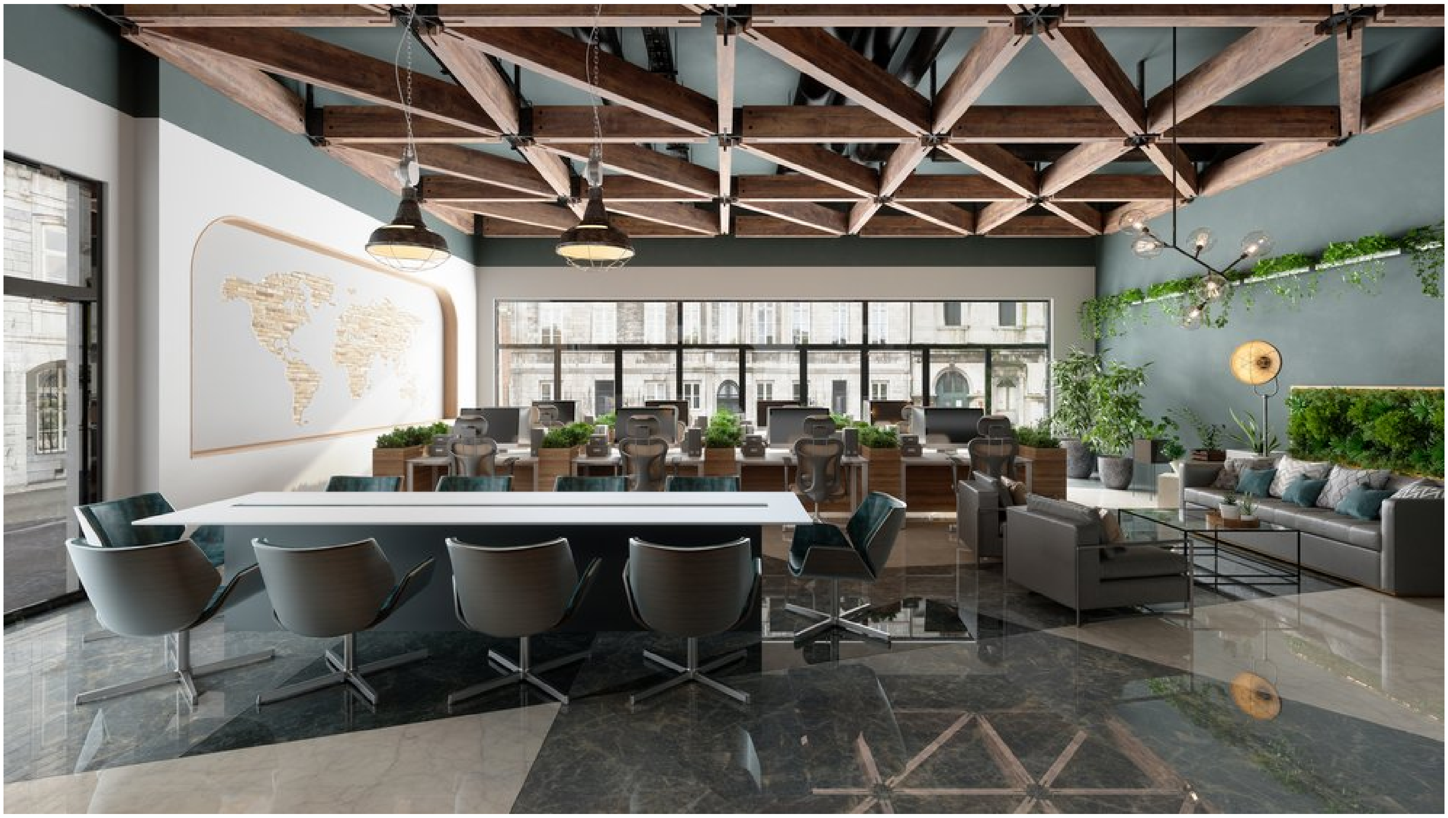
Has Your Commercial Property Insurance Kept Up With Values?



Record-high inflation is pushing up the cost of everything, including property insurance.

