $100,000. The payment bond is required as security for the protection of those who supply labor and/or materials in the construction of public buildings. If a contractor fails to pay suppliers and subcontractors, those entities have the right to sue the contractor.

Any Federal construction contract valued at $150,000 or more requires a surety bond when bidding or as a condition of contract award. Most State and municipal governments as well as private entities have similar requirements. Many service contracts, and occasionally supply contracts, also require surety bonds.

Challenge 2: Access to Working Capital

Many small and new contractors find it difficult to build up enough working capital to qualify as primes on Federally funded jobs. Contractors must have access to working capital so that they can pay for supplies and labor before the first bid payment is made. Wages on construction jobs are paid weekly, but payouts to contractors do not begin until 45 days or more after a project has started.

Challenge 3: Contractor Capacity and Experience

While contractors may hold considerable expertise in their trade, they can find it difficult to demonstrate the same level of knowledge and experience in management practices as larger firms, such as compliance with affirmative action plans, prevailing wages, or cost-management practices. Local business counseling services can help small business owners improve their management capacity, but they are not available in all localities or are difficult to find. Furthermore, small firms often require both development of managerial capacity and access to working capital, but geographic availability of both types is often limited.

Opportunities to Address Challenges

Government contracting represents a huge opportunity for small contractors who are interested in developing their business. This means public, nonprofit, and private entities must find creative ways to balance Federal requirements—implemented to ensure that public resources are used wisely—with the need to reduce obstacles to the inclusion of new contractors in the mix.

Fortunately, a series of multisector, innovative initiatives are addressing these gaps. They feature the following opportunities:

- Opportunity 1: Surety Bond Resources.
- Opportunity 2: Non-Traditional Lending.
- Opportunity 3: Specialized Training.

Opportunity 1: Surety Bond Resources

Prime contractors and some subcontractors interested in Federally funded work must obtain surety bonds. To do so, they must demonstrate that they have the management capacity and working capital to reach project milestones before receiving progress payments. The U.S. Small Business Administration (SBA) offers guarantees for surety bonds, with underwriting criteria that are more accessible than those for the general marketplace. The goal of this Federal guarantee is to encourage surety companies to bond small businesses who might otherwise have difficulty obtaining bonding on their own.

Through the Surety Bond Guarantee program, the SBA offers guarantees for performance and payment bonds issued by participating surety companies for contracts up to $6.5 million. The SBA can guarantee a bond for a contract up to $10 million if a Federal contracting officer certifies that the SBA's guarantee is necessary for the small business to obtain bonding. The SBA guarantees between 70 and 90 percent of the losses and expenses incurred by the surety company if the small business defaults and fails to complete the contract. The SBA charges the small business 0.729 percent of the contract price for a payment or performance bond. There is no charge for a bid bond.

Small business contractors can access the Surety Bond Guarantee program directly through the SBA by contacting the Office of Surety Guarantees, or through a surety bond company.

This is one resource available to small business contractors seeking Federal work. However, small and early-stage contractors still find it difficult to meet even the surety bond guarantee criteria because of credit and capital requirements, and may find the fees to be prohibitive. Contractors often still need to address financial and management considerations before they are able to obtain a SBA-guaranteed bond.

Opportunity 2: Non-Traditional Lending

Even if a contractor is able to qualify for a surety bond, other challenges remain, including managing cashflow during the project. Often, small contractors do not have a good credit rating or the financial capacity to qualify for general working capital loans from traditional lenders that are larger or more general than the present job. Furthermore, these types of limited loans may not be available in their local markets.

In situations where the surety bond agent judges the contractor capable of performing the work but unable to meet working capital requirements, they have partnered with nonprofit lenders to offer short-term working capital loans with 90-day terms (or less). The size of these loans is determined by what amount would be sufficient to allow the contractor to reach their first progress payment under the contract. Typically, these loans are 5 to 10 percent of the contract amount, and they are sometimes offered in conjunction with funds control services. This means the loan is made directly to the contractor but funds are not released until after the contract is secured. Loan proceeds are then put in escrow with a third party who manages payments.

These companies and organizations leverage professional relationships with bankers and suppliers on behalf of contractors. In making loan approval decisions, they evaluate applications on a case-by-case basis rather than relying on more standard guidelines that constrain larger institutions.

By advancing just enough money for just long enough, these types of arrangements substantially mitigate risks for both the lender and the surety company. Since the bonding industry typically allows a contractor who performs successfully to be bonded for a contract 1.5 times larger at the next underwriting, this service can also open the door to a managed path for growth for smaller or newer contracting firms. In addition, this initiative helps to build the independent credit histories of the companies to support future growth.

Opportunity 3: Specialized Training

Even with coordination among key players, the process of qualifying and bidding on Federal contracts is complicated, involving coordination among multiple entities and tight timelines. In the interest of increasing inclusion for small business contractors, HUD and SBA partnered to create the Small Contractors Initiative, a tailored curriculum to teach new and inexperienced small contractors about surety bonds, working capital, business management, and Government contracting opportunities.

The initiative seeks to help small business owners understand the complexities of qualifying to bid on HUD and other Federally funded contracts. Contractors learn where they need improvement in their financial, accounting, and business capacity to obtain a bond and how to use their bondable status to pursue a diverse set of Federally funded and assisted contracts.

