

Inflation's Impact on Construction in Canada

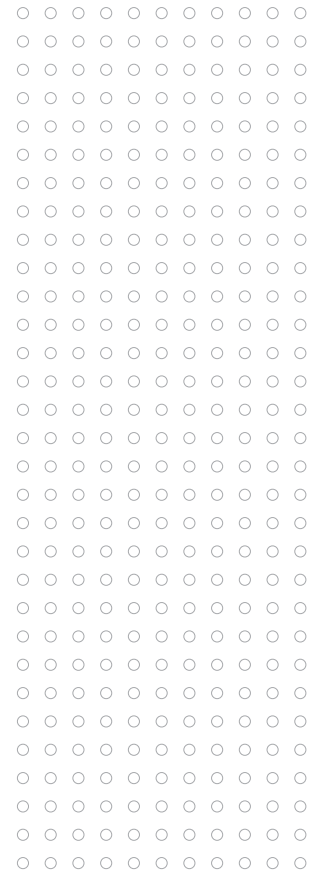
How Rising Costs and Supply Chain
Struggles Threaten the Industry's
Resilience



The 2020s started off with a one-two punch for Canada's construction industry. Government limits on building activity during the throes of the pandemic administered a major blow while supply chains came to a standstill as economies shut down globally.

The impact was widespread: Ontario's construction activity dropped 57% below the pre-pandemic baseline; British Columbia's declined by 41%.¹ Although projects in much of the country ramped back up by the end of 2020, supply chain disruptions and rising inflation quickly elevated construction costs, leaving builds underinsured.

The continuation of those challenges, coupled with today's uncertain economic environment, is forcing contractors to stay on their toes and implement strategies to reduce their total cost of risk. Here is what's important to know.



¹ Daily Commercial News, "Canada's construction sector took a COVID-19 hit then rebounded: survey," November 25, 2020.

The Big Picture

Construction is slowly rebounding in Canada after months of consecutive declines in 2022. Housing starts rose 12% in February, and new home sales increased 2.3% that month.² Investment in commercial construction floundered in the wake of the pandemic, but has steadily grown nearly every month for the past year and a half.³



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Despite these gains, Canada's economic resilience is under pressure, with the construction sector among those facing the most challenges. Elevated inflation continues to raise labour and material prices, increasing project prices by as much as 20% in many cases. Acquiring the materials necessary for a build is another challenge, with low inventories leading to project delays, extended work timelines and added expenses.

Non-residential construction costs alone jumped 12.5% from 2021 to 2022 across Canada's key metropolitan areas, the highest year-over-year increase since 1981.⁴ Although Canada's inflation rate fell to its lowest point in 11 months at the start of 2023,⁵ it's likely to remain at 4.5%.⁶ As a result, the construction industry will see tighter margins and remain under pressure.

² S&P Global, "Economic Research: Economic Outlook Canada Q2: A Dip Is Expected, Though Resilience Persists," March 27, 2023.

³ On-Site, "January a good month for building construction investment," March 15, 2023.

⁴ Storeys, "2022 Non-Residential Construction Saw Highest Cost Increase in More Than 40 Years," February 13, 2023.

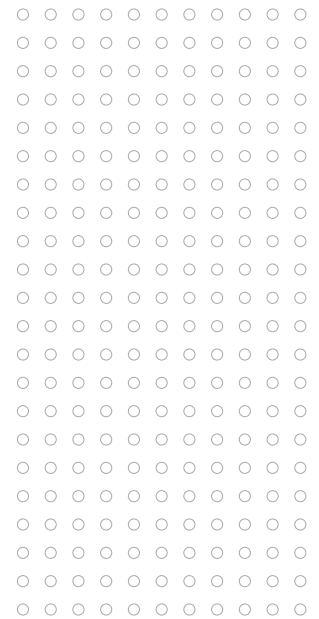
⁵ Trading Economics, "Canada Core Inflation Rate," accessed March 2, 2023.

⁶ Fitch Ratings, "Canada Rate Hikes on Pause, Bigger US Downturn Would Test Resilience," January 31, 2023.



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 also face an increased risk due to escalating inflation and costs and the likelihood of delays. Although some are attempting to cover those exposures through insurance, carriers are increasingly reluctant to cover 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.



