Building Repair Costs Review

Quarterly Update – Q1 2021

The review

Each quarter, Sedgwick Repair Solutions quantity surveying team reviews the building and construction industry market to gain an understanding of the primary drivers of cost, and make sure that our rates remain competitive.

This quarterly report provides an overview on the current situation and looks at the issues that could potentially impact on insurers' building repairs costs over the months ahead.

In earlier reports we've highlighted the impact of the COVID-19 pandemic on insurance repair costs and we forecast increases of 7%. Since our Q4 2020 report the construction industry has seen significant material and labour cost increases which are placing pressures on contractors working in the insurance repair sector where often projects are valued using pre-agreed rates.

Although the vaccination roll out has been a great success and we are seeing COVID restrictions being lifted, the way ahead for contractors still remains uncertain and challenging for insurance repair work.

Headlines

- In Q1 2021 we recorded an increase in costs of 5.0% This follows an original provisional figure of 5.5%.
- We previously forecast costs may increase by up to 7% over the course of 2021. We are hopeful that increases over the next 6 months will confirm that this forecast won't need to be changed
- The growing problem of material cost increases and shortages confirms that the pricing level of fixed schedules of rates will need to be looked at
- We think material and labour costs will start to fall after a further 12-month period allowing rates to be reduced
- There are problems sourcing materials and as the problem worsens, the type of reinstatement of damaged buildings might need to be reviewed depending on which materials are available
- There continues to be shortages of labour.

Part 1 – building cost inflation

To track the impact on insurance repair work within the building industry, we use a bespoke index that focuses specifically on this market sector. Known as the Insurance Repair Specific Index (IRSI), it monitors the four main cost components that are typically found in insurance repairs: **labour, plant, materials and waste disposal**.

The latest IRSI review shows that input costs increased during Q1 2021 by 5.04%. Construction material costs have risen during the first quarter and continue to rise in Q2 due to a variety of factors affecting the supply chain:

- **Reduced manufacturing capacity**
  Some factories have been unable to operate to their full extent due to COVID and other working restrictions. These problems are exacerbated because of the global nature of the supply chain. For example, Scandinavian timber mills will be shutting down for summer maintenance when timber stocks are at the lowest for 20 years causing the Timber Trade Federation to predict shortages in Q3.

- **Shipping difficulties**
  There is a shortage of shipping containers for use in moving goods from the point of manufacture to customers at major ports. As a COVID precaution, some ports are quarantining containers which, coupled with the delays caused by the blockage of the Suez Canal, has compounded the issue.

- **Insufficient HGV drivers**
  The Road Haulage Association reports a shortage of 60,000 drivers which is hampering the transfer of construction materials from ports to local merchants.

- **Increased demand**
  Construction orders and activity are at a high level. The private housing market output is up 4% in the first quarter as housebuilders push forward to meet the governments target of 300,000 units per annum. COVID restrictions have left many homeowners with funds to complete home improvements fuelling high demand for local small to medium contractors. Large infrastructure projects and commercial works such as HS2, Crossrail and Hinkley Point are also requiring large quantities of materials diminishing available supply.

- **Brexit**
  60% of imported construction materials used in the UK are imported from the EU. Changes to the way products are brought into the UK have led to delays, resulting in shortages and price increases.

Merchants are notifying of price increases regularly and in advance, for example contractors are being notified now of increases which will take place in August and September.

There are also significant supply issues on materials, with some being rationed. For example, a network contractor ordering certain roof tiles in June has been quoted a delivery date in March 2022. Roofing materials in the UK have been particularly affected as demand in China and the US has absorbed stock. We are seeing contractors in the UK affected by global issues which are beyond local control.

Contractors are now also encountering difficulties in retaining tradesmen as costs increase due to demand caused by:

- **Sector competition**
  Contractors working primarily in insurance repair are finding that operatives, both directly employed and subcontractors, are being attracted by higher wage offers from housebuilders and commercial contractors. For example, bricklayers are being offered £1200 per week, decorators £1000, typically £200- £400 more than average network contractor pays.

- **Labour shortages**
  As of 30 April the government confirmed 166,600 construction roles were still being supported by the Coronavirus Job Retention Scheme. This is against the backdrop of an already known skills shortage driven by a lack of training of sufficient new tradesmen over many years.

