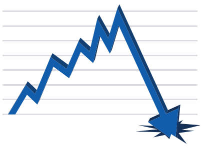
Commercial Property:

Keeping Insurance Valuations True During both Boom and Bust

Introduction



The commercial property market is often described as a hostage to economic fortune and over the last decade values have boomed and busted. But what impact do fluctuating values have from an insurance perspective and how can property owners avoid the potentially crippling scenarios of over and under insurance?

One of the most common and damaging errors when it comes to commercial property insurance is failing to recognise the difference between a property's market value and its reinstatement value.

These two valuations can, and generally do, vary significantly. The reinstatement value includes the demolition and rebuilding costs for a property – the market value represents what the owner might get if they sold it.

Both the demolition and rebuilding aspects of the reinstatement valuation contain numerous individual factors that need to be carefully assessed to come up with an accurate figure.

Depending on the loss suffered and the location of a property, the nature of the demolition work will differ dramatically. A small standalone office block in an out of town business park, for example, will pose fewer logistical problems than a city centre, multi-storey, mid-terrace building. This will impact on the cost of that work and the timeframe in which it can be done.

Older properties may contain hazardous materials such as asbestos and dealing with these appropriately will add significant cost to the work. If a professional reinstatement valuation survey has not been carried out and these issues have not been identified, then it is difficult to have confidence that the correct sums insured are in place.

On the rebuilding side, there are similar variable issues to contend with. Throughout the country there are regional differences for the cost of building materials and labour. Local market conditions will also dictate the availability of these materials and labour. This will determine the time it takes to complete a rebuild project and ultimately affect the price that is paid for it.

The design of a property is a major factor in the cost of its rebuilding. Modern Methods of Construction may create speed and financial savings during the initial construction, but following a loss they can also introduce problems during a rebuild.

Listed buildings also pose potential problems when it comes to rebuilding, given contractors need to employ certain techniques and use particular materials. Additional stakeholders may become involved, for example: English Heritage, which can influence reinstatement times.

Getting an accurate reinstatement value

Although insurance valuers, loss adjusters and chartered surveyors may use generic pricing tables to calculate the reinstatement value of a property on a price-per-square-metre basis, this is not an accurate way of working.

These tables give a price-per-square-metre value for many different categories of buildings, but the values are often represented as a wide spread, such as £1,000 to £3,000. In this example, the valuation based on the lower figure will only be a third of the one based on the top figure and so this approach hardly offers a pinpoint level of accuracy.

These price-per-square-metre values are an average for all of the buildings within a particular category and they do not reflect the individual features and logistical needs of any one specific property.

It is, therefore, essential that brokers look to encourage their property owner clients to engage the services of a professional reinstatement valuer who can assess all of the relevant information pertaining to an individual property and then create an accurate and unique valuation.

At the moment, it is not uncommon for property owners to instruct a valuation derived from generic tables and to find it is either a lot higher or lower than expected. A second valuation is therefore commissioned and its findings are significantly different from the first. The owner then gets a third valuation to try and discover which of the first two is nearest the mark.

This approach does not represent value for money and erodes confidence for all involved that the valuation figure being used for the sums insured is robust and accurate. Instructing a professional reinstatement valuer from the off will avoid these issues.

