

MIND THE GAP! WORK NOW, GET PAID - LATER

Gap jobs require the cooperation of project owners, construction firms, lenders and sureties in order to go forward. The challenges are complex, but in today's tough market, and with the guidance of an experienced broker, they can be worth the effort.

WHAT'S A GAP JOB?

Let's say you are the State of North Carolina. You need a road built. The estimated cost for the project is \$150 million, but you only have \$100 million available in the DOT budget for this job. You want to build it over three years. You can come up with the other \$50 million, but that will be spread out over the next seven budget years. That's a gap job.

Given state budget issues and tax revenue shortfalls, GAP procurement has become a hot topic in several states. To date, the expectation has been that contractors are responsible for financing the gap – eventually getting paid by the state (assuming no credit default). This means that some costs are incurred years in advance of when payment is due. The looming challenge to the construction industry is how to approach the financing of the deferred amounts and how this impacts balance sheets and surety relationships.

Florida, North Carolina and California are among the states that have either recently awarded gap jobs or are in the process of bringing a gap job to bid. Some describe these as "P3 light," but they are very different from Public Private Partnerships (P3), where public and private funds are combined to build a project. The public owner pays for the private financing via availability payments to a third party (typically a concessionaire), which actually operates and maintains the asset. Gap jobs, on the other hand, have not been for operations but rather are strictly Design-Build Finance or Build Finance. The ultimate funding comes from the public owner over a



set time period, but there is a timing gap (because the construction term is less) that has to be financed. The contractor is responsible for obtaining the appropriate financing for the gap in payment terms.

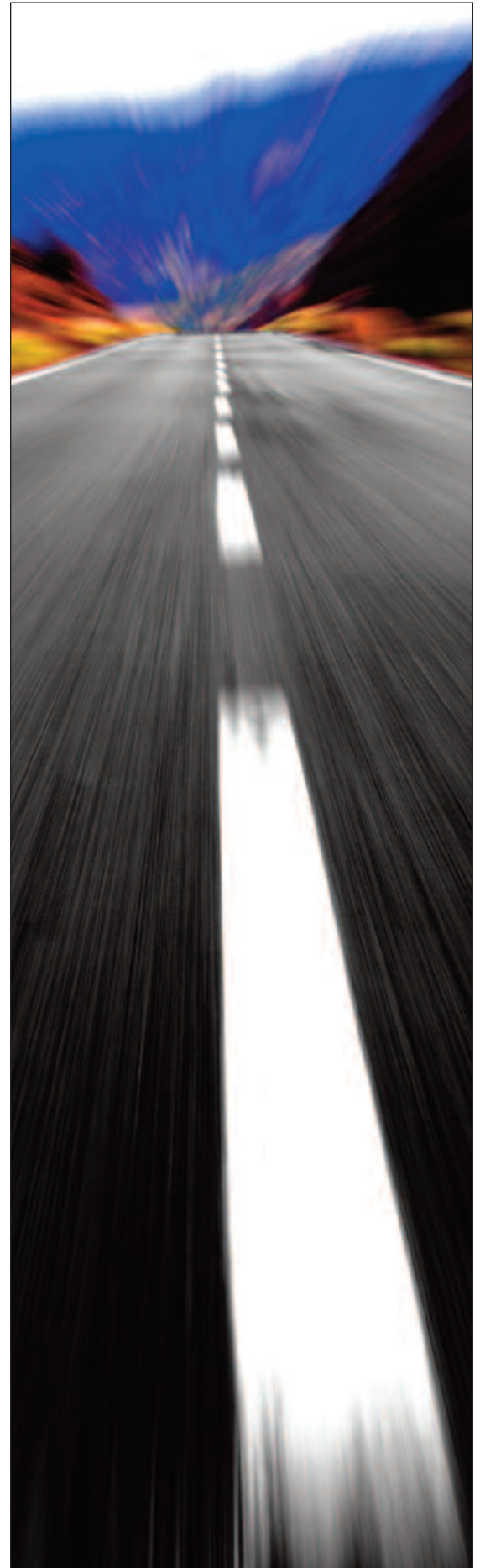
FINANCING THE GAP

Contractors and their sureties have explored different ways to finance the gap, depending on its size. For smaller gaps, larger