The target audience for the initiative is contractors that meet SBA's definition of a small business and have been in business for 5 years or more. Some of the topics covered in this class include bonding, marketing, surety bonds requirement, business planning, financial management, working capital, bonding, and capacity building. This curriculum can be a resource for small business development organizations who are looking for ways to help smaller and newer contractors navigate this complex process.

Find out more about the initiative here.

Financial support for specialized training can be found from a number of sources. For example, Community Development Block Grant (CDBG) funding can be used to not only directly fund construction projects, but also to provide business training and education through local government entities and community development centers.

Case Studies

Organizations that have been successful in increasing inclusion of small businesses in Government contracting have implemented approaches that utilize one or more of the three opportunities: surety bond resources, non-traditional lending, and specialized training. Featured below are three stories of how the public, nonprofit, and private sectors have responded creatively to increase inclusion of small businesses in Government contracting.

Case Study: Metropolitan Consortium of Community Developers

The Metropolitan Consortium of Community Developers (MCCD), a small business development nonprofit located in Minneapolis, MN, provides business coaching and loan packaging to small business contractors. MCCD utilizes promising practices in non-traditional lending and specialized training in order to increase inclusion of small business contractors in Government contracting.

MCCD provides small-scale loans to small business contractors. The underwriting for these loans is often more flexible than underwriting at traditional banks. For example, they may focus more on a contractor's business feasibility and credit history than on the contractor's credit score. In addition, they have built strong partnerships with other traditional and alternative lenders, and they are able to leverage those partnerships to package larger deals. In many circumstances, businesses would not be able to get access to lending from these institutions without MCCD's assistance. MCCD gains buy-in from these additional lenders by placing themselves in a subordinate position to be paid back, lowering the risk for the other lenders who will be paid back first.

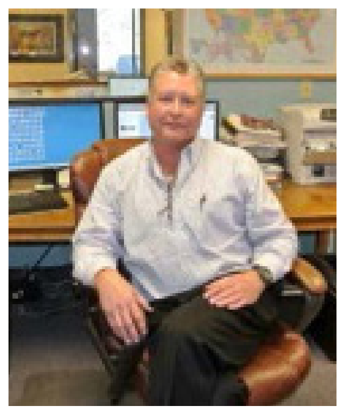
They also have an extensive network and are able to refer to other nonprofits if they identify that the small contractor needs additional training. The most successful programs for addressing management capacity issues are offered by community partners that offer business training and one-on-one technical assistance tailored to the construction industry and also offer increased access to working capital.

Case Study: CCI Surety and North American Construction Services

There are several private sector initiatives that are working to address the challenges faced by small and emerging small businesses. One of them is a program developed by CCI Surety, Inc., and North American Construction Services (NACS) that works by providing three components under one roof: lending, surety bonding, and funds control.

With three locations nationwide, CCI has created a formula that increases access to contracting opportunities for small contractors. Their successful model includes delivering surety bonds in addition to access to working capital for hard-to-qualify contractors that have poor credit or failed projects in addition to low working capital.

CCI created a product for inexperienced contractors, or those with poor credit, that provides access to working capital through an escrow account. Larger financial institutions feel more confident providing loans because they are lending to an established entity (NACS), and small contractors are able to access enough cashflow to pay their employees and buy supplies. If the contractor fails to complete the project, then CCI retains the funds and pays back the lender using unspent balances.



Michael Williams, founder and CEO of CCI, has helped hundreds of entrepreneurs by providing three components under one roof: lending, surety bonding, and funds control.

Michael Williams, founder and CEO, said that every year they are able to work with around 400 small contractors, with an average contract size of $750,000. Many of these businesses would not be able to qualify for surety bonds with traditional underwriting guidelines or get access to working capital without having a third-party escrow account. Click here to learn more about CCI.

Case Study: Rich's Construction

Located in Belcourt, ND, on the Turtle Mountain Indian Reservation, Rich's Construction has been in operation for 31 years. Owner Rich Parisien grew up in poverty in an area with very high unemployment. Parisien is a small Disadvantaged Business Enterprise subcontractor who primarily serves the Native community.

Making it as a small business contractor has not been easy. Parisien stated, "Managing working capital is hard. You are often pushed to meet deadlines that translate into overtime, which gets expensive. It gets tough to manage paying employees on time and getting materials while not having money coming in…I've had to push back my capacity because of this."

Parisien relied on training programs to increase his capacity as the owner and operator of a small business and went through workshops to develop business management skills, establish his business, and qualify for Federal contract bidding. For him, training programs were crucial not only for the knowledge he gained, but also for the relationships he built in those programs. These relationships allowed him to both learn from others in the field and helped him gain financing. For Mr. Parisien, the best way to overcome obstacles to working capital was his strong relationship with his local bank. He noted that being honest about finances and capacity was crucial to developing these relationships and ultimately obtaining financing.

One of those vital relationships came out of participation in the SBA Section 8(a) Business Development program. While in this program, he met more experienced contractors who became his joint venture business partners and secured bonding for Mr. Parisien's first Federal contract, worth $250,000.

Once the first job was completed, the door was opened to surety bonding, which led to higher profit margins and much larger contracts.