BANKING GUIDE FOR THE CANADIAN CONSTRUCTION INDUSTRY

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1.0 PURPOSE OF THE GUIDE

The primary purpose of this Guide is to foster a better understanding between members of the construction industry and the banking community. To do this, the Guide attempts to debunk some of the myths about both industries and to more clearly and correctly state the needs and expectations of both groups.

The Guide primarily targets small to medium-sized construction firms who do not have the resources to employ in-house expertise in the financial management area. The objective is not to make all construction firms bankable or to suggest the lowering of current standards, but to make small to medium-sized construction firms much more knowledgeable about the expectations and requirements of the banking community and more business-like in their dealings with banks. It also seeks to improve general construction industry financial management.

In addition, the Guide targets banking personnel. It hopes to create among the banking community a better understanding of the construction industry and the particular banking needs of construction firms.

This Guide has been prepared by drawing on the expertise and experience of individuals who work in the construction, the banking and bonding industries.

It is the hope of the authors that this Guide will form the basis for local seminars and conferences devoted to improving knowledge and understanding between the construction industry participants and their banking partners.

2.0 CONSTRUCTION INDUSTRY PROFILE

2.1 INDUSTRY IN GENERAL

Industry Size and Scope

The construction industry in Canada is a significant industry contributing over $160 billion annually to the Canadian economy. This represents approximately 12% of Canada's total GDP. Non-residential construction accounts for approximately half of that figure.

The construction industry in total directly employs over one million Canadians or more than 6% of the entire Canadian workforce and pays over $40 billion annually in wages and supplementary labour costs.

Some 90% of the businesses operating in the construction industry in Canada are small businesses with less than $1 million in annual gross sales. 95% of all construction businesses operating in Canada are Canadian-owned, and a considerable number of those are also family-owned.

The construction industry is a significant contributor and bell-weather for the overall Canadian economy. Construction investment and activity have a significant multiplier effect on the greater economy.

The Project Delivery Process

Construction is part of a multi-faceted project delivery process involving a number of participants. For the construction of buildings and facilities, the process involves seven (7) major steps/phases as follows:

1. Concept development
2. Securing financing
3. Design development
4. Obtaining regulatory approval

5. Construction
6. Operation and Maintenance of the constructed asset
7. Demolition/abandonment

Who Typically is Part of the Construction Team?

The following entities typically are part of the team that is directly involved in the construction process:

- The project owner, who is normally the owner and/or developer of the real property;
- The designer, who is normally an architect or engineer employed by an architectural or engineering firm engaged to design the project; and
- The contractor, who is the builder or constructor of the project.

The **owner**, as previously mentioned, is normally the owner/developer of the real property on which the building or facility will be situated/constructed. The owner is ultimately responsible for the overall success of the project. It is the owner who first conceptualizes the project, establishes its basic parameters, undertakes feasibility studies to confirm project viability, arranges project financing, guides the project through the regulatory approval process, and engages all of the key project participants. This will normally include the engagement of a design team and the contractor. All major aspects of the project must meet with the owner's approval.

The **designer** is normally an architect or engineer employed by an architectural or engineering firm engaged by the project owner to provide design services. In the opening stages of a project, the designer will develop preliminary designs and cost estimates, undertake cost-benefit analyses, evaluate environmental impacts and prepare supporting documentation used to market the proposal to potential financiers and to submit to government regulators involved in the approval process. Once financial support and regulatory approvals have been obtained, the designers will then develop detailed design drawings, specifications, cost estimates and seek construction pricing from interested or invited contractors.

The **contractor** is the enterprise that physically constructs the building or facility. Typically, contractors are categorized as a **general contractor**, **trade** or **specialty contractor**, or a **road builder/heavy constructor**. It is important to note that contractors are **NOT** real estate developers or landowners. They are also **NOT** project owners.

A **general contractor** normally assumes responsibility for the construction of the entire project under a single general contract with the owner. The general contractor will typically subcontract portions of the work to various trade or specialty contractors. Overall construction responsibility, however, remains with the general contractor. The general contractor schedules the arrival of building products, materials and machinery on the site, hires and co-ordinates the work of the specialty subcontractors, supervises the construction, and undertakes quality control and safety requirements.

A **trade** or **specialty contractor** performs certain types of work such as a mechanical or electrical contractor. When engaged directly by the owner, the trade contractor is referred to as a prime contractor. When engaged by a general contractor, the trade contractor is called a subcontractor.

A **road builder** is self-explanatory. A **heavy constructor** is traditionally used to describe contractors who perform engineering construction works such as roads, airports, ports, dams, utilities, and pipelines.

2.2 THE DIFFERENT PROJECT DELIVERY METHODS

There are several different contracting methods from which the owner can select to design and construct a project. These include:

- The Stipulated Price or Design-Bid-Build Method for a Fixed Price – This is the more traditional method by which the owner first engages the designer to design a complete set of project drawings and specifications based upon the project owner's requirements and budget. The owner or designer will then seek a fixed price, sometimes called a stipulated or lump sum price, from interested or invited contractors. The owner then engages the successful contractor, (normally the lowest bidder), through a separate contract from that used to engage the designer. For example, see ***CCDC2 – Stipulated Price Contract**. Under this method, the contractor agrees to build the specified project for a fixed price and within a specified schedule, and thereby assumes the risk of the actual cost to construct the project on time;
- Cost Plus A Fee Contract – In circumstances where the actual scope of the project to be undertaken is not known at the outset, and/or there is some urgency or desire on the part of the owner to commence construction as soon as possible, the owner will sometimes enter into a Cost Plus a Fee arrangement with the contractor. Under such a contract, the contractor is reimbursed for the actual costs incurred and paid a fee based upon a percentage of the reimbursed costs or a fixed fee established at the outset. See **CCDC3 – Cost Plus Contract**;
- Unit Price Contract – This is a construction contract wherein the owner agrees to pay the contractor a specified amount of money for each unit of work successfully completed as set forth in the contract. It is typically used on road and related Construction projects where the work is repetitive and the actual quantities are subject to change at the site. The contract normally defines a standard method to measure the quantities of work performed. The owner assumes the risk of the overall quantities actually required and the total price to complete, since there is no guarantee of the final quantities or the final price. The contractor assumes the risk of the actual unit prices quoted for the various units of work. See for example **CCDC4 – Unit Price Contract**;
- The Design-Build Method – This method involves procuring both the design and construction under a single contract. The design-builder becomes responsible for both design and construction. See **Document 14 – Stipulated Design-Build Contract**. The contracting entity can be a contractor who then engages a designer by subcontract, or vice versa, or a joint venture between a designer and contractor, or a single firm possessing both design and construction capabilities;
- Construction Management Method – This is a contracting method whereby a Construction Manager is engaged by the owner, usually in advance of the project design process, to work with the owner and the designer as a team to do the preliminary project planning. The Construction Manager provides construction input into the design development process, including material selection, development of the construction budget and will also provide site management, administrative and technical services for a fee, either fixed or calculated as a percentage of the total construction cost. See **CCA 5 Construction Management Contract**; and
- Project Management Method – This is a contracting method by which the owner engages under a single contract a Project Manager to oversee all aspects of the design and construction of the project on the owner's behalf from the preliminary project planning and concept to the completed construction project. The Project Manager may engage the designer and a Construction Manager or a contractor.