Inflation, availability put a big hurt on the supply chain

Inflation is aggravating a supply chain that's 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 labour to equipment to fuel — is more costly.

For example:



Manufacturers have largely stopped guaranteeing their prices, whether it's steel, lumber or mass timber.⁷ Fewer are pre-selling materials to capitalize on the rising prices.



Prices continue to climb for crucial build materials, including metals such as aluminum, copper and nickel and necessary supplies like transformers.



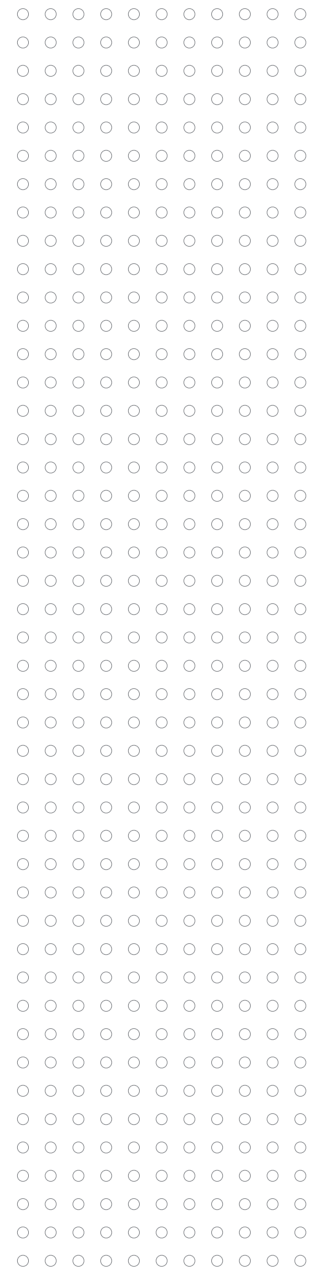
Labour shortages remain challenging. The shortfall of construction tradespeople in Canada is projected to hit 100,000 by 2029.⁸ Contractors are paying workers more to attract and retain them.



Economic uncertainty is leading to unpredictable fuel costs. Although the elevated fuel prices seen in 2022, which produced significant spikes in costs for equipment-heavy projects, have tapered off since the start of 2023, global economic uncertainty could cause another rise in petrol prices.



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.



⁷ ForConstructionPros.com, "Construction Industry Report Predicts 2023 Materials Pricing," February 14, 2023.

⁸ The Globe and Mail, "Canada's construction industry experiences labour pains as shortage of tradespeople grows," November 29, 2022.

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 challenges and pricing uncertainty for traditional construction materials have upped the interest in prefabricated buildings and even 3D-printed construction. One firm printed three residential concrete buildings in Ontario in the past few years and plans to add six to 12 more by 2025.⁹ Similarly, companies building prefabricated concrete structures have never been busier. With timelines less impacted by external forces and a simpler supply chain, the prefabricated home manufacturing industry has grown 5.8% in 2022 and is expected to hit \$2.4 billion by the end of 2023.¹⁰

Builders are also reducing their risk by eschewing single massive construction contracts for smaller projects or "pods." For example, rather than taking on the risk of constructing a 250,000-square-foot strip mall, builders are choosing to take on just one or two buildings, providing the option in the future for continuing to add to the project or stop if funds and materials are not available.

Others are changing their approach to new projects. In the early throes of the pandemic, residential builders unable to build homes for the agreed-upon price were buying out sales agreements to cancel the projects. With a more cautious atmosphere, more contractors are only agreeing to spec builds or cost-plus contracts to restrict their exposure to uncontrollable circumstances.

Provincial governments, too, are also helping contractors weather this storm in the form of payment reform legislation. Ontario, Saskatchewan and Alberta lawmakers passed legislation requiring the prompt payment of contractors for projects. Other provinces are considering similar legislation. Federal payment reform legislation received royal assent in 2019, but it is not yet in force, and the reform changes would not apply to existing contracts.



