Feature

Construction Credit for Subcontractors

by Scott Wolfe Jr.

Everyone in the world knows the term "credit," but it has many different meanings. In the consumer context, people think about credit cards, credit reports, and credit scores. In the business-to-business context, credit can refer to lines of credit or "trade credit" with suppliers and vendors, and it can refer to a company's credit score or creditworthiness.

When it comes to "credit," subcontractors sit at a very interesting intersection. On the one hand, subcontractors seek trade credit from its vendors to buy supplies or rent equipment. On the other hand, subcontractors must evaluate the "credit worthiness" of those who will ultimately pay them.

Unlike many corporations that deal with credit questions and evaluations daily, subcontractors typically do not have a credit department or much "credit and collections" experience. Even those subcontractor groups that do have the experience are required to navigate a unique landscape.

Introducing Business-to-Business Credit

In one way or another, everyone is familiar with the concept of "credit." In everyday life, people will encounter their own creditworthiness when looking to buy a house, a car, or when applying for a new credit card. Credit bureaus keep profiles and reports on every person's credit history and assign a score to each person based on that history. When a person's history is good, the credit score will be high and lenders are willing to issue more and more "credit." When history is bad, the credit score is low and lenders are more guarded.

The same concept is true in the business context. Just like a person, every business has a credit history, and based on that history, lenders will give more or less "credit" or "financing" to the business.

Business credit does have a pretty big problem, however. Business credit records are usually much more empty than an individual's credit record. This is particularly true for small and medium businesses that rarely have a complete enough credit history to mean anything.

There are a few reasons why this is the case:

1. Consumer credit reporting is very, very common. Business-to-business transactions are frequently between one small business and another, and reporting those transactions to credit agencies is not very common. Accordingly, the transaction is "invisible" to a company's transactional history.
2. Since business credit histories are largely empty, companies require personal guarantees and information about the business owner(s)' personal credit, which is a vicious cycle making personal credit more relevant and complete and business credit less relevant and complete.
3. Many small businesses are fairly new (less than 6 or 7 years old), and thus it's impossible to have much of a credit history at all.

4. While a person cannot run away from their personal credit history, a business entity can just shut down and open up another entity, which could make personal credit history more relevant than a company's history.

Business-to-Business credit, therefore, is a tricky concept that is difficult to master. This is especially true in the construction context, because so many construction companies are small to medium businesses, and because the dollar value of many construction projects is frequently out of proportion with a SMB's credit worthiness on paper.

The Relevancy of 'Credit' in the Construction Industry

Credit is relevant in almost every industry, but like everything else, the construction industry puts a twist on the mechanic's of how credit works and how credit is managed. Subcontractors, in particular, have to manage both ends of "credit," meaning that they have to seek credit from vendors, and they have to evaluate credit from those who owe them money. This presents a lot of interesting issues.

Subcontractors Get Trade Credit from Vendors and Financers

It's no secret that subcontractors face substantial working capital challenges. They are expected to furnish materials and labor to benefit a project *before* getting paid, which means they must float all of those costs. On top of this, 5 percent to 10 percent of the contract price is withheld until the end of a job through retainage practices. Most subcontractors need credit and financing to pull off this cash management magic.

Subcontractors seek lines of credit and loans from traditional lenders to make payroll while dealing with the ebbs and flows of their cash flow. They also seek trade credit terms from material suppliers and equipment rental companies, which enables them to furnish equipment and materials before putting out cash.

Traditional loans and lines of credit rely very heavily on credit scores and a company's balance sheet to justify the risk. Subcontractors large and small, therefore, must be conscious of their company's available assets, collateral, and credit history, and then must develop strong relationships with bankers to get access to these working capital aids.

Getting trade credit from vendors is a bit more peculiar. Unlike anyone else in the construction industry — such as general contractors, developers, lenders, sureties, and subcontractors — material suppliers and equipment rental companies have large "credit and collection" teams who focus on evaluating the risk of doing business with subcontractors, and who extend and manage trade credit to the subcontractors.

These credit and collection teams use a variety of tools and philosophies to manage this process.

1. Credit Reporting Tools—Just like almost any other businesses, these companies rely on credit reporting tools like Experian or Equifax. These tools produce reports on the credit history of a business. As mentioned above, however, this rarely gives a full enough picture for the vendors to justify issuing tens of thousands, or hundreds of thousands, in trade credit to a subcontractor.