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*The CCDC is the acronym for the Canadian Construction Documents Committee, a joint industry committee comprised of representatives from owners, contractors, architects, engineers and others tasked with the development of recommended standard construction contracts, forms and guides.

2.3 CONSTRUCTION INDUSTRY CHARACTERISTICS

The construction industry is comprised of two major sub-sectors, each of which accounts for approximately one-half of the construction market. Both are quite distinct, responding to different market forces, utilizing different construction techniques and materials, and employing a different labour force. They are:

- The **residential** construction sector. (i.e. single-family dwellings and low density units); and
- The **non-residential** construction sector comprised of all other types of construction.

Within the **non-residential** construction sector, there are two sub-sectors as follows:

- The **institutional**, **commercial** and **industrial construction** (**ICI**) sub-sector covering construction of non-residential buildings, including hospitals, schools, commercial office buildings, stores, hotels, warehouses, plants, etc.; and
- The **road building/heavy constructor** sector covering non-building construction projects, (e.g. roads, bridges, sewer and water projects, dams, railways, pipelines). This market is influenced primarily by government or resource industry spending/investment on infrastructure.

The construction market in Canada is comprised of three (3) key factors that have had a profound impact upon the industry's structure and performance:

- It **mimics the general economy**. The construction industry has historically followed the general business cycle but tends to lag the rest of the economy in that upswings and downswings in the general economy impact the construction industry later than most sectors;
- It is **geographically diverse**. Construction projects are spread out across the country in direct proportion to demographic, resource and economic factors; and
- It requires a **strong local presence**. Construction is a site-specific activity, requiring hands-on management and knowledge of local labour conditions and regulations.

The result is an industry that is highly diverse, specialized and composed primarily of small firms. These characteristics, however, allow it to adapt to changing market conditions quickly and to operate successfully in a feast-or-famine market environment.

Successful contractors seek to provide superior performance and service in order to attract repeat customers or to make an owner's list of preferred contractors.

Some contractors seek specialized work where margins are generally higher.

Successful contractors adjust their margins and pricing consistent with the market cycles. These also vary significantly depending upon the construction sector/market and contractor type. In addition, contractor variable and fixed costs will differ. For example, general contractors active in the ICI building market tend not to have a large, full-time labour force, a large fleet of construction equipment or warehouses full of construction materials/products. Contractors active in road building or engineering construction, however, will have more fixed costs such as equipment, while specialty trade contractors, such as mechanical or electrical contractors, might have a regular labour supply, equipment, and product inventory.

Contractors tend to specialize by confining their activities to a specific market type and geographical sector. The need to have a strong local presence has also resulted in the industry being predominantly Canadian owned and controlled. Only a handful of foreign-controlled contractors operate in Canada.

2.4 CASH FLOW IN THE CONSTRUCTION INDUSTRY

The terms of payment between the owner and the general contractor are determined by the contract between them. The same is true between the general contractor and the subcontractors, i.e. the terms are dictated by the subcontract agreement.

Typically, billing for construction services occurs on a monthly basis as the construction work proceeds, based upon the value of construction work performed. Subcontractors submit their monthly invoices to the general contractor, who in turn submits a single, combined monthly billing to the owner. Although the liability to pay for work performed is incurred as work progresses, payment does not normally become due until the monthly construction progress billing has been verified/certified by a third party, normally the designer. The owner then pays the general or prime contractor, who then pays the subcontractors. Given the normal chain of contracts on a typical construction contract, cash flow management is obviously of prime concern to contractors, since the period of time between actually performing the work and being paid can vary depending upon where the contractor sits in the contract chain. Construction payments are also typically subject to statutory holdbacks imposed by provincial lien legislation (see the section in this Guide entitled **Legislation/Regulation Affecting Credit Risk in the Construction Industry**).

Workers are typically paid on a weekly basis. Material suppliers are normally paid on a monthly basis while other suppliers, such as utilities, fuel sources, etc. are paid on a more periodic basis. In addition, government payroll remittances and other statutory obligations must be met when required. As a result, when requests for monthly payments are made at the end of the month and only paid the following month, it is not unusual for there to be a period of more than two months between when payments are made to employees and others and when the contractor is actually paid. This two-month delay is an average and can be much longer. The higher the labour content, the higher the requirement for financing will become.

As in other industries, cash flow and working capital are extremely important for firms operating in the construction industry.

2.5 HOW DO SUCCESSFUL CONTRACTORS MITIGATE CONSTRUCTION INDUSTRY RISKS

Regardless of the size of the contractor, all contractors are required to perform the necessary business functions of marketing, estimating, planning, quality control, scheduling, purchasing, accounting and training. The estimating function is especially important in the construction contracting industry because many construction jobs are obtained on the basis of competitive bids. Jobs bid too low result in business losses, and bids that are too high result in lost revenues. One way to mitigate this risk is to use Gold Seal Certified personnel.

Non payment for completed work is one of the most serious credit risks faced by all contractors. This can happen where the owner encounters financing or financial difficulties. The risk of owner non-payment can be minimized through the due diligence of the prime contractor concerning the project financing. There is a strong desire on the part of industry associations to see contractors more diligent in satisfying themselves as to project financing and payment risk prior to bidding or commencing construction. (e.g. **CCA Document 50 – A Prime Contractor's Guide to Project Financing and Payment Security**).