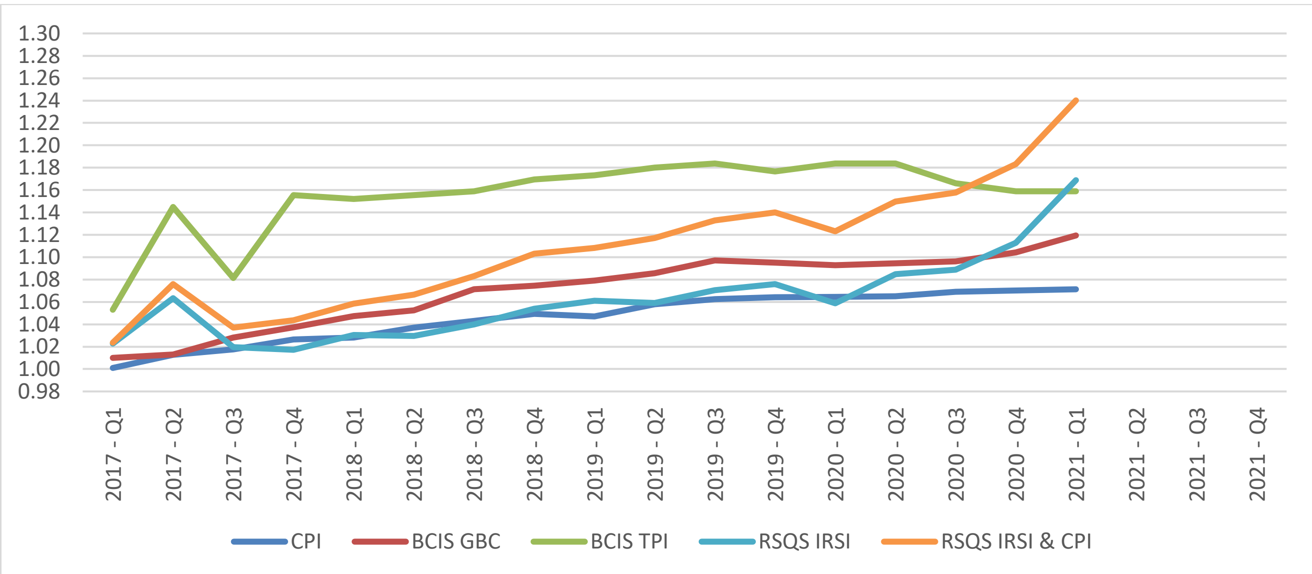
- **Foreign labour reduction**
  Following Brexit, the UK has lost a quarter of EU construction workers previously employed on projects.

In Q1 we've recorded the following changes to input costs

- **Materials** costs up by 1.82%
- **Labour** costs down by -0.01%
- **Plant costs** up by 0.16%
- **Waste** costs up by 0.07%
- **Special costs** – COVID-19 additional working costs are assessed at 3% above standard costs

The table below shows how the IRSI compares to the other key indices being the Building Cost Information Service General Building Cost Indices (BCIS GBC) produced by RICS, the Consumer Price Index (CPI), and the BCIS Tender Price Index. All indices show a continuation of an upward trend in cost.

Table 1 - Inflation increases 2017 Q1 – 2021 Q1



Due to the exceptional circumstances contractors now face we've developed a specific material cost tracker which reviews the most frequently used insurance repair items costs and focuses on how these costs are changing. We benchmarked values at the cost level of materials recorded at the start of the year and this is being refreshed fortnightly. We've combined this with the PAFI index. This shows an increase in cost of the most frequently occurring items of 4.29% but excludes uplift costs for COVID working. As a result, we're adjusting rates to ensure contractors can continue to purchase materials and complete repairs. We anticipate that costs will however fall back to 2020 levels when supply levels return to normal.

Agriculture & Rural Network insight

From a claims and underwriting perspective, we have encountered some further challenges as a result of materials shortages and supply delays in this sector. It's become common for contractors to only hold quotations for 7 days, rather than a more normal 30 to 60 days and even then, most caveat that they are subject to change.

At a recent trade show, farm building suppliers advised that agricultural buildings that were £18,500 to reinstate a year ago, are now £27,000, and another example is an increase from £110,000 a year ago, to £150,000 today. They are expecting the market to equalise over the next 6 to 12 months but there are no guarantees. These substantial increases in rebuild costs are beyond any normal index linking and declaration linked cover, and insurers and their brokers will need to consider their position in the event of a claim and any unforeseen underinsurance challenges This is also aligned to delays of up to 6 months for specialist agriculture plant and machinery from the continent, warranting an urgent review of business interruption maximum indemnity periods.

