

CONSTRUCTION WHITEPAPER

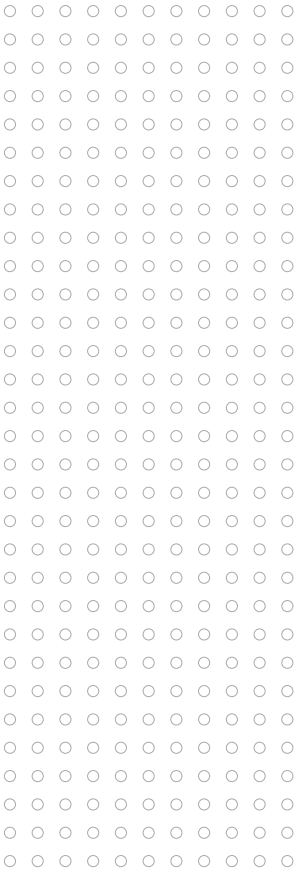
# Inflation's Impact on the Construction Industry

Rising Costs and Supply Chain  
Struggles Squeeze Profits

The 2020s started off with a one-two punch for the U.S. construction industry. Government limits on building activity during the throes of the pandemic administered an initial shock to the industry, while supply chains came to a standstill.

Although projects delayed by COVID restrictions quickly resumed in most major markets, supply chain disruptions and rising inflation quickly elevated construction costs, leaving builds underinsured. With global economies still roiling, the post-pandemic building boom could wane in 2023 as the industry’s bottom line continues to feel the squeeze.<sup>1</sup>

Continued price pressure, coupled with today’s uncertain economic environment, is forcing contractors to pivot during projects and implement strategies to reduce their total cost of risk. Here is what to know.



<sup>1</sup> Construction Drive, “Recession Likely in 2023, Fitch Says,” September 13, 2022.

# The Big Picture

Residential construction is rebounding in the U.S. after months of consecutive decline in 2022. Housing starts rose nearly 10% from January to February 2023. However, that figure remains 18.4% below the number of housing starts in February 2022.<sup>2</sup>

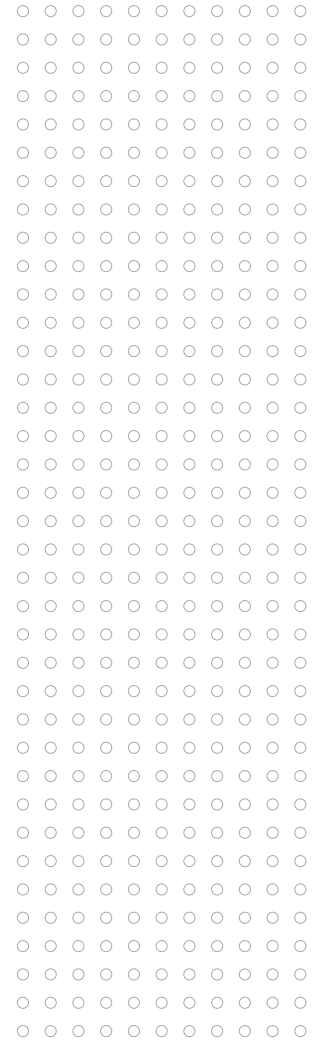
Nonresidential construction spending remains flat, up just 0.4% in February.<sup>3</sup> This modest rise is attributed to the momentum in manufacturing-related builds, which now account for nearly 35% of the year-over-year growth in nonresidential construction spending.

However, investment in public works construction is expected to increase as a result of the Infrastructure Investment and Jobs Act.<sup>4</sup> With potential government contracts for roads, bridges, transit systems, airports, water improvements and energy, experts predict new public works builds to rise by as much as 18% in 2023.

Despite the potential for gains, U.S. economic resilience is under pressure, with the construction sector among those facing the most challenges. Elevated inflation persists, and rising labor and material costs are pushing up project budgets by as much as 20% in many cases. Rapidly rising interest rates over the past 12 months have also dampened growth through the first half of 2023. Acquiring the materials necessary for a build is another problem, with low inventories leading to project delays, extended work timelines and added expenses.

The cost of construction materials remains elevated — up 5% compared with 2022.<sup>5</sup> While the price of lumber has eased, prices for cement, bricks and drywall rose in the first quarter of 2023, and the demand for aluminum, copper and nickel will continue to elevate the cost of electrical work on projects.<sup>6</sup>

The good news is the inflation rate is slowly declining, and the consumer price index has fallen to its lowest rate since May 2021. But with two high-profile regional bank collapses in March, experts predict credit tightening, particularly by small and regional banks, which may make it more difficult for construction firms to close loans.<sup>7</sup>



<sup>2</sup> U.S. Census Bureau, “Monthly New Residential Construction,” accessed March 16, 2023.

<sup>3</sup> ConExpo/ConAgg, “2023-2024 Construction Economic Forecast,” January 6, 2023.

<sup>4</sup> Associated Builders and Contractors, “Nonresidential Construction Spending Continues to Increase in February, Says ABC,” April 3, 2023.

