

# 2023 LATE YEAR CONSTRUCTION TRENDS



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Construction

The construction industry is still strong. Associated Builders and Contractors (ABC) reports that its Construction Backlog Indicator shows a backlog of 9.0 months as of September 2023.<sup>1</sup> Although this is down slightly, our Trends Update is focused on the challenges and opportunities we predict for the future, many of which are a continuation of past trends. For this issue, we concentrate on:

1. EPLI Claims on the Rise
2. Mass Timber
3. Expanded Risk Management Portfolios—A Focus on Resiliency
4. Continued Labor Shortages and the Impact of AI
5. The Commercial Real Estate (CRE) Market
6. Emerging Payment Concerns

## **TREND 1: EPLI CLAIMS ON THE RISE**

According to industry experts, retaliation and sexual harassment claims, gig worker classification, and the gender pay gap were among the top trending employment practices litigation cases in 2020. The average jury award for an EPLI case is \$250,000; and if a case is settled, the judgment averages \$75,000.<sup>2</sup> Moreover, the average cost of employment-related claims continues to rise, along with the length of time it takes to resolve a claim.

### **Increase in retaliation claims**

The number of EPLI claims has increased recently, with more than half of the EEOC claims in 2020 involving retaliation.<sup>3</sup> This has led to an increase in the number of companies purchasing EPLI coverage. To address this issue, employers should establish a policy against retaliation, educate their teams, implement a confidential process for managing complaints, and document everything.

### **Economic instability and layoffs**

With the evolving economic landscape, many companies are encountering economic instability that may lead to downsizing and layoffs. These layoffs have the potential to trigger a surge in EPLI claims. Employers can consider adopting a voluntary separation program as an alternative to involuntary layoffs, reducing hours worked across the board to distribute the economic impact of cost-cutting measures among all employees and identifying and eliminating any wasteful practices within the organization.<sup>4</sup>

### **Spike in sexual harassment claims as a result of the #MeToo movement**

The spike in sexual harassment claims, including LGBT-based harassment charges, has been steadily increasing. In fact, sexual harassment claims represent 31.7% of all EEOC claims.<sup>5</sup> Employers must be prepared to address these issues promptly. To prevent sexual harassment, employers should develop clear policies, provide training, and create a company culture that does not support harassment.

### **Gig economy leads to increased wage and hour litigation threat**

The rise of short-term contracts and gig workers has led to an increase in wage and hour litigation. Employers should be prepared to prove that their workers are classified correctly, stay updated on the new laws like AB5 in California, and use resources like the FLSA Handy Reference Guide.

### **Equal pay – gender gap remains**

In 2022, women earned 82% of what men earned on average, according to the Pew Research Center.<sup>6</sup> Employers can take action by creating policies that support women, providing mentorship opportunities, and ensuring equal pay.

## **TREND 2: MASS TIMBER CONSTRUCTION AND ASSOCIATED INSURANCE CHALLENGES**

Mass Timber Construction is based on the use of engineered wood products instead of steel and concrete as structural members. The products are generally assembled from individual pieces of kiln-dried lumber that are assembled into single pieces. Examples include Glulam, which are laminated wood pieces where the grain runs in the same direction and Cross-Laminated Timber (CLT), where the grain runs at right angles to each other. Glulam is often used to construct beams and columns, while CLT is used to form sheets to form floors and walls. Mass timber can also be joined with dowels (DLT) or nails (NLT). It should not be confused with traditional light wood framing, where a building may be constructed using 2x4 or similar pieces of individual lumber.

Mass Timber is appealing for a number of reasons. Because it is made from wood, it has a much lower carbon footprint than steel and concrete. Mass timber is also lighter, allowing for lighter building foundations. Additionally, wood is a warmer material, and architects will often leave mass timber structural elements exposed for aesthetic reasons, which reduces the need for other finishes like drywall and paint.

As a relatively new material, however, it is difficult for insurers to evaluate the risk of mass timber when issuing builder's risk and then property insurance policies. As a result, it is often difficult to place insurance on a mass timber structure and that insurance often comes with sticker-shock. To address these issues, it is important to address the most significant risks at the planning stage.

The greatest risk during construction involves water and moisture. Until the mass timber elements are placed and the building is dried in, mass timber elements are subject to damage from water, much of which is just aesthetic. Accordingly, when designing and constructing a mass timber structure, the parties need to consider and plan for:

- How to protect the timbers from water between the times they leave the manufacturer's care until they are placed in the structure.
- Lead times for re-manufacture in the case of damage.
- Temporary measures during construction to protect the timbers from water until the building is dried-in.
- How water will be removed if the timbers are exposed prior to dry-in.

