

Financing a stumbling block for public projects

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Disruption of the municipal bond market and steep declines in revenue have forced local and state governments to delay construction projects large and small.

The collapsing market for public construction projects is further stressing a beleaguered construction industry. Traditionally, contractors have been able to rely on public projects when private development faltered.

"We've had several projects bid, awarded and ready to start construction, and the owners couldn't sell bonds," says John Muter, vice president of the building division of Tarboro-based Barnhill Contracting Co. "There's been a virtual shutdown over a three-month period."

Public owners are finding a way to move ahead with critical projects, Muter says, but everything else is facing delays. In the past, he adds, public owners tended to continue design work so a project could move forward quickly when financing options improved. Now, even design work is faltering.



Jeffcoat

The municipal bond market is not entirely shut down, says Brent

Jeffcoat, a partner at McGuireWoods who specializes in government finance. But the interest rates are so high that the cost can be prohibitive, he says.

Because of tax advantages, muni bonds from healthy issuers typically

have yields well below those of Treasury bonds. Thirty-year Treasury debt was recently trading at 3.5%, about two percentage points less than the Bond Buyer Municipal Bond Index.

"The (government) revenue picture isn't looking all that good," Jeffcoat says. "You couldn't borrow for a while, and when you could, it was too expensive. You don't want to raise taxes in hard times."

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- Municipal bond yields are well above where they would be in a normal market.
- The sharp drop in tax receipts and rising cost of services are limiting new issues.
- Some municipalities are bypassing the bond market to borrow directly from investors.

The problems took hold about midyear and accelerated through the last half of 2008, he says. "By the end of the year, they just couldn't do anything."

One contributing factor is the eroding capital base of insurers that back issuers with less-than-stellar credit ratings. Without insurance, municipalities are less likely to borrow.

The only logical step for governments has been to wait out the problems.

Muter has seen a few cases in which public owners went directly to banks to finance small projects. The interest rates were more reasonable than what the bond market offered, he says.

Jeffcoat says his law firm has been able to help governments obtain up to \$30 million in bank financing, bypassing the bond market.

Bryan Knupp, senior vice president of Edifice Inc., says his company continues working on several government contracts issued before the bond crisis hit. "We're grateful for those, but they have an end date," he says.



Knupp

Knupp and other construction executives fret about when school projects and other public jobs will be launched. "Every school system we speak to has projects they would like to be moving on this year if they can get funding," he says.

Private development has come to a virtual halt as well, leaving many contractors with little in the pipeline for later this year and next.

"We have a backlog carrying us into 2010," Knupp says. "We're not so concerned about 2009. What's real uncertain is what will take place for us in 2010."

He says Edifice, which normally derives about 40% of its income from public projects, is being careful to maintain good relations with its bonding company. Contractors must be bonded to do public work, so preserving that relationship is critical, he says.

None of this bodes well for contractors banking on some public-sector work to tide them over until private development picks up.

Steve Gennett, president of the Carolinas Associated General Contractors, says companies trying to shift into the public sector will be hard-pressed to compete for bids.

Contractors also incur many upfront costs in trying to qualify for public projects, says Chip Dillman, senior audit manager at the Greer & Walker accounting firm.



Dillman

"If you're not structured to work with government, there's a lot of compliance training and a lot of filling out of forms," he says. "Companies really need to assess whether it's worth the investment."

Observers have a warning for municipalities considering projects. Contractors desperate for work can be tempted to underbid projects. While that may sound beneficial to owners, an unprofitable bid may prompt the winning contractor to request expensive change orders that will boost the project's cost.

The federal stimulus package could provide some hope, says Hank Harris, president of the Raleigh-based construction-management consulting firm FMI Corp. Although much of the money is earmarked for large infrastructure projects, smaller shovel-ready projects also stand to get funding.

"There's certainly going to be enough funding at the local level, and maybe the state level, to benefit some of the smaller, more regional contractors," Harris says.

"Construction prices are down, so there's great incentive for them to find a way to finance projects," Muter says.

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