Disputes as to the interpretation of contract documents are also a common risk in construction. This risk can be reduced where the owner and the design team are well known to the prime contractor and/or the prime contractor ensures that the plans and specifications are well done and precise. The use of standard industry contract forms, (e.g. **CCDC-2 Stipulated Price Contract**), will also minimize the risk of disputes.

Non performance by subcontractors and/or suppliers is another major risk. This can be avoided by having a good knowledge of the subcontractors to be used. Successful contractors seek good relationships with trades and suppliers in order to guarantee loyalty (and preferred prices) and good performance. Prudent and comprehensive subcontract agreements between the general or prime contractor and the various subcontractors, (e.g. **CCA-1 Stipulated Price Subcontract**), are extremely important. Also a good review of the scope of the work to be performed by both the general or prime contractor and the subcontractors will reduce the risk of subcontractor failure. Requiring subcontractors to provide performance bonds to the general contractor can mitigate this risk.

Bid preparation errors are also a major risk and occur when the contractor submits a bid that is priced too low or does not contain a price for a critical item. This is minimized through the use of qualified personnel and good planning in estimating the work and the use of standard procedures. Use of **Gold Seal Certified Estimators** is recommended;

Many other risks can cause financial loss to a contractor such as labour strikes, bad weather, late delivery of building materials/supplies, and delays caused by design reviews and approvals. These can be reduced with good planning and a back-up plan. The contractor must be ready to face adverse conditions at all times.

2.6 LEGISLATION/REGULATION AFFECTING CREDIT RISK IN THE CONSTRUCTION INDUSTRY

Provincial construction/builders' lien legislation requires the maintenance of holdbacks on payments by the owner to the prime contractor to provide some protection for unpaid subcontractors/suppliers and workers. Hence, even where the work billed for is complete and is so certified by the payment certifier, the owner must withhold the statutory amount for the specified period.

These statutory holdbacks are NOT the same as contractual or performance holdbacks, (i.e. retainage as in the United States), where amounts are withheld to guarantee the completion of the work. In Canada, statutory holdback amounts are a percentage of funds that have already been approved for payment and relate to work that has already been certified/accepted. They are not funds withheld to guard against defective, deficient or incomplete work which has not yet been certified/accepted.

Some provincial lien legislation also impresses mortgage advances and other funds ear-marked for the construction project with a trust to prevent recipient trustees (e.g. owners) from using funds intended for the project for other purposes.

It is important to note that provincial lien legislation can vary significantly between provincial/territorial jurisdictions. For example, in some jurisdictions, construction projects situated on lands owned by the province are not subject to the lien legislation of that province while in other jurisdictions, the provincial legislation does apply to such work.

2.7 CONTRACTOR PROFILES

General Profile of a Construction Contractor

The specific characteristics of a construction contractor are that they usually:

1. Set out the sequence of tasks needed to accomplish their work.
2. Are subject to the instructions outlined in the contract as to work sequencing but normally are not instructed as to when, where, or how the work is to be completed.
3. Furnish their own tools, materials, and the like, as well as the labour to install the items.
4. Hire and supervise others to assist in the completion of the work.
5. Bear all business expenses associated with the performance of the work. These expenses include items such as insurance, workers compensation, travel, advertising, etc. unless negotiated otherwise.
6. Provide the equipment and place to perform the services where it is customary trade practice to do so.
7. Are in a position to realize or suffer a loss as a result of providing their services.
8. Cannot be discharged from the work if the contract specifications are being met.
9. Cannot terminate the agreement or contract without incurring a liability.
10. Make services available to others in the general public. This includes holding a business license, having a place of business, advertising a service, and providing a listing for business telephone purposes.
11. Are free to work when, for whom, and for as many employers as they choose and are not required to work exclusively for one owner or contractor.
12. Choose the working hours for their employees who do not need to be present at any specific time.
13. Are responsible for training their work force and use their own methods to accomplish the work.
14. Are required to carry out work in accordance with statutory requirements such as the National Building Code, Labour Codes and Workplace Safety Regulations.

General Contractor

The general contractor contracts under a single contract with the owner to construct the project. The general contractor in turn subcontracts portions of the work to trade/specialty contractors as well as suppliers. Sometimes the general contractor will use own forces to perform certain parts of the work. This varies from one project to another.

The general contractor is responsible for the proper co-ordination of the work of all of the subcontractors. The general contractor is also normally responsible for overall safety on the project.

Road Builder/Heavy Constructor

The road builders and heavy constructors have expertise in:

- grading and blasting
- road building
- airport and port construction
- bridge and dam building
- asphalt and concrete paving
- road and bridge maintenance
- utility construction, and
- marine construction

This segment of the industry tends to be more capital intense than its building sector cousins given the heavy equipment often required. It is asset driven. The contractors working in this sector tend to be prime contractors, (i.e. they deal directly with the owner). Their clients tend to be governments, public sector agencies, utilities, airports and multi-nationals.

Road building and heavy construction companies typically require large fleets of heavy equipment, comprehensive professional management teams, a skilled labour force and material resources necessary to meet market demand within this industry.

Trade/Specialty Contractor

A trade contractor is an independent specialty contractor who works as part of a team with the general contractor and other specialty trade contractors to complete a construction project for an owner. The trade contractor is contracted to perform a particular service and/or produce an agreed upon outcome for a stipulated price and for conditions outlined in the tender documents or in their quotation.

The areas of specialty provided by trade contractors include the following, with one or more contractors providing each service:

- concrete work
- masonry
- structural steel
- metals
- wood and plastics
- thermal and moisture protection
- doors and windows
- finishes, including painting
- tile setting
- lathing and decking including roofing
- floor coverings
- carpentry
- mechanical, including plumbing, sheet metal, heating and controls
- fire suppression(including sprinkler and fire detection)
- electrical

3.0 DEBT FINANCING

It is important to understand that businesses are rarely financed purely by debt and so banks and other lending institutions cannot be expected to solely finance the business.

Banks

There are five (5) major banks in Canada. They have most of the market share and provide services in all major Canadian cities. There are also a number of major foreign banks that have established commercial lending operations in Canada.

Other Financial Institutions

Financial institutions other than the major, chartered banks may be willing to lend money to businesses. Among these institutions are trust and loan companies, business development banks, credit unions, caisses

populaire, and, in some instances, insurance companies.