<sup>5</sup> Associated Builders and Contractors, “Construction Materials Prices Rise 1% in January; Up 5% From a Year Ago,” February 15, 2023.

<sup>6</sup> For Construction Pros, “Construction Industry Report Predicts 2023 Materials Pricing,” February 14, 2023.

<sup>7</sup> CNN, “U.S. inflation falls to lowest level since May 2021,” April 12, 2023.



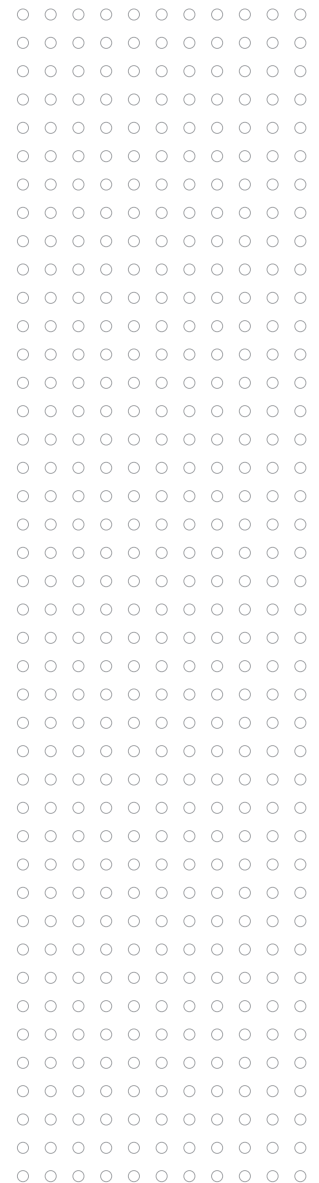
# Rising Costs Leaving Some Projects Underinsured

The construction industry can expect today's challenges to persist, resulting in tighter margins and an upswing in insurance prices, in part due to the record number of extreme weather events in recent years causing catastrophic property losses. Rates for builder's risk insurance rose 30% in the past two years — with few signs of falling back to pre-pandemic levels — and liability insurance for projects has nearly quadrupled during that same time.

For large-scale projects, such as condominium construction in catastrophe-prone areas, the insurance costs — which formerly averaged around 2% of the total project cost — jumped to 8% or more of the cost of the project at the end of 2022.<sup>8</sup>

Today's risk of supply chain interruptions and the potential for project delays has left some construction underwriters wary, which could lead to diminished capacity. In addition, some carriers are more hesitant to shoulder the risk for an entire project. Where one insurer may have underwritten a large frame project five years ago, it now takes multiple carriers to provide the same level of coverage.

Project managers and owners dealing with escalating costs and delays also face an increased risk of being underinsured. Although some are attempting to cover those exposures through insurance, carriers are increasingly reluctant to extend a buffer for the purposes of a claim. Additionally, the 10% escalation clauses that firms previously could count on as a hedge against inflation are less likely to be offered by insurers, especially for higher value projects.



<sup>8</sup> The Wall Street Journal, "Florida Developers Are Holding Off on Big Projects as Insurance Costs Surge," November, 29, 2022.

# Inflation, Availability of Materials Hurting Supply Chain

Inflation is aggravating a supply chain that has been dysfunctional since the pandemic. Supply chain bottlenecks and inventory shortages are affecting every aspect of a build — from steel to shower doors. And everything required to complete a project — from labor to equipment and fuel — is more costly.

For example:



**Manufacturers have largely stopped guaranteeing their prices.**

Whether it's steel, lumber or mass timber, fewer manufacturers are pre-selling materials to capitalize on the rising prices.



**Prices are climbing for crucial build materials.** Metals such as aluminum, copper and nickel continue to rise, and transformer shortages have led to price increases of 20% to 50% for the devices since 2020.<sup>9</sup>



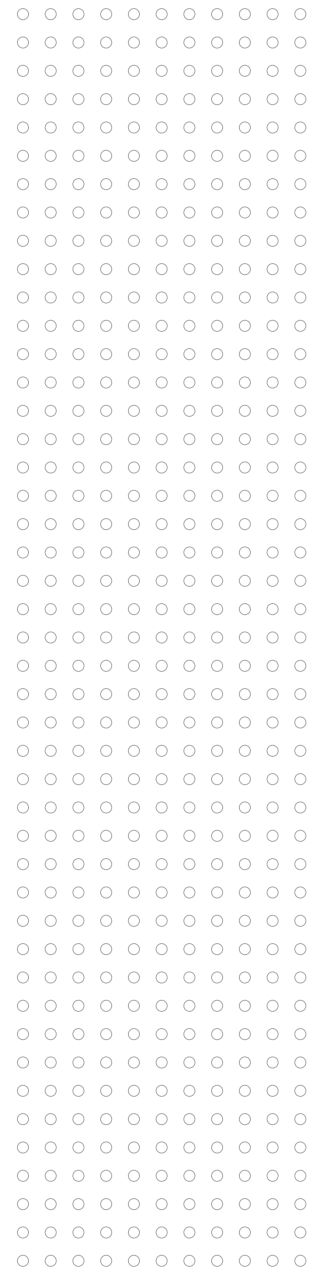
**Labor shortages remain challenging.** The U.S. construction industry is short 650,000 workers to meet current demand.<sup>10</sup> Contractors are paying workers more to attract and retain them.