Another big exposure involves the risk of fire. Many insurers assume that mass timber will burn in the same way that light wood framing burns, but that is not the case because the timbers are assembled in larger pieces using fire-resistant glues. Indeed, some evidence shows that mass timber can actually perform better in a fire scenario than steel, as steel can become plastic within an hour, but exterior charring on the mass timber does not materially affect its structural capacity.<sup>7</sup>

It is also important to engineer the building to prevent the spread of fire both during and after construction. When evaluating a risk, insurers will often look at the Estimated Maximum Loss (EML) that may occur in the event of a specific risk. In a typical high-rise fire with non-combustible concrete decking, the insurer may assume that a fire on one floor will result in a complete loss of that floor, smoke damage on the next floor or two, and water damage to the floor below, resulting in an EML of 4 floors. With mass timber, CLT floors may be considered combustible so that fire can spread to upper floors, leading to a greater EML. To reduce the premiums, it will be essential to explain how fire will be prevented from spreading to the upper floors. After the building is turned over, sprinklers may address this concern, but contractors and engineers should also consider how fire will be stopped before the fire protection system becomes active.

### **TREND 3: EXPANDED RISK MANAGER PORTFOLIOS—A FOCUS ON RESILIENCY**

Traditional risk managers focused on risk financing—i.e., procuring different kinds of insurance to cover foreseeable risks, such as accidental injury. Because more accidents and claims led to higher premiums, risk management grew to increase emphasis on safety and accident prevention. Risk managers are now expanding their portfolios to assess institutional resiliency. This often begins with a failure analysis—exploring different scenarios of what can go wrong and then adjusting processes to reduce the potential for failure, which is similar to a safety analysis but focused on other business risks.

The need for expanded risk management portfolios was demonstrated by a recent QBE study, which found that fewer than half of mid-sized companies had risk mitigation plans in place for some of their most concerning, but uninsurable risks.<sup>8</sup> These include financial risks, such as operational performance and liquidity concerns, as well as talent recruitment and retention, and macro-economic and regulatory risks. In many cases, these non-insurable risks can be addressed with resources from the traditional risk management role. For example, by using a captive insurer to make a loan to the parent to assist with temporary cash flow shortages.<sup>9</sup>

Another important aspect of resiliency involves cybersecurity. A recent survey showed that 90% of respondents were confident they had implemented best cyber practices, but 50% of the respondents did not have an incident response plan and 25% had not even undertaken basic cyber-security protocols, such as firewall/virus protection and data backup.<sup>10</sup> This is shocking when one considers the risk of inadequate cybersecurity.

### **TREND 4: CONTINUED LABOR SHORTAGES AND THE IMPACT OF AI**

#### **Craft Labor Shortages**

Labor shortages continue to plague the industry and drive up labor costs. On October 6, the Bureau of Labor Statistics showed strength in residential, heavy, and civil engineering hiring. Although there was a loss in nonresidential construction jobs, overall construction unemployment dropped to 3.8%, while wages rose 5.5%, year-over-year (YOY).<sup>11</sup> Despite rising hourly pay, many jobs are going unfilled.

We have previously reported on innovative attempts to address the labor shortage by using innovative materials and techniques such as 3D concrete printing and robotics. These efforts continue and one company has developed a fiber-reinforced material that can be molded into blocks and assembled.<sup>12</sup> The manufacturer claims this can reduce the need for heavy cutting and skilled welding and masonry work. Indeed, it states it assembled a 3-story building with a crew of only 11 workers with varying skill levels.

We are also seeing an emerging trend where large contractors are developing their own factories to prefabricate assemblies' offsite. Self-prefabrication is just in its infancy but could radically change the industry by not just reducing the need for skilled labor, but also reducing demand for subcontracted work.

We expect to see further emphasis on technologies that will reduce the need for production labor, but expect long lead periods between the development of those technologies and widespread adoption. This is driven in part by the need for local code officials to consider novel techniques and materials. For example, in the case of 3D Concrete Printing (3DCP), existing code requirements for concrete did not apply directly to 3DCP.<sup>13</sup> To address this issue, the International Code Commission adopted Appendix AW, allowing code officials to approve 3DCP, but only after an independent review by an organization that would create an individualized specification for that work.

### **Design Labor Shortages**

While craft labor shortages have gotten the most attention, there are also challenges on the design side. There are too few designers for the available work, and this shortage is causing some design firms to turn down work.