Secured Transactions

The usual practice in Canada is for financial institutions, including banks, to take full security on any loans they make. Security may be taken in a variety of different ways and over a variety of different assets. Common examples include:

1) **Real Property**

   Corporate borrowers provide a mortgage or debenture as security over real property.

2) **Company Assets/Borrower Assets**

   Lenders typically require corporate borrowers to provide a General Security Agreement (GSA) that grants the lender blanket security over all assets owned by the borrower at the time of the granting of the security interest and all assets acquired thereafter. The GSA is registered pursuant to the Personal Property Security legislation in the applicable provincial/territorial jurisdiction. This does not act as a Mortgage on land and buildings. The most typical assets secured by a GSA are Accounts Receivables, inventory, equipment, or other movable assets.

   Canadian provinces have each enacted Personal Property Security legislation, (i.e. Personal Property Security Act – PPSA), that governs the creation, registration and enforcement of personal and company property security interests. The provisions and requirements of each do vary slightly from province to province.

3) **Personal Guarantees**

   Banks and other lending institutions often require personal guarantees as collateral for loans. Contractors should attempt where feasible to limit these.

4) **Bank Act Security**

   The Bank Act creates a form of security that chartered banks can take over raw materials, work in progress or finished goods in inventory of businesses.

Impact on Bonding Capacity

Contractors should be cognizant of their surety bonding needs when dealing with their bank or other lending institution. Make sure the bank is aware of your bonding limits and needs. Loan agreements may impact the bonding capacity of a contractor. In addition, under the lending agreement, the contractor may be required to pledge certain assets as collateral, to which a surety might otherwise want access. Most bonding companies will rank behind the commercial lender (e.g. bank) when it comes to General Security Agreements.

4.0 BANKING INDUSTRY PROFILE

The banking industry continues to change in lock step with the demands of its shareholders, to improve shareholder value, be more vigilant in risk management criteria to meet expectations and criteria of the Bank Regulators (Office of the Superintendent of Financial Institutions - OSFI), and ensuring full compliance with all aspects of proper Corporate Governance.

Banks have become very diverse in their business lines. Most of the Canadian Chartered Banks have segmented their business into specific business lines in order to become more focused and specialized on various components of their business.

The various business lines are Retail and Commercial, Wealth Management, Securities or Equity and mezzanine financing, and Whole Sale Banking (corporate banking).

Each business line requires capital to operate. The bank and its shareholders have an expectation that there will be a targeted minimum return on capital that will be generated through those business operations in order to warrant the allocation of capital, or even providing more capital to fuel growth. In other words, a bank will allocate or reallocate capital to those business lines that are meeting or exceeding the minimum thresholds of return on capital. The returns for all business lines combined will equate to the overall return on capital for the entire bank. This is important to its shareholders, and the markets, as this generally means the bank is generating a level of profitability that allows for growth in shareholder value and dividends.

Bank regulators have continued to demand improved risk management processes of banks, which in turn requires changes to how banks lend money, the type of information required of their customers, as well as the amount of analysis, due diligence and structuring of commercial credit to customers. Ongoing reviews of all banks' underwriting and risk management practices are completed by the OSFI. Key areas of focus are, industry concentration, average risk rating of the portfolio, level of monitoring and type of financial analysis completed, level of security taken vs. risk on the deal, level of due diligence and monitoring capabilities of lenders. Historical loan loss performance is reviewed and sophisticated models are used to stress test a bank's portfolio.

These measures are intended to maintain a strong Canadian Banking system, reduce the probability of large loan losses, and Risk Rate Canadian Banks on credit worthiness, which in turn impacts on their cost of capital. The higher the cost of capital of one bank versus another, the less competitive one bank will be versus the other. As well, a higher cost of capital will constrain the bank's capabilities in generating the desired return on capital for its shareholders.

Corporate Governance has gained greater attention over the past three years given the debacles with inaccurate accounting information or inappropriate reporting processes. Canadian Banks have and continue to be very focused on this, as credibility in the eyes of the market, shareholders and customers are paramount.

Commercial Lenders are required to be more vigilant in obtaining complete and accurate information from their customers, and to manage their portfolios in accordance with bank and regulatory policies.

The subject of bank capital and the respective return on capital is important in relation to how loans are priced. Commercial lenders will review a company's financial position, level of security, past performance, the industry and management in order to provide the bank with an internal risk rating. The risk rating is not public information as it is only of meaningful use by the bank. Most banks are somewhat similar in their risk ratings, however, there are still a few anomalies. For every loan the bank makes, it must (as required by the OSFI), set aside a certain amount of capital. This capital does not earn any form of return for the bank or its shareholders. As the risk profile on a borrower increases, the amount of capital to be set aside also increases. To account for the increased risk profile and capital, loan pricing must also increase, to offset the extra capital now set aside for which there is no return. The converse is true when the risk profile decreases (which means the risk improves). In the end,

this will impact shareholder value. To under price loans relative to the capital set aside as it relates to risk, results in substandard returns to shareholders thus impacting how the shareholder (and the market) will view the bank's stock. If shareholders are not content with the return or perceived stability of the banks earnings, they will invest elsewhere. This can impact the bank's stock, earnings and overall financial performance. As a result, banks have become and will continue to become more disciplined in pricing loans in relation to risk.

Often, banks will structure credit proposals with performance or incentive pricing, which is tied to financial ratios that best measure financial performance of the company, and measure financial risk for the bank. This will involve one or two financial ratios that cover a range of risk thresholds (risk that is acceptable to the bank), as well as different pricing established for each range. If financial performance improves and moves to the more favorable range of the financial test, then risk should decrease, which means the bank needs to set aside less capital, and can earn a lower return given the less capital allocated on which the bank earns zero return. The converse holds true if financial performance decreases. There will be a level of risk beyond which a bank will not want to lend. Banks are not high risk lenders. That is where mezzanine or equity financing can be used depending on the financial circumstances of the company.

Industry Risk: Banks have and continue to lend to virtually all industries. Banks assess each industry to determine Industry Risk. Industry risks are those that the company and the bank have little or no control over. As a result, there are some industries that are deemed a higher risk than others. In those cases, the financial position of the company, and the depth of its management must be very strong in order to be able to withstand unexpected variances.