Part 2 – rates benchmarking

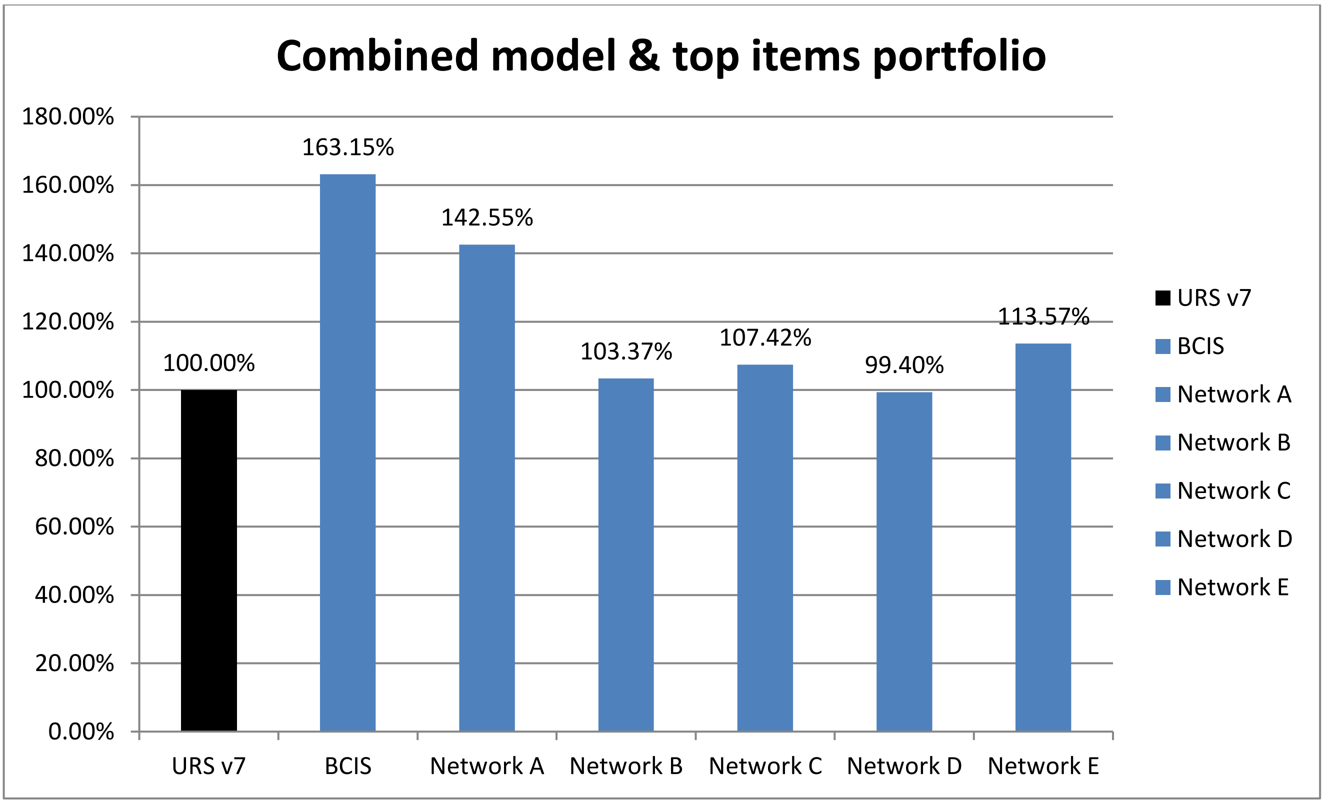
To ensure that Sedgwick Repair Solutions repair costs are competitive, our quantity surveying (QS) team undertake a quarterly review of our managed contractor network repair rates – known as the URS.

The URS is compared with published rates and those used by other networks in the insurance repair market. This benchmarking exercise combines:

- A cost review of 25 of the most frequently used repair rates
- A review of the output costs of repairs on typical £5k and £25k escape of water claims

The results of this review are shown in table 2 below – it shows that the URS remains competitive. We've included in the URS the adjustment of +4.29% to reflect an increase to deal with the rising material and labour costs. For comparison purposes, URS is shown as 100% with other networks shown as a percentage cost compared to the URS.

Table 2 – Benchmarking



Part 3 – dynamic pricing

Sedgwick Repair Solutions quantity surveying team also carry out a specific benchmarking exercise to compare the URS with wider market tenders. This provides a good indication of the competitive nature of URS against tendered repair jobs, which are typically at the higher value end (greater than £50k).

