

# Storm Clouds: Not on the Horizon, But Directly Above!

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Subcontractor defaults are on the rise in the construction sector in North America and financial insolvency is the leading primary cause of this increase.

**Since the start of the COVID-19 pandemic, the subcontractor market has faced many challenges.**

Some projects were stopped, delayed or all together shut down initially, causing problems with staffing the projects. Fortunately, government intervention led to loan programs which temporarily allowed subcontractors to pay their employees and helped their businesses survive. Then, supply chain disruptions impacted the subcontractor's ability to deliver critical goods to the projects on time. Next, there were wild swings in the prices of key inputs and materials.<sup>1</sup> Then to top that off, there was a dramatic rise in prime interest rates in the US, which rose from 3.25% in March 2020 to 8.50% in July 2023. This has substantially increased the cost of capital for subcontractors putting further strain on their financial stability. To say it's been a challenge would be putting it mildly.

Peter Ukstins, a risk engineer with AXA XL's Subcontractor Default Insurance team, recently shared, "We're seeing a high rise in electrical trade defaults. Over the last 12 months we've seen almost a 15% to 18% increase regarding electrical trades."<sup>2</sup>

## KEY INSIGHT

**When prequalifying and selecting subcontractors, general contractors need to be able to recognize their financial health.**

**Dive into three key trends to watch when analyzing subcontractor financial health.**

That’s on top of AXA XL’s previously reported 58% increase in claim notices from 2021 to 2022,<sup>3</sup> where again electrical subcontractor insolvencies were a driving factor in that increase.

The challenge general contractors face when pre-qualifying and selecting subcontractors is to be able to recognize how these risk factors are affecting the financial health of the sub trade. Knowing this, NFP and COMPASS, by Bespoke Metrics, collaborated to highlight some insights derived from the COMPASS database of subcontractor prequalification data. COMPASS is a subcontractor/supplier prequalification technology that collects and analyzes financial, business and safety data on the construction industry supply chain. The results of our joint investigation brought further concern to the table when it comes to the financial stability of the subcontractor marketplace.

Many key performance indicators (KPI) showed an increase in the financial health of subcontractors for year-end 2020 and to some degree even into year-end 2021, which correlates to an industry wide belief that the government financial support programs helped improve subcontractor’s financial health. However, since that time there has been a marked decline in some of the key metrics, which seems to correlate with the rise in subcontractor insolvencies the general contractors and subcontractor default insurance carriers have been witness to.

A note about the data, before jumping in. The COMPASS data set comprised of over 35,000 subcontractors across North America, which includes year-end financial statements. These trade contractors represent a wide range of specialty trades across all 45 CSI divisions of construction work. After removing the outliers, the decline in key metrics is consistent across all companies. Now onto the data.

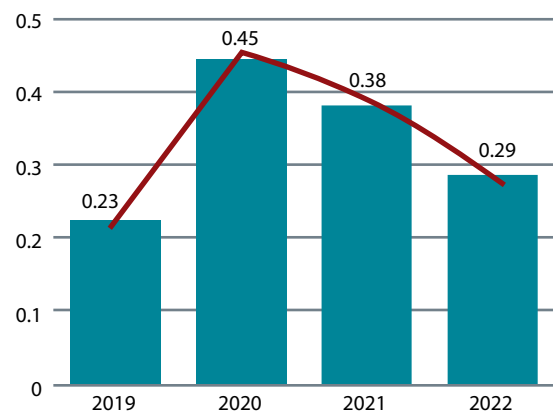
### Three Key Trends

The following are three interesting ratios that highlight current trends in subcontractor financial health: cash to liability, margins and days of cash.

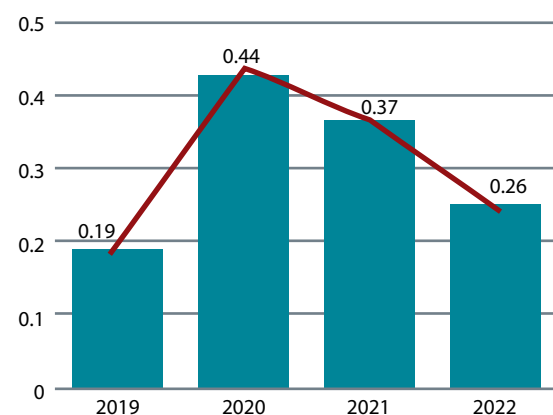
### Cash to Liability

The cash to liability ratio measures the ability of the company to pay off short-term debts. The cash to liability ratio from 2020 to 2022 decreased 36% for all trades, and electrical trades were down 41%!

Cash to Liability (All Trades)



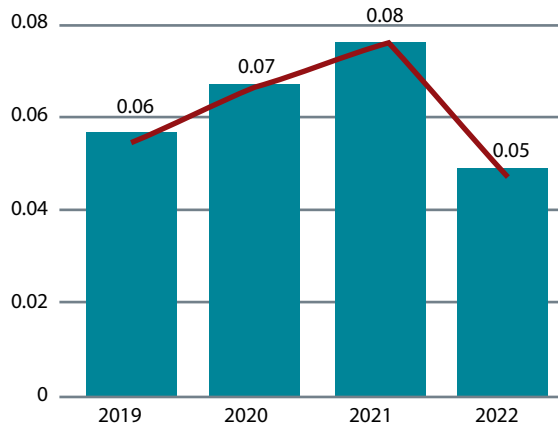
Cash to Liability (Electrical Trades)