Financial Risk: Financial Risk is determined by the bank based on past financial performance, current financial performance and financial position, track record on managing the company, its finances and production/service provided, type of assets and business cycle of the company/industry.

Business Risk: Management is critical. If management is weak, it will be difficult for a bank to support a loan request. Banks will spend considerable time and due diligence determining the capabilities and depth of management/management team. In some cases, the bank will utilize third party professionals to assist if required to assess the strength of both internal and external accounting systems, and how the business is being operated.

As outlined above, Industry, Business and Financial Risk are the key areas that cover the bank's general risk assessment. Generally speaking, if Industry Risk is considered High, then Financial Risk and Business Risk need to be Moderate to Low. This means that High Risk Industries typically have risks that are beyond their control, and can cause a material variance in financial performance. This means the financial performance is less consistent or less reliable because of those factors. A good example of risks beyond anyone's control is the impact of weather on agriculture, the construction industry (to some extent), the nursery industry, vacation resorts, tourism, to name a few. Industries with high risks cannot handle large debt loads on an ongoing basis. As a result, their debt carrying capacity will be less than other industries.

In conclusion, banks are more than just lenders and deposit gatherers. As outlined, they have become very diverse and their focus is to grow shareholder value, by delivering consistent, predictable earnings that increase over time through gaining market share and or other forms of acquisitions.

The Construction Industry is one industry where the banks have written off large sums of money in the late 1980's early 1990's. Naturally, given what has been outlined above, shareholders are very conscious of how the banks operate. While the construction industry is deemed a High Risk industry, banks will always support the top tier companies/operators, as is the case with other High Risk Industries.

The Banks will be selective, and it is hoped that this document will provide a greater understanding by the construction industry of how the banks operate, why they ask or do what they do, and tips on how to improve your relationship with a bank.

4.1 KEY FINANCIAL STATEMENT RATIOS

Banks and lending institutions typically use financial statement ratios as tests by which to assess the ability of a business to repay a loan and /or as conditions of credit. Some of the key ratios are:

Debt to Equity Ratio

(Also referred to as Debt Ratio, Financial Leverage Ratio, or Leverage Ratio).

$$= \frac{\text{Short Term Debt + Long Term Debt}}{\text{Shareholder's Equity}}$$

This ratio measures the extent to which the business relies on debt financing as opposed to equity to fund its operations. The upper acceptable limit of the ratio is normally 2:1. A high Debt to Equity Ratio indicates potential difficulty in paying interest and principal (debt service) while obtaining more funding. The definition of "debt" may vary amongst financial institutions.

Working Capital Ratio

(Also referred to as Current Ratio)

$$= \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

This ratio is used to evaluate the liquidity of a business, or its ability to meet current (short term) payment obligations. The generally accepted target ratio is 2:1 with a minimum acceptable level of 1:1. Companies with a Working Capital Ratio of less than 1:1 may be technically insolvent under certain provincial statutes and unable to enter into further borrowing arrangements. Financial institutions may set a minimum ratio level that must be maintained under a borrowing facility.

Quick Ratio

(Also referred to as Acid Test)

$$= \frac{\text{Cash + Short Term Investments + Accounts Receivable}}{\text{Current Liabilities}}$$

This ratio is a variation of the Working Capital Ratio, which indicates whether current liabilities can be paid without selling inventory.

Debt Service Coverage Ratio (DSCR)

$$= \frac{\text{Net Income}}{\text{Annual Debt Service}}$$

(Debt services include all interest expenses and scheduled capital lease and debt principal payments).

This ratio measures the ability of a business to repay term debt obligations and related payments such as bank debt, equipment loan payments, capital lease payments and mortgage payments. A DSCR of less than 1 would mean a negative cash flow. For example, a DSCR of 0.95 would mean that there is only enough net income to cover 95% of annual debt service payments.

Gross Profit Margin Percentage

$$= \frac{\text{Revenue – Cost of Goods Sold (Gross Profits)}}{\text{Revenue}}$$

This percentage is used to monitor performance from period to period and amongst competitors in a particular industry segment to determine whether profitability is increasing or decreasing.

If the gross margin is less than the total marketing, general; and administrative expenses, then the business is losing money.

Interest Coverage Ratio

$$= \frac{\text{Earnings before Interest, Taxes, Depreciation + Amortization (EBITDA)}}{\text{Interest Expense}}$$

This ratio indicates what portion of interest on debt is funded by cash flow for the business' operations. A ratio of less than 1:1 indicates that the business is not generating enough cash flow from operations to pay its interest expenses.

Return on Equity (ROE)

$$= \frac{\text{Net Income}}{\text{Shareholder's Equity}}$$

This ratio indicates the relative level of return on earnings that the business is earning on the capital invested by the shareholders. A declining ROE from one period to the next may be an indicator that the business is heading towards a period where it will have difficulty meeting its debt service obligations.

4.2 WHAT YOU SHOULD KNOW ABOUT THE BANKS AND BANK LENDING PRACTICES

- Banks are Not in the business of losing money nor are they in the business of high risk lending.
- Canadian banks lend based on their risk assessment of the Industry, Business and Financial risk. Cash flow, profitability, financial position and the type of collateral provided, are the final part of the analysis critical to the lending decision. The amount of credit provided will be a function of the company's capability to repay the debt in an orderly fashion, and the level and quality of collateral provided to secure the loan(s).
- Banks will typically not accept 100% of an asset as collateral since the liquidation value of an asset is often well below the market value. Banks usually follow internal guidelines for collateral – for example, an assignment of accounts receivable within 90 days may be valued at 50 to 75 percent (90% if insured, example EDC). A chattel mortgage on business equipment or machinery may be limited to 50 to 80 percent unless there are additional assets available to make up the appropriate margin to secure the loan.

For example, a bank may finance 100% of the purchase of a piece of equipment, or building if there is other equipment/property available to make up the additional margin (whatever that may be). Inventory is usually not given more than 50 percent of its value when used as collateral and there is normally a maximum dollar amount above which the bank will not finance. This will also depend on the financial position of the company and the type of inventory.