Regular valuations

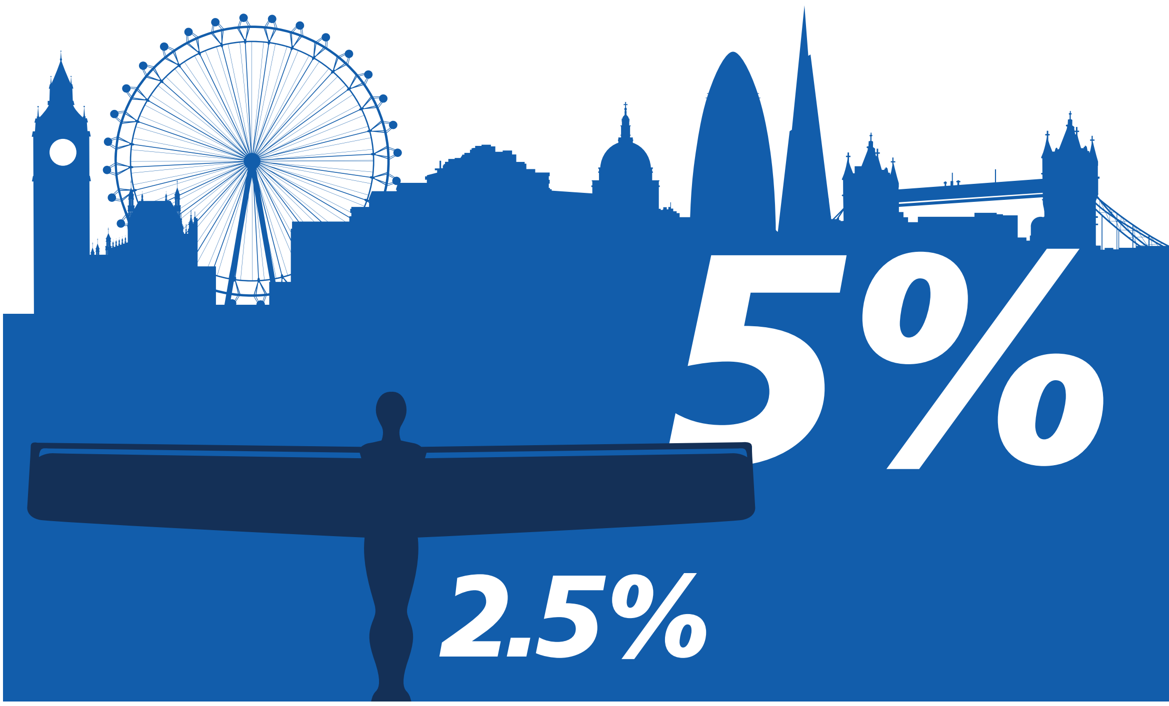
It is also important that such reinstatement valuations are conducted regularly. The temptation may be to do this once and then simply index link the valuation going forward. However, this creates a number of problems.

In the first instance, the rate of inflation can vary at a regional level given the idiosyncrasies of local markets. For example, valuation specialist Gleeds has forecast tender price inflation of 2.5% in the North East, Yorkshire and Humberside region between Q1 2014 and Q1 2015. In Greater London, however, the forecast is 5% for the same period.

Over the course of a number of years, such differences will soon destroy the accuracy of the reinstatement valuation, even if the figure was correct to start with.

In the second instance, there is then the issue of which index to use. There are numerous indices available including the Tender Price Index and the Building Cost Index - there are also separate indices for everything from individual materials to labour costs.

These indices give an estimation of how costs are changing, but they should not be relied on to keep valuations accurate over long periods of time.



Understanding the cost implications of stricter building regulations

While inflation and regional market dynamics have an influence on the speed at which rebuilding costs change, the patchwork of building regulations that apply to construction are also a major driver of costs.

Since the turn of the Millennium, building regulations in the UK have been overhauled and the ongoing changes have significantly increased rebuilding costs.

Sean Durden is a director at Durden Risk Management Ltd and the firm has set up a joint venture with international consultancy Gleeds to provide reinstatement valuations for the insurance sector.

Durden says the baseline requirement for construction in the UK has been pushed higher and higher in the last 15 years and points particularly to wholesale changes in the following five areas:

- Fire protection
- Drainage
- Passage of sound
- Conservation of fuel and power
- Disabled access

He believes the changes that have come into force in these areas since 2000 have added as much as 30% to the rebuilding cost of a property – even if it was only built 20 or 25 years ago.