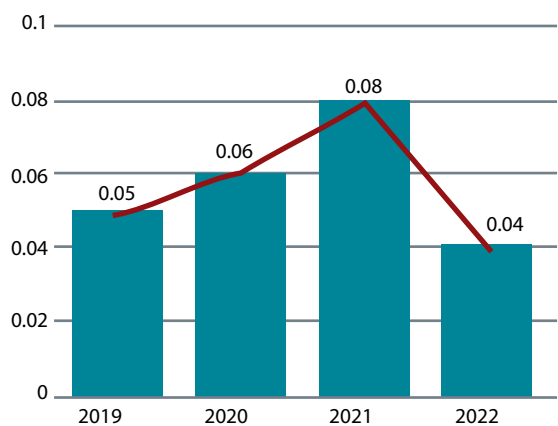
### Margins

While gross margins for all trades remained steady at around 24% over the past four years, net margins fell from 8% in 2021 down to 5% in 2022, showing a 38% decline. Electrical trades dropped from 8% to 4%, a 50% decline over this same period! This may indicate that the cost of interest, taxes and operating expenses are perhaps starting to weigh more heavily on these firms.

Margins (All Trades)



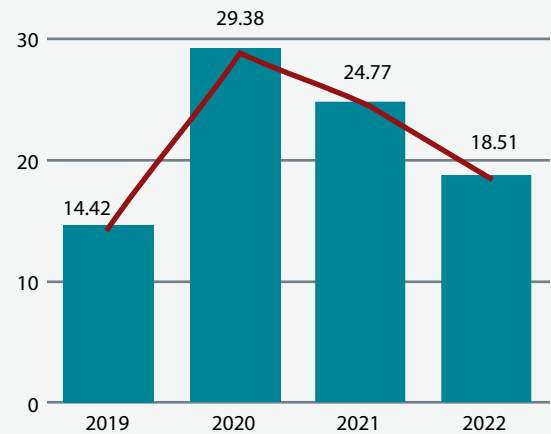
Margins (Electrical Trades)



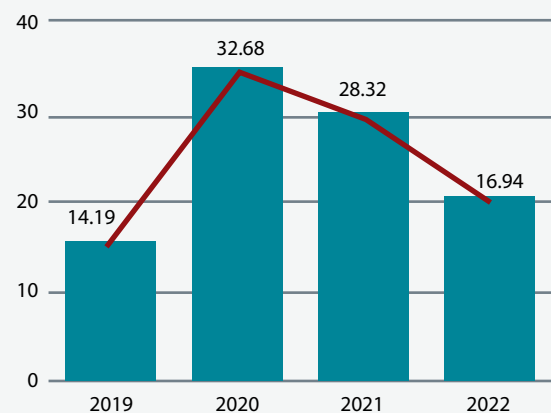
### Days of Cash (To Cover Total Expenses)

A similar story surrounds the “days of cash” metric, which has fallen from 29.4 days in 2020, down to 18.5 days in 2022, a decline of around 37%. Electrical trades were down from 32.7 to 17.0 over this same period — a decrease of 48%.

Days of Cash (All Trades)



Days of Cash (Electrical Trades)





What do we expect to see once the 2023 statements start to be compiled and submitted into Comp COMPASS in 2024? While past performance does not indicate future results, it won't be surprising to the subcontractor prequalification community that we are bracing ourselves for additional declines in KPIs. When we compare the past 12 to 24 months of declining financial results to an increase in subcontractor defaults during that same period, it might suggest further financial stress and potential default claims as we go forward in 2024 when factoring in the various macro-economic stressors mentioned above.

### How You Can Protect Your Business

Given the above clear evidence of subcontractor financial strain, here are two ways to prepare your organization for continued construction supply chain weakness.

- **First, remember that cash is king, and you should be closely monitoring subcontractors who are showing cash flow KPI stress. If you see a decline from their 2022 to 2023 statements, consider adjusting single project limits and aggregate limits accordingly, to be sure to not expose yourself to adverse risk. Even better, perhaps pause the award of new subcontracts to subcontractors who are struggling financially.**
- **Second, if you have work in progress with a subcontractor that shows financial strain, consider deploying risk mitigation plan (RMP) tools like joint checks or direct payments to lower tier subtrades and suppliers, writing purchase orders directly to the suppliers, demanding parental guarantees if available, securing a dedicated letter of credit, or deploying other**

**RMPs. Remember, an RMP is only effective if you follow through with it and are prepared to act on it if necessary. If the RMP doesn't materially reduce the risk, then it's not worth using.**

With storm clouds not only on the horizon, but actually above you should start taking a much closer look at the operational practices related to prequalifying and managing the construction supply chain. Further, you should be investing in tools that allow you to see subcontractor insolvency coming well in advance of its arrival. For many, the supply of labor is their primary risk or concern — this risk is not only related to the supply of labor, it is related to the financial structure that supports your access to this labor. If you are not preparing for supply chain deterioration, you absolutely should be!

#### Questions? Contact:

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This article made possible through the data and expertise of  **COMPASS**  
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1. **Construction Inflation Alert Dec 2022 (agc.org)**
2. **AXA XL Post (LinkedIn.com)**
3. **Default risk - Electrical contractors in a bind (axaxl.com)**





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**CERTIFICATE OF FITNESS**  
A fitness certificate for  
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### About Bespoke Metrics

Offering multi-language concierge service for both subcontractors and general contractors, COMPASS by Bespoke Metrics is a leading prequalification platform that supports industry-wide data collection, verification, and analytics. Through the COMPASS 1Form, subcontractor data is collected using a unique standardized approach, while giving subcontractors full control of their data. General contractors benefit from the analytics derived from standardized data, enabling them to effectively manage project and default risks.

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