- While banks finance assets, there is a misconception that if an asset worth "$x" is provided as collateral, then the bank will automatically finance"$y". As indicated previously, banks will not only assess the asset being financed, but the financial position and capabilities of the company as well. This holds true for financing accounts receivable and inventory. Rapidly growing companies often encounter difficulty obtaining steady increases in their operating lines of credit. The company will submit that their accounts receivable have grown 30% and therefore the bank should automatically increase the line of credit to match the extra margining available given the increased dollar level of receivables. If this were the case, the banks would be in the business of "Factoring". There are finance companies that will provide credit based solely on the quality of accounts receivable and essentially replaces the bank's line of credit. These companies charge a risk premium as they will collect and take their cut. Banks on the other hand need to lend based on the financial viability of the company. That means the company needs to maintain a proper balance of equity and working capital versus too high a level of debt financing, otherwise companies can literally grow themselves into bankruptcy. Growth needs to be controlled and is very difficult to do. This is where the bank and the accountant need to be heavily involved in providing input to the business owner.

5.0 HOW TO DEAL SUCCESSFULLY WITH THE BANK – Some Banking Do's and Don'ts

The relationship between a contractor and the contractor's bank is one of the most important for the success of the contractor's business. It should be one of trust and good communication.

The bank is in business to make money. It makes money by lending money and by charging rent for that money, (i.e. interest), and by charging fees for certain work completed. The interest rate charged will be in proportion to the risk the bank determines through its overall risk analysis. If the risk is beyond an acceptable level, the bank will simply not lend the money. Interest rate spreads should vary with the degree of acceptable risk levels, which are determined by certain financial tests that are generally established by the bank, (covenants or conditions of credit). Pricing can be tied to certain financial tests that best measure the financial performance of the company. As those financial results improve, so should pricing. If they deteriorate, pricing should increase. This is referred to as performance pricing or incentive pricing. It takes the guess work out of determining when the borrower should pay less or more for the use of the bank's funds and is a very transparent and proactive way for the bank to clearly outline its pricing rationale.

Typically, most banks will incorporate performance pricing on credit facilities unless they are less than $300,000 - $500,000. This may vary from bank to bank. As well, this generally will not be applicable for very short term bridge loans.

When a bank does not have enough information about the business seeking credit, it will assume the worst case scenario and therefore increase the risk evaluation. It will do the same as a contractor when preparing an estimate. If there is a lack of information, the contractor will cover the risk by assuming the worst case scenario and therefore increase his price. And in case where there is too much doubt, the contractor will simply not submit a tender.

The following are some dos and don'ts in forging and maintaining a good working relationship between a contractor and a bank. Most are frankly based upon good old common sense.

Do's And Don'ts

Choosing a Bank

- Look to establish a credit facility before you need it!
- Do understand that the banks operate to make a profit not to loan money. They want to know that any loans they grant WILL be repaid with interest.
- Don't select a bank simply because it is in a convenient location. Good businesses go out of their way, if necessary, to find a bank that best serves their needs.
- Typically, Commercial Banking Centres provide a concentration of more experienced commercial lenders and generally provide for industry specialization. Most retail branches are only positioned to provide small business loans of approximately $300,000 or less, and the lending decisions are based more on the personal assets and net worth of the individual(s) who own the company. Typical security can take the form of a collateral mortgage on the personal residence or other acceptable property. The process is very formula driven and is a lower cost, lower maintenance deal for the client and the bank. Commercial Banking will generally cost more given the need for more in-depth analysis, monitoring, and general expertise.
- When selecting a bank, talk to other companies in your business about the relative level of experience and knowledge of the banking community in that area.
- When you apply to do business with a bank for the first time, ask to meet the Account Manager when you are setting up your bank accounts. Also ask to meet the Manager or Vice President if it is a larger centre. Remember that you are the customer and the bank is there to serve your needs. Ask the Account Manager about the bank's approach to evaluating loan requests, its process for approving loans, the bank's background and experience, personnel turnover, and its familiarity with your industry and your business.
- Banks typically rotate Account Managers. Be prepared to have to repeat this process.

Role of Your Accountant/Bookkeeper

- Make sure you have a competent person doing your books and that your bank is aware of that competency. If you don not have such a person on staff, you should engage a Professional Accountant for that purpose. Take your Accountant and bookkeeper to your meetings with your banker or at least to the annual review. A banker who is satisfied that your staff are capable, competent and conversant of the issues will be more confident of your company.
- Make sure your Accountant gives you the banking downside to all tax-based accounting decisions, (what might save you some tax liability could cost you dearly on your credit with the bank!).
- Understand your financial statements! Review them prior to any presentation to the bank and ask your accountant for layperson explanations of each item you cannot fully explain on your own. Have your Accountant prepare a set of expanded statements with explanations attached to line items for you to use as reference or notes.
- Make sure your Accountant and bookkeeper understand your banking/credit arrangements.

Meeting with Your Bank Account Manager

- Don't rush into a meeting with your banker. Be prepared. Set aside preparation and review time and build that into your appointment schedule.
- For a first meeting with a prospective new banker be prepared to bring:
    - past financial statements, (up to five years), as well as Interim Statements for the year in progress;
    - an up-to-date business plan (describing current operations and outlook for the short and longer term, including earnings projections and cash flow);
    - customer/client lists;
    - credit references;
    - current inventory statement, including an analysis of inventory age and turnover;
    - current accounts receivable statement, including an analysis of receivable age and turnover;
    - a statement of the current market value of machinery and equipment;
    - a statement of the value of fixed assets such as land and buildings;
    - customer/client testimonials;
    - profiles of your management team; and
    - how you manage your projects (construction programs, progress billings, other monitoring procedures).
- Your Account Manager will do an annual review of your file. Always take the time to sit down and go over it carefully with him/her and ASK QUESTIONS.
- Don't expect your Account Manager to understand all "year over year" changes in your financial statements. Be prepared to fully explain, especially any differences from prior years or other companies.
- Have your Account Manager explain why your credit rating with the bank is what it is! If you are not satisfied, negotiate and be prepared to explain why you believe you are entitled to a better rate.
- Take notes at all meetings with your banker and send a copy of them to him/her for review and retain.