Commercial real estate insurance rates are up by at least double digits this year, which insurers largely attribute to higher construction and replacement costs and more frequent disasters. Though the Insurance Information Institute reported replacement cost increases slowed down slightly in the second half of 2022, they were still up 40% compared to 2019.

While replacement costs are up, commercial property prices are down. Multifamily properties fell 10.3% from March 2022 to March 2023 and all commercial property fell an average of 8% during that time, according to the MSCI World Insurance Index.

With commercial property prices falling in market value, you may think the value reported to your property insurer should also decline. However, your property's market value doesn't adequately determine your insurance needs.

Instead of using the resale or market value of a property to insure for property damage, insurers want an appraised value of the cost to rebuild or repair. The insurer often relies on the policyholder to supply an accurate value of the building's property for insurance purposes. If you are using market value instead of reconstruction value, you may find yourself underinsured.

A professional appraiser who specializes in insurance requirements should valuate the property. Values should include the costs of demolition, debris removal, labor and materials. Because of the volatility of these costs, it is wise to recalculate periodically. Your insurance professional can advise you on how often.

And it's not only the structure that needs to be included in your total insurable value. The value of the equipment, materials and products stored in your building needs to be factored in. The cost to replace these and repair the building is affected by inflation and availability. You'll also need to consider the cost of renting a substitute until a replacement becomes available.

What goes into an insurer's evaluation of a structure?

On top of your valuation report, there are some general features insurers of commercial buildings consider:

- Building size
- Construction materials
- Age
- Location
- Use or operations

The construction of the building can determine its survivability in a catastrophe. The more resilient the structure is to fires, floods, earthquakes and windstorms, the better your insurance rate will be.

Your building's interior protections are also important in light of your operations and location. Do you have sprinklers for fire suppression? Do you have controlled access to the premises? Do you use special outbuildings for storage of flammables or potentially incendiary work? Do you use security or water sensors and alarms? Report any upgrades you make to your insurer so they can be reflected in your premium. They may also affect the valuation of the structure you report.

Occupancy, operations and location are other factors insurers consider. A building used to produce fireworks is obviously more at risk than a building used for market research. And a building on a coastline or in a hard-to-access spot may have special risks or complications.

Lastly, the age of the property must be factored in and appropriate terms must be included in your insurance policy.

For example, an older building with a damaged electrical system may require full rewiring to rebuild to code. That would not be covered except under an ordinance or law provision of your property insurance policy. As you can imagine, the original wiring could raise the total insurable value because there would be a higher replacement/reconstruction cost than if modern wiring had been used.

Coinsurance penalties from undervaluing

Most commercial property insurers insist that you insure at least 80% of your property's value, though that number differs across insurers. The uninsured portion, or coinsurance, is what you would pay if there was a total loss of the property. For example, if you experienced an $800,000 loss on a $1 million property, the insurer would pay $800,000.

But that's only if the property was properly valued. If you have a large claim, the insurer will likely have the property appraised. And if your valuation is wrong and you bought insurance for less than 80% of the real total insurable value, you will get hit with a substantial penalty for underinsuring. Worse, coinsurance penalties apply across your entire property policy, including business interruption. That means your losses are not limited to building repairs.

If you have chosen an agreed value policy rather than a replacement cost policy, you might avoid the complexities of coinsurance and volatile valuations. An agreed value policy means you and the insurer have agreed to the value of your property and your insurance reflects that. As with all valuations of commercial property, it's wise to revisit the numbers when you renew your policy.

If you got a deal on a commercial building with high-end finishes that would be expensive to replace, you may find that your total insurable value is elevated. That's even if you don't need the high-end finishes to operate your business.

In such an instance, you might want to ask about functional replacement cost insurance. It will pay to make your building functional again without paying to replace the upscale finishes. You would have to work with your insurance agent or broker, your appraiser and the insurer to make sure your insurance coverage accurately reflects what value exists and what you are willing to sacrifice.

As you can see, inflation, labor markets and supply chains can significantly impact your commercial property insurance. Fortunately, you have options. Working with an agent or broker specializing in commercial property will help you get the right values and appropriate coverage so you are not caught short or penalized at claim time.

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