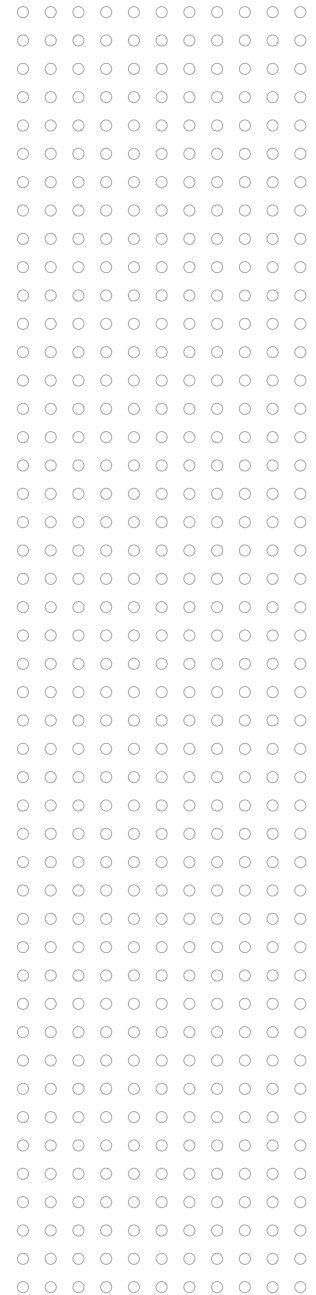
⁹ Daily Commercial News, "Ontario's housing crisis: 3D printed buildings more than a pipe dream," January 26, 2023.

¹⁰ IBIS World, Prefabricated Home Manufacturing in Canada, January 12, 2022.

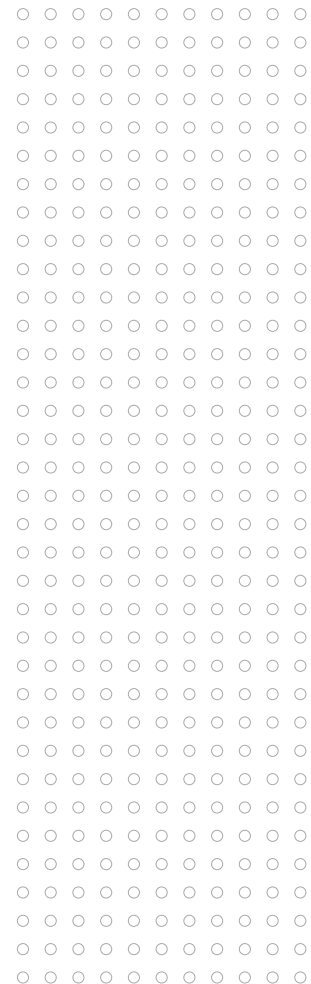
How to Make it Through

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 job sites and investing in mitigation technology can help. This includes products designed to prevent common issues, like treatments available for wood to cut back the risk of fire and systems to mitigate water leakage. Their deployment can result in discounts on insurance rates.
- **Prequalify your subcontractors.** Be sure you thoroughly assess all subcontractors by ensuring they are financially stable, have the capacity to complete the project, maintain a reputation of performing quality work on time and a positive safety and claims record.
- **Consider contractual risk transfer options.** Use contractual tools such as subrogation waivers, indemnification agreements and insurance endorsements to hold subcontractors responsible for their own incidents.
- **Focus on valuations.** Proper valuations are critical, not just for projects themselves, but also for equipment. With most equipment sourced in the U.S., contractors making purchases will need to grapple with not only rising inflation and supply chain delays, but also conversion rates. Closely read all contracts and share them with brokers to ensure valuations — and the associated insurance coverages — are accurate.



- **Take steps to mitigate the impact of inflation.** Be realistic about the additional costs that could be incurred during the bidding process. If possible, purchase materials in advance, and include contingencies in pricing models for materials that must be purchased later on to account for price fluctuations.
- **Don't forget to consider insurance implications of change orders.** If change orders are requested in a build that will increase the costs, don't forget to contact your broker to ensure the project is still adequately insured. Consider adding contract change order endorsements for projects requiring flexibility to make sure the build is covered and to potentially avoid errors and omissions claims.
- **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, well-being plans and financial wellness programs can be attractive, particularly for Millennial and Generation Z workers.
- **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.
- **Find a good partner.** Work with a broker who understands your needs and can help you design a risk mitigation strategy that can help you secure the best coverage and reduce your total cost of risk.



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