How to Maintain a Good Relationship with Your Bank

- Don't ignore your banker in between annual meetings. Keep in touch. Make sure your banker is happy with the reports you provide.
- Banks typically rotate Account Managers. When your Account Manager advises that he/she is changing positions, ask him/her to set-up an introductory meeting with your new account manager with the old one present. It is incumbent on the bank to advise their customers of changes in Account Managers, and make introductions ahead of time. This is why it is important to know who the Manager is and ensure you have second point of contact at a more senior level. There should be more than one or two people in the Banking Centre that knows who you are, and about your business.
- Be prepared to provide monthly aged accounts receivable and accounts payable reports. In addition, banks often have additional reporting forms that must be submitted on a monthly basis such as compliance certificates, construction or builders programs and progress reports, reconciliation of billings, and over-billings.
- Be aware of your payment period on invoices and pay them on time. Always remember that your bank is aware of your credit rating.
- Always bill your receivables in a timely manner. "If you don't have time to bill for your work, maybe you don't have time to do the work?"

- Always make your loan payments on time. Your repayment record is a lasting indicator of your credit-worthiness, and stays with you forever! If you do anticipate any repayment problems, meet with your banker BEFORE and be the one to suggest a solution.
- Write a comprehensive Business Plan and update annually. This document is a fundamental requirement of most financial institutions. If you are unclear on what to provide, check with your banker on what they would like to see. This will save you time and money as opposed to you or your accountant guessing. Also make sure you understand the business plan and ensure it is realistic. Depending on the size of company and level of debt, banks may ask for the business plan projections to be sensitized. That means providing a "likely, worst and best" case scenario which include the impact on your ratios that are set out in your conditions of credit. This also gives you a sense of how much down side you can withstand and provides some thought as to what you will need to do as a contingency in the event things do not go entirely as planned.
- If you think you are not going to be able to meet your bank conditions of credit, (i.e. financial tests/ratios), arrange to meet with your bank as soon as possible to discuss matters (ask to include the Manager). Be prepared to outline why the ratio may not be met, and how and when you think you can meet it. This may require certain concessions on your part, however, the bank will be in a much better position to support your request as opposed to hiding the issue. As outlined earlier, if financial performance is slightly off, be prepared to pay a higher interest rate until you are back on side. This will be a function of how much of a variance there is to not meeting the financial test.
- Don't hide any financial information or problems that are or could impact your business. If you have made a mistake, be up front. Tell the bank and outline how you expect to remedy the situation and by when.
- Don't extend your scope of work beyond your capacity. Stick to your core competency. Don't use your earned money for other business ventures without first consulting your bank.
- Don't take all or substantially all of the money out of your business. If you are not willing to take the risk of leaving some of your money in the business, why would or should the bank?

6.0 GLOSSARY OF ACCOUNTING/CREDIT/BANKING TERMS

Any businessperson, in construction or in any other business, should know the basics of accounting. One of the main reasons for business failures is the lack of understanding of basic accounting and financing. The following are some of the most basic terms used in accounting and financing. If one does not fully understand their meaning, you should seek assistance and learn how significant they are.

(Many of these definitions are taken from the Canadian Bankers' Association website.)

Acceleration Clause
A provision in a credit agreement, security agreement, mortgage, bond or trust deed, stipulating that the debt secured, together with accrued interest, may become due and payable upon breach of some condition.
Accounts Payable
Money owed by a business for goods and services received.
Accounts Receivable
Money owed to a business by purchasers of goods and/or services
Accounts Receivable Financing/Pledge
To obtain a loan from lender to finance day-to-day business operations by pledging the accounts receivable of the business as security for the loan.

Account Agreement
An agreement which you sign and which lists your rights and responsibilities and the bank's rights and responsibilities for the bank account.

Aging
The process of analyzing receivables and payables by classification according to the length of time they have been outstanding. A long period may indicate the business' credit policies and collection procedures need attention.

Amortization
The gradual reduction of a debt by periodic payments over the term of the loan.

Assets
Things that you own which have value in financial terms

Balance Sheet
Shows the assets and liabilities (legal responsibility of your company) at any particular time. The assets on a balance sheet will always equal the liabilities plus the owner's equity. Your company's assets include: Cash, Inventory, Accounts Receivable and Fixed Assets. Your company's liabilities include short-term and long-term liabilities.

Bank Rate
The interest rate paid by major financial institutions if they borrow from the Bank of Canada. The Bank Rate influences the rates of interest major financial institutions charge and pay their customers.

Bridge Financing
An interim loan made for a short period of time during which the borrower is arranging long-term financing.

Business Plan
An overview in words and numbers of the history of a business and its owners, the aims and objectives of the business, and proposals to achieve business goals. It's a tool in the form of a document that will chart the course of a company for the future. It's a road map showing how the company will get from point A to point B. It will detail what resources will be use: material, human and financial. It will set the objectives to be reach within a specified time frame. It will describe the product, the market and the industry. The threats and the opportunities. It will also include the marketing plan.

Capacity
An assessment of the ability and willingness of a borrower to repay a loan from anticipated future cash flow or other sources.

Capital Gain or Loss
The difference between the price you paid for an investment and the price at which you sell (in other words, the profit or loss you make). Investments that earn capital gains or losses include equity and growth funds.

Capital Investments
Money used to purchase permanent fixed assets for a business, such as machinery, land or buildings as opposed to day-to-day operating expenses.

Cash Flow
Net profit after tax plus depreciation, deferred taxes and other non-cash expenses.

Cash Flow Forecast
An estimate of when, and how much, money will be received and paid out by a business. It usually records cash flow on a month-to-month basis, for a period of two years. It helps you time your expenditures in order to avoid cash shortages.

Chattel Mortgage
A pledge of business or personal property other than real estate in exchange for a loan to purchase the property in question, e.g. equipment, automobiles, or other supplies required to operate a business.

Collateral
Property (real, personal or otherwise) pledged as security for a loan. Also, any supplementary promise of payment, such as a guarantee.

Commercial Banking
Commercial banking centres serve small- and medium-sized businesses such as franchising, leasing and cash management services.

Commitment Letter
A document by which the lender agrees to provide financing within a specified time and according to the stated terms and conditions.

Comparative Statement
A form of financial statement presentation in which current period results and positions are presented with corresponding figures for previous periods.

Compounding
Refers to earning income on your income. For example, on fixed income investments that pay interest over time at periodic intervals, compounding means making interest on your initial investment and also on the interest as it builds up (i.e., earning interest on your interest).

Consumer Price Index
An index that measures movements in the average price of products and services typically consumed by Canadian families.

Corporate Banking
Banking services for large firms.