The annual portfolio review involves applying URS rates and rules, and comparing the results with tenders received from panel contractors, or the customer's preferred building firm.

The analysis benchmarks the Sedgwick Repair Solutions QS figure against:
a) The lowest cost tender
b) An average of the lowest two tenders
c) An average of all four tenders (lowest quartile). This gives an indication of market pricing of repairs by indicating the spread of tenders presented

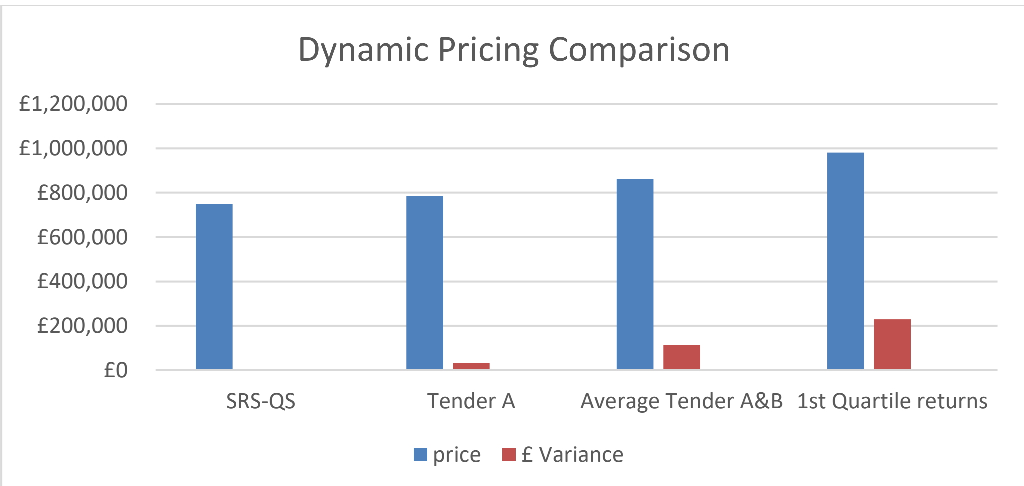
The most recent analysis (as shown in table 3 and 4 below) is as follows:

Table 3 - Dynamic pricing cost savings

	Sedgwick - QS	Return A	Average return A&B	1st Quartile returns (A B C D)
Price	£750,527	£784,064	£862,788	£980,434.58
£ Variance		£33,537	£112,261	£229,907.35
% Variance		4.47%	14.96%	30.63%

This quarter's results indicate the market increasing pricing as contractors ensure that rising and unforeseen costs are recovered. The exercise demonstrates that compared to free market tenders the URS is competitive, generating a saving of c.5% compared to the lowest cost tender.

Table 4 - Dynamic pricing comparisons



Part 4 – What may follow in 2021

We expect the current material and labour supply difficulties to continue for at least 12 months whilst manufacturers recover their capacity and the distribution problems are resolved. Until then, supply and demand will cause prices to rise. The government is so aware of this that in response to a written question about the specific difficulties small housebuilders face, the Housing Minister, Christopher Pincher, said "If material shortages become an ongoing and material obstacle to growth it will be factored into our plans to support the sectors." It's recognised that construction needs help.

In circumstances when the building industry is experiencing rapidly rising input costs, mechanisms need to be in place to give contractors the ability to continue to work with confidence. For example, when securing work via tender on a major project, which will be completed over several years, it's usual for the use of a rate adjustment mechanism to be explained during the tender period. This avoids contractors including large contingencies or inflating prices as a precaution to an unrealistic level. Our dynamic pricing suggests tenders are being inflated and probably for that reason.

Whilst insurance repair projects are rarely completed over a period of years, similar problems do arise when work is valued on a fixed schedule of rates which might be expected to be operational at a set level for many months or years. The circumstances being experienced in the construction economy now are such that regular tracking of rates and adjustments need to be considered as without this, contractors may be forced to decline work. We've mentioned above the tracking mechanism we have in place. We've invested in our IT system to make this possible.

Whilst prices are the utmost concern, the availability of materials is also worrying. It's possible that as shortages continue circumstances may arise where it's not possible to complete a repair without changing the existing finishes or specifications. An example might be a major house fire. Whilst repairs could be completed to enable re-occupation, a temporary kitchen might have to be installed, or an alternate roof covering used, whilst delivery of the required like for like materials are sourced.

Finally, the current situation highlights the problem which has been previously noted of a growing skills shortage. Resolving that needs a UK wide solution involving all stakeholders.

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