**Elevated fuel costs to operate equipment persist.** Though construction firms faced a nearly 60% increase in diesel fuel between 2021 and 2022, prices began to dip in December 2022. Prices are expected to continue to decline, but costs remain high.<sup>11</sup>



**Equipment shortages continue to be a problem.** A lack of new construction equipment has forced firms to purchase used equipment for the price of new, leading to disparities in valuations between the purchase price and the insurable value.



<sup>9</sup> Utility Dive, "Utilities sound alarm over distribution transformer shortage as procurement times surpass 1 year and costs triple," December 9, 2022.

<sup>10</sup> Construction Dive, "Construction faces over half-a-million-worker shortage," February 23, 2022.

<sup>11</sup> For Construction Pros.com, "Construction Industry Report Predicts 2023 Materials Pricing," February 14, 2023.

# Pivoting on Projects

Builders are pivoting on projects as they evaluate the barriers in today's economic landscape and weigh those against the project's costs and the potential payout. With the high returns on low-interest rate projects no longer available and growing market uncertainty, fewer investors are willing to tie up their money in longer-play real estate projects.

But these challenges have increased creativity. The supply chain lags and pricing uncertainty for traditional construction materials have upped the interest in prefabricated buildings and even 3D-printed construction.

Similarly, companies building prefabricated concrete structures have never been busier. With timelines less impacted by external forces and a simpler supply chain, the prefabricated building systems market is increasing at a compound annual growth rate (CAGR) of 6% through 2028.<sup>12</sup>

And 3D printing is creating components for buildings, bridges and highways — in some cases saving as much as 70% in construction time and 80% in labor costs.<sup>13</sup>



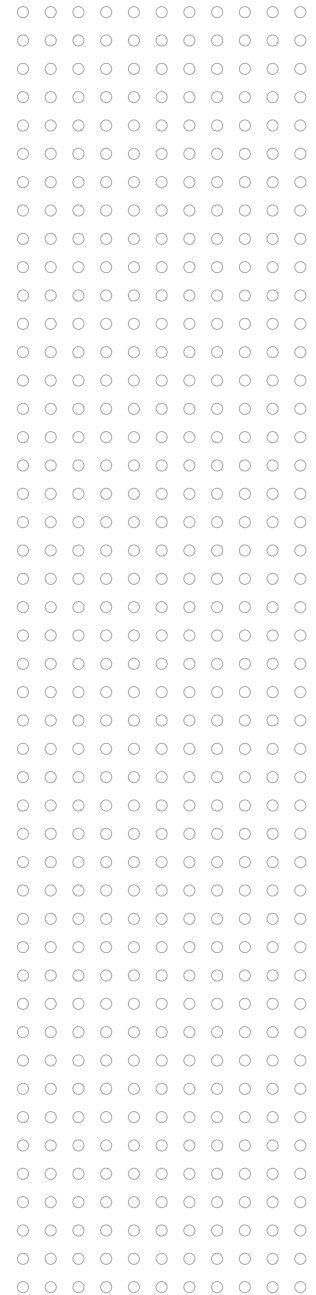
<sup>12</sup> Mordor Intelligence, "Industry Reports on Prefabricated Building System Markets - 2023-2028," January 2023.

<sup>13</sup> Reliable Plant, "Manufacturing in Minutes: The 3D Printing Revolution," accessed April 10, 2023.

# How to Make it Through

There are plenty of building projects on the horizon, even if economic forces make it hard to predict costs and timelines. But contractors can no longer rely on their traditional playbook for managing projects in today's environment. To ensure their companies survive and thrive, contractors should:

- **Make risk management a priority.** Market conditions make it more important than ever for construction firms to position themselves as a best-in-class risk. Developing thorough risk management plans for jobsites and investing in mitigation technology can help. This includes purchasing products designed to prevent common issues, such as treated wood that curtails fire risk and/or alert systems to mitigate water leakage. Their deployment can result in discounts on insurance rates.
- **Show carriers you're a good risk.** Contractors seen as good risks by underwriters will receive the best rates and be in the front of the line for insurance when capacity gets tight.
- **Focus on valuations.** Proper valuations are critical, not just for projects themselves, but also for equipment. Contractors making purchases will need to grapple with rising inflation, supply chain delays and conversion rates. Closely read all contracts and share them with brokers to ensure valuations — and the associated insurance coverages — are accurate.
- **Plan for the future of your workforce.** Consider benefits that are both cost-effective and could help attract and retain workers. While pay is always important, health plans and financial wellness programs can be attractive, particularly for millennial and Generation Z workers.
- **Find a good partner.** Work with a broker who understands your needs and can help you design a risk mitigation strategy that secures the best coverage and reduces your total cost of risk.



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