Correspondent Bank
In a country where a bank does not have offices, it will often make arrangements with another bank to act as its agent in that country. The correspondent bank provides services to the first bank's customers visiting or doing business in that country on behalf of their own bank in Canada.

Credit Risk
The risk of loss one assumes under a financial contract that a borrower or a counterparty to a loan or other credit-related contract may default or fail to perform its obligations.

Current Assets
Total of cash, deposits, trade receivables, inventory and other assets due within one year.

Current Liabilities
Total of trade accounts payable, bank operating loans and other debt due within one year.

Demand Loan
A loan that must be repaid in full on demand.

Depreciation
You can deduct a specified amount of the purchase price of business equipment, for tax purposes, to calculate your company's taxable income. Your accountant can provide details about depreciation of different types of equipment.

Documentary Credit
Written undertaking by a bank on behalf of an importer authorizing an exporter to draw drafts on the bank up to a specified amount under specific terms and conditions. They are used to facilitate international trade. In the United States these instruments are called commercial letters of credit.

Equipment financing
Borrowing from a financial institution, financing or acceptance company to purchase machinery or equipment, and using that equipment as collateral.

Equity
For an incorporated entity, it is the book value of a business ' assets after all debts and other claims are settled. Also the amount of cash a business owner invests in a business and/or the difference between the price for which a property could be sold and the total debts registered against it.
Fixed Assets
Assets like machinery, land, buildings, or property used in operating a business that will not be consumed or converted into cash during the current accounting period.
Fixed Charge
A charge currently attaching property as opposed to a "floating" charge.
Fixed Expenses
Fixed business costs that do not change with the volume of business, such as rent for business premises, insurance payments, utilities, etc.
Fixed-Return Instruments or Vehicles
Instruments that pay a fixed rate of interest for an agreed-upon length of time such as term deposits, Treasury bills and Guaranteed Investment Certificates.
Floating Charge
A continuing charge on the assets of the borrower but permitting the borrower to deal freely with the property in the usual course of business until the security holder intervenes to enforce the security or until there has been an event of default.
Futures
Contracts to buy something in the future at a price agreed upon in advance. They first developed in the agriculture commodity markets but often involve foreign exchange, Eurodollar deposits and government bonds.
General Security Agreement
It gives the lender the right to security over a broad range of assets including vehicles, machinery, equipment, receivables and inventory, including after-acquired property, i.e. property acquired after execution of the agreement.
Gross Profit Margin
The difference between the sales your business generates and the costs you pay out for goods.
Holdback
Money retained on a payment until the end of the lien period of a project to protect the owner against any lien.
Income Statement
Also known as the profit & loss statement or P&L, enables you to calculate your company's profits by subtracting total expenses from total revenues. Expenses include such things as the cost of raw materials and labour and other costs incurred in selling your company's products or services. Expenses also include fixed costs such as salaries, rent, electricity, and insurance.
Indemnity
A collateral contract, security or assurance by which one party agrees to indemnify another.
Interest
A charge for the use of money supplied by lender.
Inventory
Stock on hand in the form of goods ready for sale. Also includes raw material in the process of being manufactured or completed for sale.
Letter of Credit
A letter issued by a bank authorizing the person named therein to draw money up to a specified amount from the bank's branches or correspondents, providing the conditions set out in the letter are met.

Line of Credit
An agreement negotiated between a borrower and a lender establishing the maximum amount of money a borrower may draw. The agreement also sets out other conditions, e.g., how and when money is to be repaid. Different from an Operating Loan in that while the total amount is fixed, the borrower can use any portion and pay interest only on what is used.

Long-term liabilities
Money that you owe over a period longer than 12 months, such as mortgages, bank loans and other obligations.

Net Interest Margin
Net interest income (the difference between interest income and interest expense) as a percentage of average total assets.

Net Worth Statement
A summary of your financial position at a particular point in time (on a given date). It is a list of all financial assets and all financial liabilities. Net worth is the dollar amount you have when you subtract everything you OWE from everything you OWN.

Operating Loan
A loan intended for short-term financing, supplying cash flow support or to cover day-to-day operating expenses. Different from a Line of Credit in that it is for a fixed period, fixed amount and payments include both principal and interest.

Personal Guarantee
A personal promise made by an individual on behalf of the borrower to repay the debt if the borrower fails to repay the debt as agreed.

Personal Liability
Responsibility for the payment or performance of an obligation which exposes the personal assets of the responsible person for such payment or performance.

Personal Property
Furniture, equipment, and other moveable property and assets. Buildings and land are not personal property, they are real property.

Personal Property Security Act (PPSA)
The legislation in some Canadian provinces that allows lenders and sellers to register their interest in the personal property pledged by a debtor to secure payment of a debt and to establish a priority position in that collateral.

Prime Rate/Prime Lending Rate
The rate of interest charged on loans by chartered banks to their most creditworthy customers. It is the lowest rate of interest available to borrowers.

Ratio
Comparison of two figures used to evaluate business performance, such as debt/equity ratio and return on investment.

Real Property
Real estate, including land and buildings

Retained Earnings
All the profits or losses that you've accumulated from prior years and from this year's income statement, less dividends paid to you.

Secured Creditor
Those creditors who hold security for a debt, for the duration of the debt.

Short-term Liabilities
Money that you have to pay in less than 12 months, including wages, short-term loans, taxes, credit card balances and long-term loans with less than 12 months remaining on their terms.

Term
Generally represents the period of time over which the loan will be made available at a specified interest rate. Term and amortization are not the same.
Term Loan
A loan intended for medium-term or long-term financing to supply cash to purchase fixed assets such as machinery, land or buildings or to renovate business premises.
Unsecured Creditor
A creditor who does not hold security from the debtor.
Variable Expenses
Costs of doing business that vary with the volume of business, such as advertising costs, manufacturing costs and bad debts.
Venture Capital
Commonly refers to funds that are invested by a third party in a business either as equity or as a form of secondary debt.
Working Capital
The excess of current assets over current liabilities. This is a measure, in dollars, of surplus cash that could be generated in the event all current liability obligations were met, at a given point in time. The larger the surplus, the better positioned the company is to withstand a reduction in business, losses, or to finance additional growth.
Work-in-Progress
Partly finished goods or contracts that are in the process of manufacturing or completion at the end of the accounting period or at any particular time.