One solution to this problem is Generative Artificial Intelligence (AI), which uses algorithms to create and then test hundreds or thousands of alternative designs against metrics identified by the architect. Indeed, it's estimated that AI will eliminate about 37% of A&E tasks.<sup>14</sup>

While we predict long lead times before changes in materials will impact the need for field labor, we believe AI will quickly impact the design world. This is for two reasons. First, there are almost no regulatory barriers, as permitting officials do not care how a designer creates the design. Second, adoption of a new material like 3DCP requires infrastructure to build printers and factories for the printed material, but AI infrastructure is already in place.

Firms using AI to generate new designs, however, will need to think long and hard about new ways to develop talent. Traditionally, newly minted architects and engineers trained on the job by doing many of the same tasks that we expect AI to perform. As design professionals learned from that experience, they gained the skills needed to develop design parameters and oversee the work of the next generation. If AI performs tasks once assigned to junior professionals, how will those junior professionals develop the skills needed to oversee the AI?

## **TREND 5: THE COMMERCIAL REAL ESTATE (CRE) MARKET**

CRE continues to be a concern with high office vacancy rates across the U.S. In Q2 2023, Atlanta, Dallas, New York, San Francisco, and Washington, DC, all had vacancy rates of more than 20%.<sup>15</sup> This is leading to lower rents and fewer starts, but at least one broker expects a shortage of premium space to emerge in 2025, at which point we can expect to see an uptick in office renovations. There is some strength in select retail markets, and while growth is moderating in the logistics CRE market, it is still strong. Hospitality is also very strong, with the key industry metric of Revenue per Available Room (RevPA) actually 10% higher than in 2019.<sup>16</sup>

A weak rental market has led to decreased CRE valuations, with an average YOY rate decrease of 8% in the first quarter. However, there have been slight increases in the industrial (+3.3%) and hotel (+4.4%) markets.<sup>17</sup> At the start of 2023, the total sales of office buildings declined to the lowest rate since the 2008 financial crises, with the weakest sales in Central Business Districts (CBD).

CRE loan rates generally follow the 10-year Treasury Bond, and the difference or "spread" between 10-year Treasuries and Commercial loans provides a measure of the additional risks perceived in CRE loans. In the second quarter of 2023, those spreads had widened by 40 basis points.

Increased debt costs, together with increased property insurance premiums, are pressuring many developers. One way for a property owner to conserve cash is to finance the project with interest-only or partial-interest-only loans. At the end of Q2 2023, property owners were financing their properties with a record number of such loans. Indeed, the percentage of "interest-only" loans jumped from 22% to 34.1% from Q2 2020 to 2023.<sup>18</sup>

Despite these glum figures, there are bright spots for developers and contractors—notably in the industrial and hotel markets, where prices are still rising. One important factor to consider is the demographics of today’s market. In 2005, seniors accounted for less than 14% of consumer spending, but that number rose to 22% in 2022. The Fed has calculated that baby boomers have accumulated \$77.1 trillion in wealth, and they are living a much more active lifestyle than previous generations.<sup>19</sup> If retirement can be divided into three stages: go-go, slow-go, and no-go, then sectors catering to seniors in any of those stages should continue to prosper despite other CRE headwinds, like increased interest rates.

## **TREND 6: EMERGING PAYMENT CONCERNS**

For well over a year now, there has been a persistent fear that the US economy will enter a recession, and recent projections are for the recession to hit in the next 6 months.<sup>20</sup> The Fed’s tightening cycle is driving this fear, as it usually takes about a year to produce an economic downturn. While the recession has yet to hit, we are seeing anecdotal evidence of delayed payments on many projects. These include PPP infrastructure projects and general building construction.

Most construction contracts require the owner to provide evidence that it has adequate financing to complete the project, and form contracts like the AIA A201 allow the Contractor to request further assurances under certain circumstances. If the owner cannot produce those assurances, the contractor can suspend or even terminate the contract. Contractors availing themselves of those rights should rarely find themselves in a position where the owner cannot timely pay and they cannot timely pay their subcontractors. During the financial crisis of 2008, however, we learned that was not always the case because the banks could (or were forced to) pull project financing.

While causes for slow payments will vary by project, anecdotal evidence indicates that banks are not only tightening lending standards for new loans but also tightening loan administration. More often, banks are holding draws if borrowers do not strictly adhere to loan covenants and are reluctant to increase loan amounts or extend deadlines. Instead, if a project is delayed or experiences cost overruns, they are looking for developers to inject more capital into the projects, which is slowing down payment.

Accordingly, contractors should be asking not just for evidence of adequate financing for the current contract sum, but also for some amount over the current contract sum to cover delays and other project costs the owner must incur outside the construction contract to achieve an economically viable project, such as FF&E.