The baseline standard required in construction will continue to get pushed higher and as it does it will continue to impact on rebuilding costs – that inflationary pressure must be reflected in reinstatement values.

Clauses have been developed for policies to provide cover for increased reinstatement costs on the back of stricter regulatory requirements and these could not only save money for property owners in the event of a claim, but also help them keep their portfolios up to date with market requirements.

The importance of a correct reinstatement valuation

Getting the reinstatement valuation correct is essential for two simple reasons, namely under insurance and over insurance.

Where a building is under insured an insurer may apply average in the event of a loss. This means that if the building is only insured for 60% of its correct reinstatement value, then the insurer will only pay out 60% of the claim – even if the total claim is less than the sum insured.

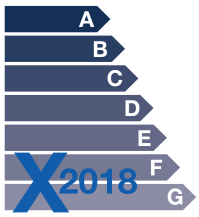
This leaves the property owner with an unwelcome shortfall to make up and devalues the response of the insurance policy at the time when it is most needed.

At the other end of the scale over insurance is the equivalent of throwing money down the drain.

Getting a professionally prepared and accurate reinstatement valuation is therefore fundamental if property owners want to pay a premium that reflects the correct level of cover for the risk that their property actually represents.

Impact of changing legislation on property portfolios

Owners must be mindful of events on the horizon and adapt their portfolio management strategies to cope with forthcoming trends and changes that will have an impact on both the value of their portfolio and the income they can realise from it.

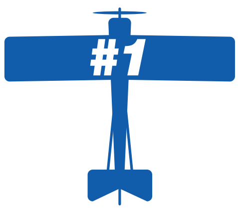


One of the biggest issues to contend with at the moment is the Energy Act 2011. The legislation comes into force in April 2018 and from that date owners may not be able to let commercial property if it has an Energy Performance Certificate rating of 'F' or 'G'. These are the bottom two ratings on the 'A' to 'G' scale and market estimates suggest as much as 20% of commercial property falls into these two categories (McBains Cooper, April 2012).

Market research from consultancy 4See Environmental says that 34% of commercial properties do not even have an EPC and addressing this issue must be the first priority for owners.

Thereafter, they will need to assess portfolios, target their worst performing properties and implement a programme of works that will bring them up to scratch. Where property owners do make changes, they must be mindful that meeting higher standards in thermal and acoustic performance can come at the expense of fire and water resistance. This is potentially a major problem and so the impact of any changes needs to be examined in the round.

Without an awareness or understanding of the Energy Act 2011, property owners are sleepwalking into a potentially expensive problem and the Royal Institution of Chartered Surveyors is already factoring a property's EPC rating into its valuation.



Indeed, hitting the minimum environmental threshold might not be enough if owners want to make the most out of their property. Research conducted by Sustainable Investment and Asset Management LLP found that 57% of tenants – by rent generated – have a publicly declared sustainability policy. They are unlikely, therefore, to renew a lease for a property that only just scrapes through its EPC obligations and will instead be actively looking for those that pass with flying colours.

The better informed property owners are about both the reinstatement value of properties within their portfolio and the issues that will affect their performance going forward, the better they will be able to ensure their insurance programme matches their specific needs.

This is an area where brokers can demonstrate the expertise they have and the value they add. By providing detailed information and advice through both their own internal capabilities and professional links to third parties, brokers can use reinstatement valuations and associated issues to engage with clients more closely and offer them a wider range of services which will benefit the broker, insurer and crucially, the customer.

Key Issues for Brokers to Consider

- The market value and reinstatement value of a commercial property are different
- Calculating an accurate reinstatement value for an individual property requires a professional reinstatement valuer
- Full reinstatement valuations should be carried out at least every three years
- An accurate reinstatement valuation avoids running into under and over insurance problems
- The Energy Act 2011 carries a raft of environmental performance obligations and property owners must comply with them by 2018
- Clauses are available to provide cover to meet increased reinstatement costs driven by more stringent building regulation standards

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