contractors will be inclined to finance it themselves out of their balance sheet and cash flow. As the gap gets bigger or the contractor smaller, some kind of third-party financing becomes necessary. If the owner will allow the contractor to assign the receivable to a bank (so far this has not happened in FL or NC), the contractor can use it as collateral for a “true sale,” essentially off-loading the long-term credit risk of the state to outside lenders. The third-party lender funds the gap portion of any draw request in exchange for a first lien and an assignment for that portion of the state’s deferred payment. The bank passes the time value of the money onto the contractor who in turn puts it into their bid cost. Unfortunately, to date no state or public owner has agreed to provide the lenders a direct claim against the “sold receivable,” so this approach has not been feasible. Instead, lenders have to rely on the contractors and/or the sureties to try and pursue these claims. This has made it extremely difficult to negotiate acceptable terms among all the parties. Our current assessment is that inter-creditor agreements acceptable to all parties are not achievable until the owner legally recognizes the lender’s role in this procurement process.

Another approach is having the banks provide a working capital line for the project or a specific project term loan that the contractor uses to cover the gap. Some contractors, especially publicly traded ones, do not like this approach as it puts additional debt directly on the balance sheet. Most surety companies are not comfortable with it either, because if there is a contractor default and resultant bond claim, the surety will have a gap in its completion funds. As a result, most surety companies have been requiring contractors to post a letter of credit equal to the gap. The contractor can pass the letter of credit cost on to the owner in their bid but it also ties up more of the contractor’s credit line.

As more of these jobs come to market, more pressure and competition is felt among banks and sureties to find solutions. The current marketplace has attracted the largest and best capitalized firms, as they are the ones with the wherewithal to work around the gap. Those firms are interested because they see their competition as more rational and realistic in pricing risk on these jobs, and these larger firms are more willing and able to take on that risk. States are moving slowly in allowing more gap jobs, but many states are interested in finding ways to stretch tight budgets. As a result we see GAP financing becoming a more popular approach to funding state work at least in the short term.



CONSIDERATIONS AND QUESTIONS

In considering a gap job, a construction firm should answer the following questions:

1. DOES THE OWNER ALLOW ASSIGNMENT OF CONTRACT RECEIVABLES?

If yes, then it is easier to arrange third-party financing that can coexist with surety bonding.

2. WHO HAS THE APPROPRIATIONS RISK?

States cannot commit project funds over the long periods of time typical in gap jobs (7-10 years). If payments in the years after the construction is completed are delayed or not appropriated due to a budget impasse or political maneuvering, who has the risk? Lender? Contractor?

3. RIGHTS OF OFFSET.

Can the owner set off a receivable on one job due to a dispute on this job or another job? Who will be subject to this risk, the lender or contractor?

4. WHAT IS THE BREAKAGE COST SHOULD A PROJECT GET CANCELLED?

Banks that finance a job are looking to recover loan origination costs from someone – the state or contractor if the project gets cancelled.

5. HOW BIG AND HOW LONG IS THE GAP?

Prepare a gap schedule that compares when costs are incurred versus the owner's funds availability. Usually early in the job the contractor is cash flow positive, but later in the job, financing may be required to cover the gap once it manifests itself. It is helpful to see when the gap occurs, for how long and how big. Banks are more interested in jobs with large gaps, e.g., in excess of \$75 million (because they can spread out their acquisition costs) and less interested in smaller gap jobs, e.g., under \$25 million (because their fees and origination costs are disproportionate to the gap loan amount).

CONCLUSION

Despite the challenges, some contractors have been interested in gap procurements because they see it as a smaller universe of competitors with potential for greater margins. Likewise, only a few surety companies have been willing to entertain gap financed projects, but given that some of their best capitalized customers are interested, they have been willing to listen. Willis has successfully brokered several gap projects for our clients based on the combined resources of our local surety teams and our National Practice. Be sure to discuss any interest in a gap project early with your Willis broker, banker and surety company, because it takes time, partnership and creativity to craft a deal that resolves the challenges of a gap structure.

Willis is the leading construction broker in the world. With more than 800 construction Associates in North America in 60 offices, we offer unparalleled expertise to the construction industry locally, nationally and globally. Our clients range from local contractors to international integrated firms.

The observations, comments and suggestions we have made in this publication are advisory and are not intended nor should they be taken as legal advice. Please contact your own legal adviser for an analysis of your specific facts and circumstances.

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