In light of these concerns, we would like to re-emphasize our comments elsewhere regarding consent agreements, in which lenders obtain consent from contractors and designers to an assignment of their contracts to the lenders. These agreements often contain terms modifying the underlying design and construction contracts if the lender takes over. In one such agreement we recently saw, the lender asked a contractor who had no design responsibilities to:

- Assign rights to the plans and specifications that it did not have.
- Reduce the contractor’s termination rights so that it could become bound to the lender even though it had terminated the underlying contract.
- Subordinate its lien rights to the bank.
- Provide notices to the lender that it would likely fail to give as the consent agreement was outside the contract.

Having just negotiated the construction contract, these terms forced the contractor into a second round of negotiations with the bank. To provide some leverage, contractors should always insist on contract terms, providing that they will not be required to enter into consent agreements that increase their risk or reduce their rights.

## **CONCLUSION**

The industry continues to evolve and it faces many risks over the coming years, but many of those risks come with new opportunities. Rising insurance rates signal a need for design and construction to address losses before they occur. Labor shortages are providing incentives for labor-saving innovation, and changes in the CRE market provide areas of growth. To prosper in this changing world, industry participants must proactively identify and address the risks they face.



<sup>1</sup> "ABC's September Construction Backlog Indicator Dips," [contractormag.com](https://contractormag.com), 10 Oct 2023.

<sup>2</sup> "EPL Insurance: Risks and Exposures Scenarios," [the Hartford](https://www.hartford.com), accessed 1 Nov 2023.

<sup>3</sup> "EEOC Releases Fiscal Year 2020 Enforcement and Litigation Data," [US EEOC](https://www.eeoc.gov), 26 Feb 2021.

<sup>4</sup> Mitchell, Jonathan. "EPL Insurance Pricing Trends 2023," [Founder Shield](https://www.foundershield.com), 21 Sep 2023.

<sup>5</sup> "Employment Practices Liability (EPL) Claims: Trends, Stats & Examples," [AmtrustFinancial](https://www.amtrustfinancial.com), accessed 1 Nov 2023.

<sup>6</sup> Aragão, Carolina. "Gender Pay Gap in U.S. Hasn't Changed Much in Two Decades." [Pew Research Center](https://www.pewresearch.org), 1 Mar 2023.

<sup>7</sup> Agnew, David. "Mass Timber's Resilience Makes It an Increasingly Popular Choice – but Are Insurers Pricing Its Risks Accurately?," [Risk & Insurance](https://www.riskandinsurance.com), 28 Sep 2023.

<sup>8</sup> Prah, Lucas. "QBE RP October 2023," [Business Insurance](https://www.businessinsurance.com), accessed 1 Nov 2023.

<sup>9</sup> Souter, Gavin. "Risk managers to move beyond ERM toward resilience," [Business Insurance](https://www.businessinsurance.com), 15 Sep 2023.

<sup>10</sup> "Data spotlight: Cyber preparedness," [Business Insurance](https://www.businessinsurance.com), 2 Oct 2023.

<sup>11</sup> Ichniowski, Tom. "Residential Sector Propels Construction Jobs to Sixth Straight Monthly Gain," [Engineering NewsRecord RSS](https://www.enr.com), 6 Oct 2023.

<sup>12</sup> Yoders, Jeff and Scott Judy. "Real-Life LEGO Set: Putting Together a New Way of Building," [Engineering NewsRecord RSS](https://www.enr.com), 11 Sep 2023.

<sup>13</sup> Ramage, Matt. "The Most Impressive 3D Printed Structures in the World," [Constructible](https://www.constructible.com), 15 Aug 2021.

<sup>14</sup> Kiderlin, Sophie. "Goldman Sachs says generative A.I. could impact 300 million jobs – here's which ones," [CNBC](https://www.cnbc.com), 28 Mar 2023.

<sup>15</sup> "Global Real Estate Perspective August 2023," [JLL](https://www.jll.com), Aug 2023.

<sup>16</sup> "Subdued activity as occupiers maintain caution," [JLL](https://www.jll.com), Aug 2023.

<sup>17</sup> Hota, Rajeev and Bhuwan Joshi. "Commercial real estate lending trends in 2023," [Acuity Knowledge Partners](https://www.acuityknowledge.com), 26 Jul 2023.

<sup>18</sup> "Commercial Mortgage Lending Continues to Slow," [CBRE](https://www.cbre.com), accessed 1 Nov 2023. PDF download.

<sup>19</sup> Guilford, Gwynn. "The U.S. Economy's Secret Weapon: Seniors With Money to Spend," [The Wall Street Journal](https://www.wsj.com), 8 Oct 2023.

<sup>20</sup> Conerly, Bill. "The Recession Will Begin Late 2023 Or Early 2024," [Forbes](https://www.forbes.com), 2 Nov 2022.