

Rising construction costs leave properties underinsured

Republished from Austin Business Journal

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May 4, 2007

Commercial property owners are at risk for unexpected losses. Industry experts estimate that most property owners in Central Texas are underinsured, and many are so underinsured against losses that they may face insurer penalties and other issues in the event of a claim.

Austin faces unique challenges related to replacement costs, many of which are due to the region's economic expansion. The demand for materials and labor remains high in the region, making it potentially more expensive to replace existing buildings here compared to other regions of the United States.

Commercial property insurance, much like homeowner's insurance, covers replacement costs of the improvement, not market value or appraisal value, which takes into account the location of a building. Replacement cost reflects the costs of bricks and mortar. With Austin's rising real estate market, building owners may think they're spared by keeping up insurance coverage to align with rising values, but think again.

In the past five years, the cost of building materials nationwide has skyrocketed, and costs continue to climb each year. Experts estimate that as many as 75 percent of owners may not be appropriately increasing the coverage of their insurance policies, leaving them vulnerable to huge coverage gaps.

The lack of coverage could leave policyholders responsible, if a claim is filed, for any amount more than the rising replacement cost, or worse depending on the terms of their policy. Policy clauses often state that the insured is responsible for coverage gaps when a property is underinsured. The gap widens, particularly in a partial loss, leaving property owners to carry a much wider burden of the total replacement cost.

According to RSMeans Construction Cost Index, from January 2006 to January 2007, construction costs rose by 5.6 percent nationwide. That's a

substantial gain, but a drop in growth in comparison to the previous 11-month rise of 7.3 percent. For the region, the costs of construction are likely several percentage points higher.

Steel, concrete and Katrina

China's consumption of steel and concrete, and the flurry of reconstruction left in Hurricane Katrina's wake, have all been blamed for higher construction costs. While construction costs have increased nationally and have been impacted by global trends, those factors don't give the full story.

"There has always been volatility in materials pricing," says Tommy Burt, president of Austin-based general contractor Burt-Watts Industries Inc. "When a large supplier goes down, or demand in an area of the world spikes, it is felt here. In Mississippi, one PVC manufacturer was flooded due to Hurricane Rita. A nearby manufacturer worked to pick up the slack and their facility burned to the ground. As a result, PVC went up in cost substantially. That incident was felt for months."

With 2 million square feet of commercial real estate and 22,000 apartments and condominiums either being planned or under construction in Austin, materials and labor are in high demand regionally. According to Burt, this concentration of activity is making construction material and labor forecasts less predictable.

Typically, general contractors outline cost of materials and labor to a client in an estimate that is expected to remain accurate for 30 days. Due to local market shifts, the 30-day window has shrunk to two weeks.

"Construction in Austin is at higher levels than we've seen in eight years. As a result, availability of key materials and labor is stressed locally," Burt says. "Replacement value for commercial properties has a direct link to local conditions, and Austin is experiencing an incredible spike in construction across all real estate."

Large building owners tend to be more attuned to rising replacement costs and factor these costs into their policies, according to the Consumer Federation of America. Smaller building owners, however, are not as aggressive in evaluating the rise of construction costs. A typical small commercial property owner can easily be 25 percent underinsured in a matter of a few years.

A typical Class A office space built in 2003 in Austin has a replacement cost that is 25 percent to 30 percent higher today than four years ago. Many policies add a penalty for being underinsured by 20 percent or more. In any claim, this could leave owners holding the bag.

To ensure assets are not at risk, building owners should evaluate their current policies if they have not done so in the last 12 months and up the coverage if necessary. Indexes, such as those published by Marshall & Swift, can help building owners understand the rising costs.

Building owners in Central Texas should be diligent about monitoring the amount of coverage they have due to the volume of local construction. The rise of construction costs are anticipated to level off toward the end of 2007, according to Burt, but it can be a volatile landscape with global implications.

The good news is that upping coverage for a building may not be that expensive for property owners. Central Texas is a very desirable location for insurance companies. Many of the leading national property insurers are in expansion mode and want to gain a larger footprint in the regional market; as a result, property coverage options are less expensive than they've been in a decade.

Due to the competition and drive of insurers to ramp up market share, property owners are likely to find they have greater negotiating room on premiums and are able to get more coverage on buildings for less money.

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