2. Risk Mitigation Tools—Since a subcontractor's credit history is rarely full enough to justify the trade credit needed, these groups use other tools to mitigate their risk:

- Personal Guarantees: For some companies, credit and collection teams will want to get past the corporate shell and have the debt guarantee by a person with a strong credit history.
- Joint Check Agreements: Credit teams can justify issuing credit to a subcontractor when they know that a project is sound and worthy, and so they will agree to issue credit if the general contractor or owner agrees to make all payments to the subcontractor through a "joint check," naming the vendor on the check.
- Mechanic's Lien Rights: Suppliers and equipment rental companies can take collateral from the project through their mechanic's lien rights, which enables the vendor to issue trade credit on the project with much less risk.

3. Collection and Credit Management Tools—Finally, while subcontractors must navigate through "pay-when-paid" provisions, retainage delays, and other payment problems, most vendors will not accept such nuances. Their terms are strictly counted in a flat number of days. After 30, 60, or 90 days, it's time for them to collect, and they use different credit and collection management software to keep up with this and to make sure that things are collected on time.

Subcontractors should keep these tools in mind when seeking trade credit for a vendor. Understanding how the vendor must evaluate the subcontracting business and the risk on the account will enable the subcontractor to have a stronger relationship with the vendor, and to sometimes find ways to bridge the risk gap and get more credit.

Subcontractors Must Evaluate Credit from Those Paying Them

While every subcontractor encounters their own credit getting evaluated by banks, financers, and vendors, it is very common for subcontractors to forget that they frequently sit at the other side of the table. Subcontractors, in other words, must do a healthy amount of credit evaluations themselves.

Everything that a subcontractor does is done on "credit." A subcontractor furnishes labor and materials to a project, and then, only after the labor and materials are provided, the subcontractor will send a bill. The subcontractor has just provided labor and materials to a third party on "credit." The furnishing was provided based on a promise to pay.

Now, what evaluations did the subcontractor do to make sure that the party promising to pay has the creditworthiness to fulfill that promise?

Did the subcontractor run credit checks on the business and the business owners? Did they get a personal guarantee or a joint check agreement? Did they preserve their collateral by sending a preliminary notice and protecting their mechanic's lien rights?

It's unfortunate that subcontractor rarely have "credit departments" or "credit professionals" in house, and they rarely evaluate their credit risk on a project. For the most part, subcontractors will rely on "relationships," or worse, rely on nothing on at all. This can become a very expensive bet.

Subcontractors can mitigate against this risk, and it works the same way as it does for vendors, banks, and lenders. Subcontractors can use the same tools and philosophies to manage their own credit risks, with particular importance placed on the subcontractor's mechanic's lien rights.

Those who position themselves to use mechanic's lien rights will insulate themselves against the risk of non-payment, and since the lien rights are preserved, the subcontractor is more likely to avoid a non-payment situation to begin with. That's because general contractors, owners, and lenders, place great emphasis on mitigating their exposure to lien claims, and those subcontractors who send preliminary notices to protect their lien rights are bookmarked by these paying parties, and are given stronger priority when it's time to make payment decisions.

What Subcontractors Need to Know About Construction Credit

Subcontractors encounter construction credit issues all the time, whether or not they are conscious about it. Great subcontractor organizations, however, are very conscious about how credit works for and against them in the construction industry, and they use that understanding to their advantage to get more trade credit from vendors and banks, and to take less risk with those who will ultimately pay them.

Subcontractors must know how credit and collection teams work within material supply and equipment rental companies. Rather than fighting against all the credit mitigation tools that these vendors use, subcontractors should understand and embrace them, as they can be used to make these vendors more and more comfortable with issuing better and better terms.

Subcontractors must also understand that they are issuing trade credit on every project, just like their vendors. If they ignore the credit risks, they are just waiting for the ticking time bomb to explode. Instead, subcontractors should employ credit risk mitigation strategies, such as the use of mechanic's lien protection, to decrease their nonpayment risks.

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ASA offers national recognition to prime contractors that are committed to superior business practices like prompt payment. ASA's annual National Construction Best Practices Awards, developed by the Task Force on Ethics in the Construction Industry, recognize elite prime contractors that uphold best practices and refuse to do business according to the "lowest common denominator."

The deadline for prime contractors to submit applications is Nov. 13, 2015. The application fee is $495. Each prime-contractor applicant must supply three sealed business-practices recommendations from specialty trade contractors that have worked for it in the past year, along with a copy of its standard subcontract, with its application.

ASA will honor recipients during an awards ceremony at the ASA annual convention, SUBExcel 2016, March 3-5, 2016, in Miami, Florida.

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Watch the National Construction Best Practices Award Video

Prime contractors: Download the **2015 National Construction Best Practices Award Application Form**

Specialty trade contractors: Download the **2015 National Construction Best Practices Award Form for Evaluating the Applicant's Business Practices**

ASA Chapters: Download the **ASA Chapter Guideline for Processing the 2015 National Construction Best Practices Award** and other materials under "Industry Relations" in the ASA Chapter Toolbox.

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